Financial Management for Managers
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Lecture 05
Fundamentals of Financial Management Part V

Welcome all, so in the process of learning about the Fundamentals of Financial Management, in the previous class we discussed about that what is the Principle of Finance, that whatever the investment, we make in any kind of the business in or in any kind of the business organizations in any kind of the business firms.

The return from that business should be more than the initial cash we have invested. There is ultimate purpose because reward for that investment where we means invest the funds of our surplus funds and we take the risk of moving in to the business. So, the reward has to be certainly more than what we have invested in the beginning.

So, I told you in the previous class, that in the form of investors, that weather it is a shareholder or as a lender whatever the investment people make in the businesses is or whatever the cash, they provide to the business that is the, say invest in the business forms, the ultimate return has to be more than that.

If the return is more than that for example, we are investing 100 rupees and the return at the end of the year or end of the period is 150 rupees then certainly we are generating some value. Otherwise there is no purpose moving into the business and here one important point we born in mind is that, what return we should be satisfied with? Should we satisfied with the cost of the capital? Then what is my cost of the capital? Or something more or something less than that.

Because say I have, two options available with me, one option is that I have got 100 rupees and I can go to the bank deposit that 100 rupees in the bank and at the end of the year, I will be given, if it is a saving bank account 3.5 percent rate of interest and if it is a fix deposits, I will get somewhere around 6 percent rate of interest and that is sure.

I am not taking any kind of risk, I am not involved into any kind of the uncertainty and I am sure that I am giving my money to the bank and that 100 rupees are going to be 103 rupees 50 paisa, if it is deposited in the saving bank account and 100 and 6 rupees, if it is deposited into the fixed deposits account. So, it means 0 risks and assured appreciation.

But, if I am moving into the business, I am not satisfied with that 103 rupees or 106 rupees. I want 150 rupees, it means I am not giving my money to the bank and I am not risk averse. When you move to the bank risk averse. So, when you are not risk averse, you are risk pro or you are risk neutral.

In that case, we want higher rate of return of return on our investment whether I am a share holder in the business or I am the lender in the business. I want the higher rate of return and for that higher rate of return, what I had to do is, I am moving into the business. I can do it in two ways directly moving into the business or indirectly moving into the business.

If I directly moving into the business, I become entrepreneur, I start the business, I establish the business or I become the part of the business which is going to be established. So, I become the part of the initial promoter stream. But, if I want to move to the business indirectly.

Then I can subscribe to the shares of the companies, which are trading in the secondary market or the stock market, I can buy the shares in the stock market and I am into the stock market, I am going into the stock market, because I am risk neutral, I know that I want the higher rate of a return.

So, it means at the same time when I am expecting a higher rate of return, I am going to take a higher amount of risk also. So, if am taking the higher amount of the risk, so cost of capital cannot be the desired rate of return my desire rate of return has to be, or my return on investment has to be cost of capital plus some premium for the risk I am taking and that is why I am expecting that my 100 rupees should become 150 rupees.

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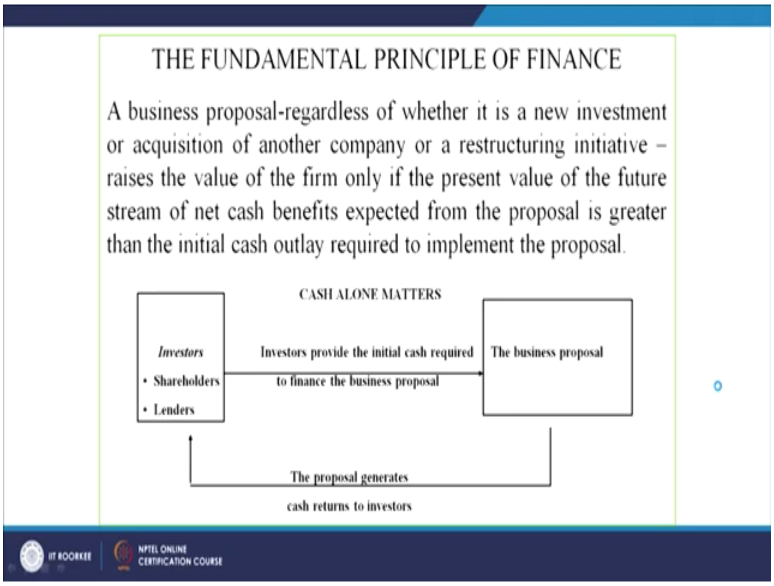

So, this is what we discussed, in the previous class that is the Fundamental Principle of Finance where we have concluded is, a business proposal regardless of, whether it is a new investment or acquisition of another company or the restructuring initiative. Raises the value of the firm only, if the present value of the future stream of the net cash benefits expected from the proposal is greater than initial cash outlay required to implement the proposal.

