Financial Management for Managers
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Lecture 03
Fundamental of Financial Management Part III

Welcome all. So, we are in the process of learning about the basics of the financial management or fundamentals of the financial management. And in the previous class we learned about some of the important decisions areas of financial management, where we discussed about the importance of investment analysis, working capital management, sources and cost of funds and determination of the capital structure. Now, there two more decision areas like dividend policy and analysis of the risks and returns.

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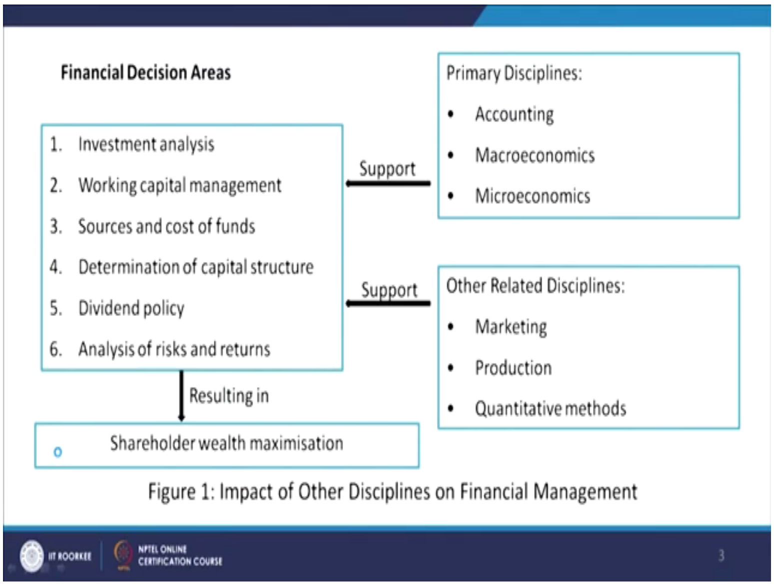

These are the two further more important decision areas of the say financial management. Here the financial manager has to play a very very important role. In terms of say for example, fifth decision areas, the dividend policy. Now, when you talk about the dividend, dividend is the something like that, when you prepare the profit and loss account and when we calculate the profit, say for example here we have the profit and loss account and whatever the profit comes up here, this is our profit and loss account.

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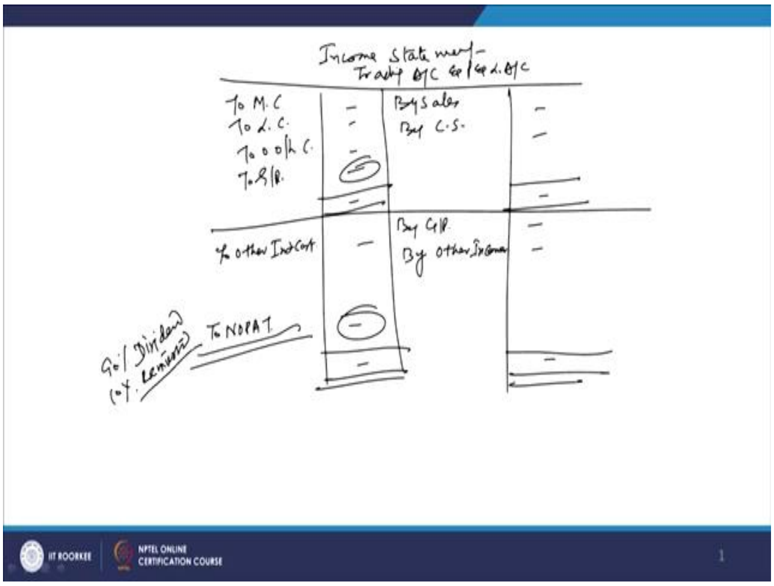

So, we call it as the income statement. This is the income statement and it has two parts. First part is called as the trading account, trading we call it as a trading and profit and loss account, trading and profit and loss account.

So, it has two parts. Upper part is called as the trading account where we talk about the direct revenue is coming from sales, by sales and then it is by closing stock and then it comes as a to material costs, then to labour cost, then to other overheads cost.

These three costs we take and this, these two we take here and then finally we try to find out that what the net result here is. And for example, if the sales are more than the cost so the net result here is the to gross profit, this is a gross profit.

So, gross profit is basically we calculate with the help of the trading account where we have the two sources of the revenue that is the sales and closing stock, and this side we have the cost and then with the differences called a gross profit. Then we bring this gross profit here by gross profit.