I am giving 100 rupees, I am getting back and that is a discounted value mind it. That is a discounted value, we will discuss after this, I will talk to you the financial planning and after financial planning I will take you to the next level of the time value of money and in the time value of money, what we will discuss is that a rupee earned today is not equal to the rupee earned after one year, a rupee earned after one year is less than, what the rupee I am earning today.

So, we have to discount that value of that earning which is coming to us, in the future period of time, to make it equal to the present level of the earning or the present amount of the earning. So, there we apply the different discount rates and the principle of the time value of money is applied there. So, I will discuss there, so when you are making investments you are making investments, today in the 0 period. Current period we call it as the 0 period.

So, your outflow of the 100 rupees in the 0 period and your inflow is coming first inflow. For example, you are making investments for the 4 years, first inflow comes after one year. So, that inflows comes of the 50 rupees and that 50 rupees inflow of coming after one year is not equal to 50 rupee you are earning today. So, you have to discount it against that time value of money. So, it will not be 50 rupees earned one year, hence, it will be less than that.

So, we will have to discount it with the help of some discount rate and then we will have to, means sum it up that first year at the end of the first year how much earned? What is the discounted value as per the today's value.

Second year, third year, fourth year sum it up and then see that today's 100 rupees, value is 100 rupees and next 4 years cash inflows discounted value has to be and summed up and discounted value has to be more than 100 rupees and that more than 100 rupees has to be my expected return on my investment which includes both, my cost of capital also or opportunity cost of capital also and the risk I am going to take the premium for that risk.

So, this is the principle of finance that appreciation of the money, appreciation of your investment, has to be attained and if you are able to do that, we are going to achieve, means attain the principle of the maximization of the value of the firm or the maximization of the wealth of the shareholders.

I think you must be clear now, that what is the principle, say fundamental of finance or you can call it as the major fundamental of finance, that where you talk about the financial management you talk about the best utilization of your scarce resources and appreciation growth of your scarce resources and that will happen only if we are managing our funds in a best possible manner in the professional manner, in the desired manner.

So, that the desired rate of return can be earned and we have different revenues the amount of risk, you take the amount of return you can expect minimum is the bank investment, you give your money to the bank take 0 risk, and then the return is also 3.5 percent or 6 percent move to the business directly become entrepreneur, you can have a 100 percent return also.

Or you move to the stock market, so there you take risk but certainly the return is more than what you are earning from the bank investment that is you can call it as the risk-free investment. If you are moving to the stock market, you are taking certain amount of the risk certain your returns are expected to be higher than what is going to be the amount of the return at the level when the level of the risk is 0 or negligible.

So, risk and return go hand-in-hand and ultimately we will have to manage the risk, grow with our funds and whatever is our outflow, the inflow discounted value of the inflow has to be certainly more than that. So, this is the fundamental principle of finance everywhere in the subsequent discussions in the subsequent lectures. We will take this principle along, so that we learn about that best management of the funds requires appreciation of your funds, growth of your investment and multiplication of your savings or multiplication of your funds. Now, next thing this is for this this class only.

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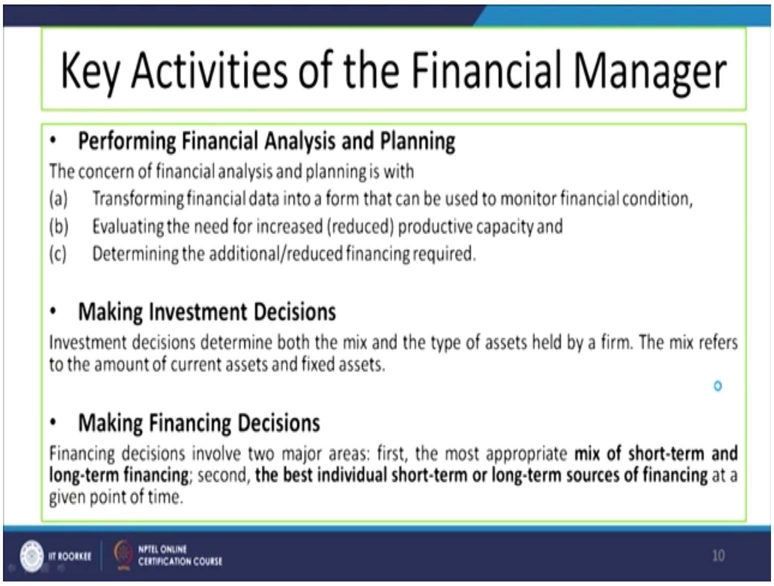

I will be concluding this class with some important observations about the changing role of the financial managers. We must discuss this, very important component, changing role of the financial managers and say what challenges we have been seeing in the past, in the recent past especially after globalization. There are so many challenges which have come in front of the financial managers.

Today's financial manager is not the same as it was before 1991. Managing finance was much easier before 1991 but managing finance today is very, very complex because risk has gone up in the market, complexity has gone up in the market, competition has gone up in the market, uncertainty has gone up in the market.

So, with all these new features in the overall business, say field or in the business management, the job of the financial manager, CF has also has become very, very complex. So, what are the important say requirements of say, of being a good financial manager. Let us discuss some of the important points here.

First part is performing financial analysis and planning. This is a continuous job means, if you want to manage your finances well in the best possible manner then financial analysis and planning is a continuous process. It is a never-ending process at every point of time you have to plan. Even you are investing 10 rupees, you have to be careful that were this investment is going. How much return I am expecting back out of it and whether I am able to add value to my shareholders or not.

So, in this case, the concern of the financial analysis and planning is (())(10:50). Number one transforming financial data into a firm that can be used to monitor the financial conditions. You have got for example sales value, you have got different cost means figures input figures. Like raw material cost is there, labour cost is there your interest cost is there depreciation is there, so many costs at there.

So, you have to now convert that into the financial statements and then simply preparing the financial statement that is a profit and loss account and balance sheet does not serve the purpose these days. You have to analyse these financial statements. It may be possible that, the CFO when he gets the financial statements prepared from his department and they present a copy of the balance sheet and profit and loss account before the CMD of the company or CEO of the company, he may not be the finest guy.

He must not be knowing what this balance sheet is all about. He must be operation's guy. He must be the marketing guy. He does not understand what this all is about. So, what you have to do is, your job is to simplify those financial statements. So, you have to prepare the financial statements in the one hand on the other hand. You have to analyse them with the help of some very, very useful ratios.

Or maybe you have going to convert that into the cash flow analysis, or you have to convert that into the common size of the comparative statements. So, that if you explain with the help of the analytical values to the CEO or maybe the board members who certainly might not be carrying the finest background then you need to means make it simpler for them. So, again the job of the CFO is very, very complex.

B, evaluating the need for increased or reduced productive capacity and determining the additional or reduce financing requirements. Financing requirements in the firms keep on changing, because market response keep on changing. We require the amount of the funds to be invested especially in the short term funds, depending upon the demand for the product in the market. Whatever the product we are going to sell in the market. It may be possible that for example in one market there are the four players already operating.

So, our sales, our market share till the end of the current year is 25 percent, but it may be possible that now the next year, two more players have entered into the market and now our market share has gone down. Your market share has gone down, I agree with you that fix assets investment will remain fixed but the current assets investment, the working capital will change.

So, you have to assess, that how much is going to be the impact on my sales? How much is going to impact on my working capital? How I have to, means reduce my working capital requirements? In what proportion you have to reduce my working capital requirement and how I have to arrange for the, means the funds if additional funds are required and if my surplus funds are going to be available with me where I have to invest them.

So, that I have the desired rate of return available with me. Now, for example you think about Jio came in the market two three years back, before that, Airtel was in the market, Idea was in the market, Vodafone was in the market in the mobile telephony for example we talk about. These three companies never had thought about that Jio as a fourth player come in the market, they will slash down the, say the prices of the mobile services, so means to a level to such a level that were the sustenance of the other players will become a question mark.

You might have seen there is a joint venture now formed by Vodafone and Idea. Idea was independently operating in the market. Vodaphone was independently operating in the market but the moment Jio entered in the market. There was a total turmoil in the market means the customer base was totally shaken and most of the customers of the Airtel, of the Idea, of the Vodafone, they shifted from their existing service providers to the new service provider because of the innovation in the services and pricing offered by Jio.