And by other incomes, by other incomes we call it as other indirect incomes we added up here and then, to other indirect cost we take here the other indirect cost we subtract here we total it up here again and then you talk it about here is the difference becomes is the to net profit, net operating profit after tax. After adjusting for the tax and everything you get this net operating profit after tax. This is a very summarized view of your profit and loss account or the income statement.

Now dividend policy, when we are talking about that this profit when we have earned about is net operating profit after tax, how these profits will be distributed? We have the two options available here. One option here is that we can distribute larger part of this. For example, 90 percent of this is distributed as a dividend, and 10 percent of this is invested reinvested in the business. This is called as reinvested in the business. 10 percent is reinvested in the business.

So, it means what is happening, the dividend policy of the form is that larger part of the profit, net operating profit after tax, which is up reward of the business operations that profit, larger part of that profits will be distributed among us the shareholders and only very nominal part of this profit will be reinvested back into the business. So, what will happen in this case?

That if for example, if the dividend, the part of the profit we are earning from the internal sources, if the larger part of that we are distributing as dividend, it means that for our own investment requirements we have to go out in search of the funds and there may be so many problems that when we go out in search of the funds that first of all you have to decide which one is the best source available because cost of capital is a very important thing to be taken care of we have decided in that other decision area that is a determination of the capital structure and in the previous part we have talked about is the cost of capital.

So, if you reinvest your internal funds, the profit which we have earned, larger part of the profit if it is reinvested back into the business, so it means there are so many say means facilitating points are here. That funds that internally available. We have not to go out in search of the funds.

Cost of the funds is within control because that is our only opportunity cost and says other administrative and transaction costs can be saved because we are generating the funds largely we are generating the funds internally.

But when you go out in search of the funds you have to pass through so many hassles. Sometimes the funds may not be available and it raises the important say point here also and it raises many eyebrows also, that when 90 percent because if the firm does not require the funds internally within the firm, then it is means is justifiable that larger part of your profit you distribute as dividends because firm is optimally capitalized.

But if you are requiring the funds for your internal operations, internal investments and for that you are going out in search of the funds, you are going out in the market, you are searching with the financial institutions, you are face searching with a say FPOs, IPOs and FPOs or you are searching with the other revenues of the funds and where as your internal funds are available. You are distributing that as a dividend to the shareholders that does not make a sense.

So, if you want to maximize the value of the firm, your dividend policy has to be very clear. That what do you want to do? If the internal funds are available and the businesses is for example, is on the growth path and more funds that are required internally for the internal investments, then our dividend policy has to be the financial manager has to take stand.

CFO of the company has to take a stand that we should that clear minimum amount as dividend, maybe 10 percent, 20 percent of the profit can be distributed as dividend to the shareholders whereas 80 to 90 percent of the funds should be reinvested back into the business. So that our own investment requirements can be met internally.

And it makes sense also that if you have the surplus funds available why to distribute as dividend? Because if the shareholders are not satisfied because you have not declaring dividend, they have every option to sell off their stock in the stock market in this country market and get rid of the stock.

If shareholders are satisfied with that whether we are getting the dividend or we are not getting the dividend, we are getting the say value maximization of our investment in that case it is better to invest the larger amount of the profit back into the business and not say distribute it as a dividend.

Only shareholders who want dividend if they are have bought the shares of the company for the want of dividends, they are the free because country market is there, stock market is there, you can sell of the shares in the stock market and you look for the shares of the companies who are declaring the liberal dividends.

So, dividend policy has to be very very clear. Dividend policy has to make clear, CFO has to contribute, Chief Financial Officer has to contribute in designing the dividend policy of the firm that if in any case the firm requires a funds internally, for the internal operations, for the development and growth of the internal operations, certainly we would not declare dividend or we will declare dividend as the minimum amount.

But if the funds are not required internally only in that case the dividend will be declared. So, ratio will be either 90 10 or 10 90 that depends upon the internet requirement of the funds. So, here financial manager has to play a very very critical role, very very important role helping the management to decide, helping the board of directors of the company to decide about the dividend policy.

If you are not retaining the funds generated internally, then you have no right even to look for the funds from the external revenues and that may create the problem of the funds for the firm. Many and in many cases, in many cases, what happens?

That for example, that when the firms go out in search of the funds for the additional investment, the sources of the funds they also look back and they also try to analyse the balance sheets of the firms who are seeking the furnace from outside, avenues that what you are doing with your internal funds.