So, in this case, it came a big challenge to the CFO because the cash collection of Airtel, cash collection of Idea, cash collection of Vodafone went down. So, it is again a challenge who thought about it that Jio will come to the market and they will perform start performing in such a manner that now the new things will start happening in the market.

So, any time there might be the increase funds requirement. There might be the reduced funds requirement. You have to change it, with the change in the demand for the funds. There is not a problem in the fixed assets of the long-term investments, all base problem comes, challenge comes with a short-term investment with the short term say investment in the current assets.

So, it means you every time you have to keep on planning and performing the financial analysis. Planning job is, that how to deal with the future, financial requirements? And analysis means how best possibly we are utilizing our current amount of the funds or the finance available with us.

Next important challenge is the making investment decisions. Many a times, we have to make the investment decisions. I discuss with you, the your this anchor story, fruit beer story. They made a proper analysis thorough analysis. But still the product failed, 350 crores of the very scarce resource went down in the drain.

Everybody had made analysis and everybody had means tried at that level, Anchor had involved the, say market and demand analyst also. Research agencies also, best consultants also. The product was means say thought well about that whether it is a expectable product in the Indian market or not and even some customer service were conducted and all these precautions were taken but despite that when the shape was given when the product was brought into the market it failed, miserably failed in the market.

So, what can you do? Means ultimately this disaster happen to anchor and they have to go with it. And finally means, it means disturbed the total financial position of the company and this kind of the situation comes everyday or sometimes, not in case of the long term funds but in case of the short funds the problem comes. So, the market is volatile, market is means uncertain. So, you have to be very careful and CFO has to be always on his toes, that how to mange a long term as well as the short term funds.

And then third one is the making financing decisions, once you identify a new product, new area, may be it is a restructuring process or entering a in the new market or may be adding a new product in the adjusting product line or it may be the horizontal integration. It can be the vertical integration everywhere you need new funds. If any investment, new investment decision has been conceived, and if is been found that yes firm will go for the new investment, best investment in the market.

So, in that case once the investment is oked, by the different comities, by the different experts. Now, the next challenge to CFO is from where to arrange the funds. Because he has to create a finance mix, where the composition of the total you say finance mix is such that both equity and debt are involved in a balance proportion. The approach here should be that most of the amount of the fund should come from the internal sources and dependence on the external sources should be as low as possible.

Because every firm would like to keep its borrowing capacity intact, if you borrow to much from the market it becomes sometimes risky. So, deciding the financing mix, I have discussed at length in the previous classes also and here I am just referring it back to as a duty of the finance manager, it is a very, very complex job that making of the say investment decisions, investment decision still may be a joint exercise, because so many people are involved.

May be the people for the other departments are involved within the firm consultants are involved, financial institutions are involved, financial experts are involved. So, if the say investment decision when we arrive at, it is a joint exercise, it is a you can call it as the joint exercise of the many people it is a combined exercise of many people, many trust groups.

But as far as the financing decision is concerned, finance department and CFO has to take the decision that how to now, say bring the funds in, in what proportion that, in what proportion equity? How much internal funds we have available from different sources? We have to manage and look for every kind of the say funds available and decide a very, very judicious financing mix. So, another challenge is there, so the role is very, very you can call it as very, very active, proactive rather we would say and then it is a challenging also.

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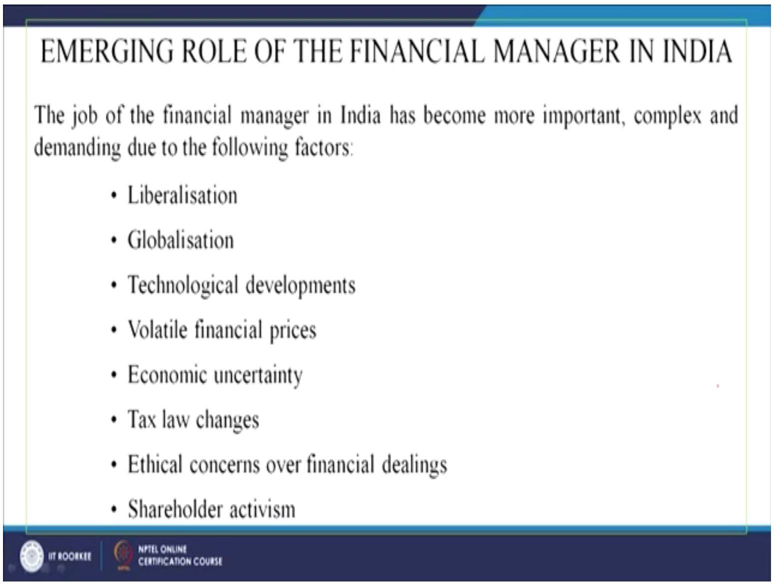

Now, I will take you the next important some important points which are concerning the CFO’s duties or changes to the CFO’s duties, emerging role of the financial manager in India. Why I am just discussing this slide? I though it is important to discuss with you, it is written here the job of financial manager in India has become more important, complex and demanding, due to the following factors, due to the following factors.

Now, these actors had been made the simple and state job of the CFO of the company which was till 1991. Now, after 1991, especially in the 20 th century, 21st century it has become more complexed not in 20th but in 21st century, 2000 onwards it has become more complex. Why? Because of this factors liberalization, globalization, technological development, volatile financial prices, economic uncertainty, tax law changes, ethical concerns over financial dealings and shareholder activism. These are some demanding points from CFO, liberalization and globalization.

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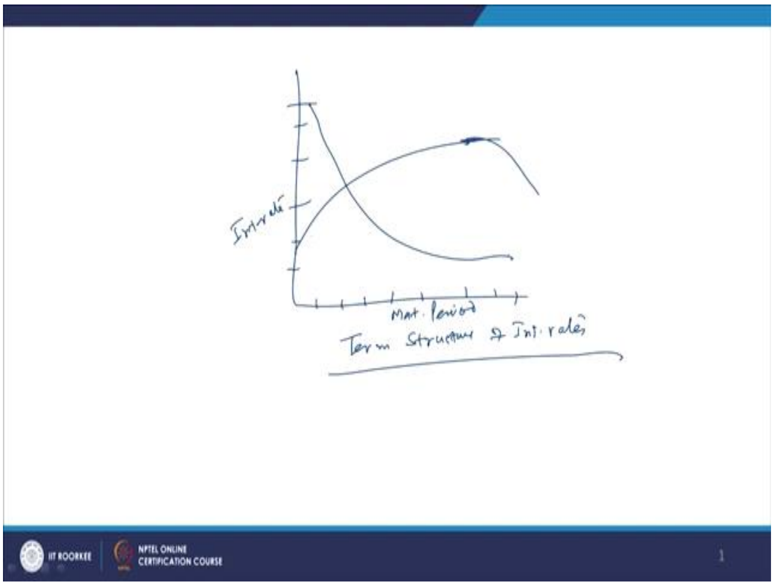

The major change that happened because of the liberalization and globalization is that India has now move towards the, term structure of interest rates. What we call it as, term structure of interest rates. What is the term structure of interest rates? Term structure of interest rates is that, interest rates on any kind of the borrowing or any kind of the investments in India.

Now we, related to it is term and it is a maturity period and term structure of interest rates moves something like this, it is the maturity period and this is the interest rate this is the interest rate and this goes something like this you can say that term structure of interest rate moves like this.

It is going up, if your maturity period of any investment is increasing from this to this then your interest rate is also going up from this to this and after some period time at this point it is becoming saturated and this is started coming down after this. So, it means this is the term structure of interest rates.

Now, if you borrow the funds for the longer duration your cost of the funds is going to increase, your cost of the funds is going to increase and this has happened largely after the liberalization of Indian economy. Sometime, in the past there was a reverse of the term structure of interest rates also this was something like this. What is the term structure of interest rates? If you borrow for the shorter duration, you have to pay the higher rate of interest.

If you borrow for the longer duration, you have to pay the lesser rate of interest, but now we have aligned with the rest of the world and aligning with the rest of the world means, that we have now started following the term structure of interest rate and when you are following the term structure of interest rate, it means if you are borrowing the funds for the longer duration your interest rate is going to increase. If you are borrowing the funds for the shorter duration your interest rate is going to decrease, you are going to be lesser.

So, now the bigger challenge here is that, we have two kinds of the assets, one is the long term assets, others are the short term assets. Long term assets are fixed assets, short terms assets are the current assets and current assets investment requirement are fulfilled through working capital, should we fulfilled through working capital, because rate of return on the current assets is much less as compared to the rate of return on the long-term assets.

So, sometimes what happens, when we invest the long term funds for the short-term requirement or in the current assets. So, the long-term funds are very, very expensive because of the term structure of interest rates and if we invest these funds into the current assets which are less productive. So, there is a mismatch between the cost and returns. And that effects the profitability of the business.