If you are a profit making company, you are generating sufficient funds internally, why are you not investing your own funds back into the business? Why are you distributing that as dividend? It means your intention is not clear.

Your intention is not to continue with the business for the longer duration. And in that case, the external sources of the funds also do not come out in support of the firms and they face the say capital problem or the capitalization problem and it becomes very difficult for the firms to raise the funds from the external sources.

And in many cases, even the businesses have failed, there the intentions of the shareholders was something like that they wanted to close down the business. That is why their internal funds they distributed as dividends and for their own requirements they went out in search of the funds.

For example, if we talk about those Kingfisher and other companies owned by Vijay Mallya, many banks were lending him money 9000 crores was lent by SBI and the other banks, they never even looked for that what these companies are doing from their internal funds.

When the internal funds, internal profitability, they are distributing as a dividend to the shareholders and for their own investment requirements, they are coming to the financial institutions through the banks. It means their intention is not a fear. They do not want to continue with the business. There is something going to be fishy and this business and other funds, other say lending may also be at risk.

So what we have to do is, we have to be very very careful. Or second thing is for example, in this case for example, if you want to lend any external sources of the funds want to lend the funds to any of these companies. So, it means they have to ask for the long term collateral or the proper collateral, proper security of their funds and even if you are not asking for the collateral or the security of the funds, it means rest assured your funds are going to be at risk and do not expect your funds will come back smoothly.

In case of the Kingfisher and the other companies held by Vijay Mallya and that associated group that, there was no physical collateral, there was no appropriate collateral ask by the banks while extending the loans to the Kingfisher and other related companies.

And when they were asked, when the banks were asked by the different interest groups that how could you lend 9000 crores to a person who has nothing to give us a security. So, they said that only the brand name was a security with us. So, it means dividend policy plays very very important role.

What you are going to do with your own profits and how much are your internal financial requirements? Be clear about that. If you need more funds for internal investment, do not declare liberal dividends. Sometime you cannot declare any dividend and total amount of the profit can be reinvested back into the business.

People who want to support to genuinely and who have the long term investment needs, they will continue with the company. Others will have the option to sell off their stocks in this secondary market and look for the stocks who are going them immediate dividends or the immediate liquidity.

So, dividend policy deciding the dividend policy financial manager has to take very important decision. CFO has to take very important decision and they have to assist the board of directors of the company, that since we require a larger amount of the funds within the firm, so whatever the profit we are earning that profit rather than distributing as a dividend should be reinvested back into that business.

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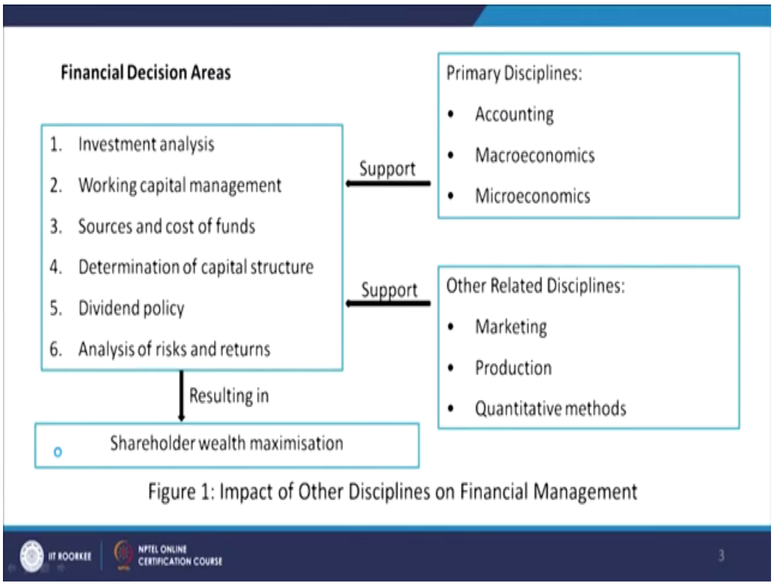

Next financial decision area is analysis of the risk and returns, analysis of risk and returns. That is a very very important this criterion analysis of risk and returns. Because every decision when we take, we have to be very careful about that, how much is the return available for the given amount of the risk we are taking in the business?