So, it means this after liberalization, the term structure of interest rates introduction has made the life of the CFO challenging one. Second thing is till liberalization the firms in India, never bothered about the financing cost, means if you talk about the, for preparing your profit and loss account.

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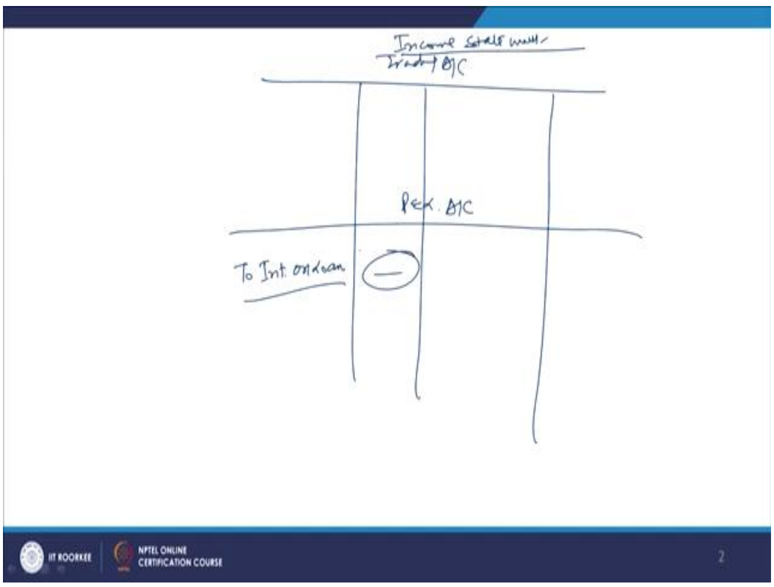

For example, when you are preparing profit and loss account. This is the lower part of your financial statement, this is a trading account upper part. This is a trading account and this is a profit and loss account, lower part is profit and loss account in, now some total we call it as, income statement, this statement is called as income statements.

And it has two parts, in this part we had one cost, these days we have now is the interest cost, interest on loan. This is the interest cost, interest on the loan. So, when you are preparing now the cost sheet, interest cost or the financial cost has become a very, very important component of the cost.

Earlier this cost, was never recognized by the CFOs, or maybe while calculating the total cost of the product, the finance cost was not very, very important. Because in India, we had the reverse of the term structure interest rate, if you are borrowing the amount of the funds in bulk from the financial institutions and for the longer duration the interest rate which you are paying is comparatively lower, as compared to when you are borrowing in the small amount and for the shorter durations.

So, now the interest rate has gone up because you are borrowing the funds for the longer duration because of the term structure of interest rate you end up paying higher rate of interest. So, when the interest rates are now going, have gone up in the market, the interest cost has overall, not rates but the cost has gone up in the market. So, what is happening that your financial cost has become very, very important.

So, in the total cost of production, after liberalization one important cost we have added is the financial cost and we have to be very careful that our financial cost must be under control. So, the challenges of the liberalization is the one like the introduction of the term structure of interest rate in India. Second thing is the, say you call it as increasing financial cost to be kept under control this is another challenge that is because of the liberalization and the globalization in India.

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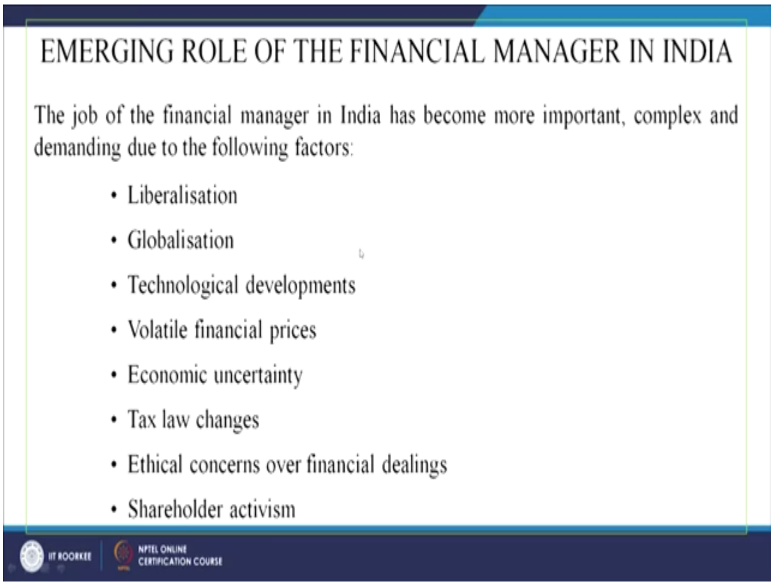

And another important factor, which has come up in the market because of the liberalization, globalization is the international competition and competition in terms of the cost of production. Multinational companies always focus upon that their total cost of production has to be under control. So, Indian companies also have to, means match their cost of production with their multinational counterpart, and if their financial cost is rising which was never recognise as a cost in the past.

So, overall cost of production will increase and your product will become less competitive in the market. So, in this situation because of the, in the wake of the increase competitive situation in the market, you have to keep your cost of the funds under control, cost of the product under control and this is another challenge not to the production manager not to the marketing distribution and purchase manager but to the finance manager also.

If you are investing the expensive funds for the say manufacturing of your product or buying of raw material certainly your overall cost of production is going to increase. So, the pressure on the CFO also has increased. Technological developments, technology is changing very fast, technology is changing very fast.

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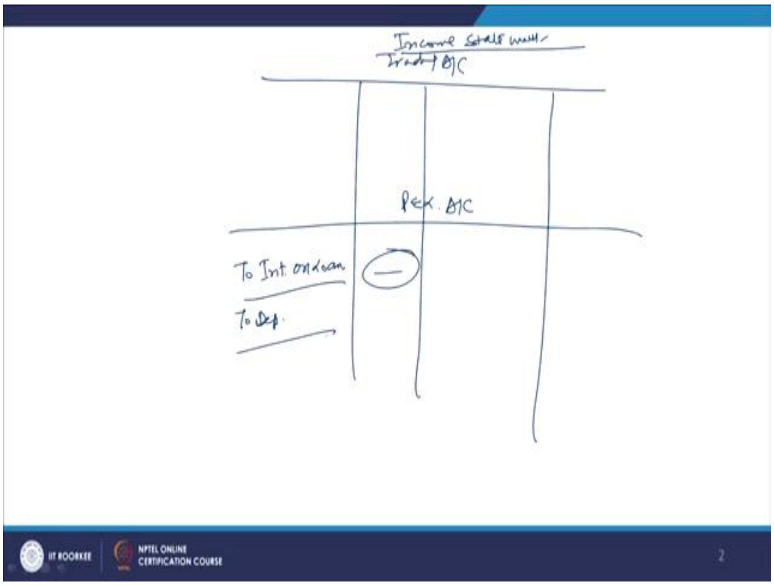

So, in this case, how it creates a problem one thing you add up here the depreciation. Depreciation though it is a noncash cost but it is a cost, it is a part of the cost sheet, it is part of the total cost of production it is a part of the total cost we are showing, we are debiting in the profit and loss account.

So, when the technology is changing very fast, your depreciation rate is also very high. For example, there is one IT system which we have, say put in place in the firm. For managing our finances and we know that software's life is only 3 years. After 3 years new software will come, better efficient software will come in the market and the software's price is for example 100,000 rupees. So, that 100,000 rupees you have to recover in the period of 3 years only. So, it means 33.33000 rupees depreciation you have to provide every year.

Had it been the another way around, that for example you are means this technological advancement are not very, very fast. So, you can use that software for the next 6 years. So, depreciation amount will become just half and the moment your depreciation cost increases or depreciation as a cost increases the total cost of production increases.

So, this is the problem with the CFO also finance people also, because of the technological advancements you have to change your technology very fastly, you need the fund and whatever the funds are invested into adjusting technology, they need to be recovered at the faster pace. Volatile financial prices, marketile financial market, your stock market has become highly volatile. Predicting the prices is not so easy these days, there is a presence of the financial this, institution named as foreign institution investors.

There is a presence of more now shareholders in the stock market, more people in the stock market. So, when the more people are into the market, market has become active more people presence is there in the market, volatility in the market has increased. So, again it is a challenge and if you want to make an investment of your surplus funds in the market even then it is a challenge.

If you want to monitor your own company's stock in the market, even then it is challenge. Because it is very difficult to predict at what price the investment will be available in the market and at what price our company share will be trading in the market. So, again there is a big challenge.

Economic uncertainty, these days now for example, India is passing through recessionary phase. Every sector is suffering from the recessionary problems. So, it means we have to deal with that and it is a challenge to CFOs also. Tax Laws emergence of GST, emergence of GST. 2 years back when the GST came to the market everything has become now become fragile.

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Similarly talk about the ethical concerns over financial dealings that whatever you do the financial dealing it has to be very crystal clear neat and clean, borrowing, lending, investment in the market, everything has to be with a proper record and with the proper say, the documentary evidence and shareholders activism.

Shareholders were not as that active as they are today, in annual general meeting shareholders are asking CFO they are asking the management of the companies that how the company has performed in the past 1 year and what is appreciation our of our investment. So, because enlightenment and activism of the shareholders have put forward the, another challenges to the CFOs. Lastly, so it means when you talk about the emerging role of the financial manager in the wake of the challenges.

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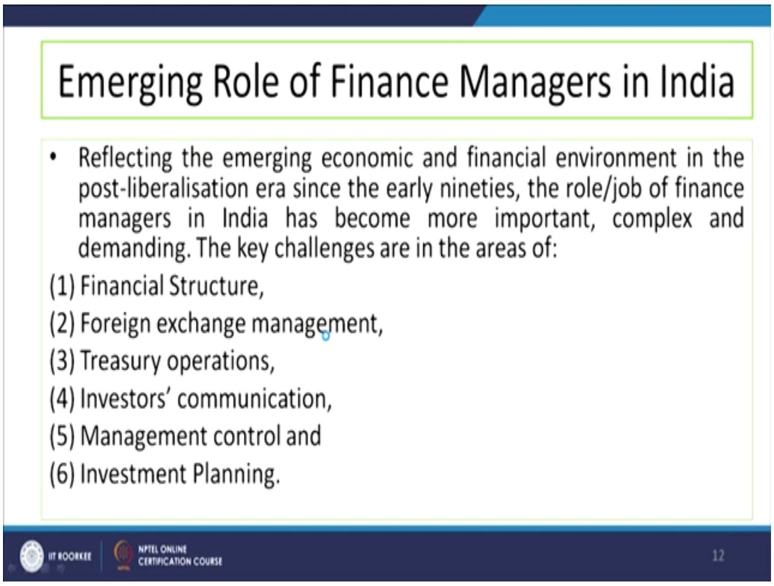

So, you can say, here you can understand that, reflecting the emerging economic and the financial environment in post liberalization era, since the early nineties, the role oblique job of the finance manager in India has become more important complex and demanding the key challenges are in the areas of financial structure, deciding about the capital structure of the firm that tend equity in what proportion we have to have.

Foreign exchange management, because now we are dealing with the foreign, we are making the foreign exchange transactions. So, rupees fully convertible on the current account. So, it means you, foreign exchange has come into the picture treasury operations, day to day operations. You need to borrow money form the market, you need to invest surplus funds in the market, so your working capital your even the long terms funds investment has becomes challenging, investor communication is very important thing.

At the end of general meeting you need to communicate to the investors or you need to communicate to the financial institutions who are our lenders, that how we are performing in the market and how is overall financial performance of the firm. Similarly, the management control and investment planning these have become continuous of years, these have become continuous of years.

So, it means you can understand that now the say, the job of the financial manager is very complex is very, very demanding and we have to spend lot of time in managing the affairs of the firm. So, that finally we can deliver the value to the shareholders and we can try to say, manage the business in such a manner where it creates a win-win situation for all and where the shareholders stand gain, customers stand gain.

The suppliers are also in a benefiting position. The even the government authorities, the taxes also, sufficient taxes we returning back to the government and overall means we are working as per the existing regulatory environment of the country. So, this is something beginning the foundation of this your financial management this course, this particular say, the subject which I introduce this time.

So, whatever I could means discuss or I could share with you for building the foundation or just discussing the conceptual part with you, I did at this point of time and for the further reading, if you want to go for the further reading, if you want to know all these things in detail or the fundamentals or basics of the financial management in detail.

I would request you to refer to the book that is the financial management by Prasanna Chandra. Some of the concepts most of the material I have also taken form that book. So, you can refer to that book for your detailed reading for the detailed reference. A very good book, it is easily available in the market. It is a Tata McGraw, it is a McGraw Hill Publication and you can make use of that. It is not Tata McGraw Hill but it is McGraw hill publication.

So, you can means refer to the book for the further readings, but currently but I could discuss with you as the fundamentals or the basics of the financial management we have done that. So, I am stopping here with regard to the fundamental and in the next class will be talking about something more interesting, a next area next topic and that is financial planning till then, thank you very much.