How much is the return available for the given amount of the risk? It is very clear that when you are into the business, you are going to take risk. But you want the reward for that risk. I was giving you example in the previous classes that when a person graduates or he does his MBA, he has option two options is in his hands. One option is to go for the placement and join a job and become an employee with some existing organization.

There what he is doing? He is taking the minimum risk. He is not investing his own funds. He is only going to render his services and for those services the firm is going to pay the price and that price is called as the pay package. So, it means whatever the work is assigned to him, he will go to the office, he will do that work come evening home, next morning again will go.

At the end of the month, he will be paid for that. If he has the second option in his hand and if he exercise that, that he rather than becoming an employee to some existing firms, if he prefers to become the entrepreneur, so he is going to manages all resources by himself or by his team it means there can be success also, there can be failure also.

So, he is going to take the huge risk by becoming entrepreneur and when you are taking the huge risk by becoming an entrepreneur, you are not satisfied with the salary or that amount as you are getting it as a salary from some company when you are an employee. You want more return and that return has to be number one is a return for your efforts, second one the returns for your risk. So, it means analysis of risk and return is always important.

Another important example here can be for example we have. For example, I have 100 rupees available with me? I can give that hundred rupee to the bank simply deposit in the bank, rest assured, I will be getting 3.5 percent of the saving bank rate of interest and I am going to get that nobody can stop that and that 100 rupee will become 103 rupees and 50 Paisa after 1 year.

But I have another option that I can buy the stock of a company for a 100 rupees, one share of the company for a 100 rupees if it is available. And I can say think of that rather than making a 100 rupees 103.5 rupees at the end of one year, I would like to make it 110 rupees.

It means I am going to the stock market, I am taking more risk and if I am taking more risks, I want that more reward for that. I need to be compensated for that. So, analysis of risk and return goes hand in hand in every business decision, in every business decision analysis of risk and returns goes hand in hand.

Whatever the business decision you are going to take, you first think in terms of the returns available and at the same time you think of that for this much amount of the returns, this much amount of the risk I have to take and it may be possible that I get the desired return, It may be possible that do not get the desire return, it may be possible that I get 0 return, whatever the investment I am making that goes down in the drill. Anything is possible, but if I want higher returns I have to take risk.

So, every decision we have to take in that perspective of the risk and return. I give you the example in the previous class of that, fruit beer project of the anchor industries or the anchor India limited. In that case also because they thought of diversification from their say conventional business of the electrical products.

They thought of diversifying to the consumer products and they thought that fruit beer is a product, which is going to be a new in India and the anchor may be the pioneer in that area or in that product or in that field.

As the product is a welcome product in the Europe, US and the other some advanced countries. It may be a welcome product in India also. So, they invested 350 crores into this project, into this particular area. So, their intention was to maximize the returns because they thought that we will be pioneers, we will be the pioneers in this area.

So, when you are pioneers, you are the first mover in the market, so you take some risk also but the returns are also equally high. But in that case only it was a risk, no return was available because product finally failed.

Similarly, you talk about the Karsan (())(17:55) story in Nirma. When you talk about the Nirma in Nirmas case, Karsan why did not take say uncalculated risk? This is the one important advice I would like to give you here is that, any risk you want to take because we should take risk. That means for sure.

That if we want to grow in the life, whatever the decision you take, whether it is the investment decision, business decision, entrepreneurship decision or any decision, you have to take risk in the life. If you are take risk in the life, certainly the turns will be higher. But there can be the things happening other way around also. So, but if you want to take risk, always take that calculated risk. Warren Buffett also says that when you take risk, take risk. Nobody can means earn anything extra without taking the risk.

But always take the calculated risk. And then Karsan Bhai moved into the market with the Nirma washing powder, he did not take much risk. He manufactured the product, he started distributing it free of cost. So, what is risk was? Initially investment into the factors of production and producing that product at a very small scale.

He distributed it free of cost to his neighbours or people living in his vicinity, then to his relatives, then to others. So, whatever that investment he made during that manufacturing and free sales of the product, he took that risk that if my product is acceptable to the people, I will go for a manufacturing it at that larger scale.

But if my product is not acceptable to the people, I lost some a few thousand rupees and in 1982 few thousand rupees was also a big amount. So, means he took the calculated risk and finally the product was huge success. So, whatever that say free distribution he did, he could recover that total amount back.

So, here when you talk about the analysis of risk and return in every business decision, when you think of earning the good return on your investment as a true financial manager, you have to always think about that risk always goes hand in hand with the returns and we have to be very careful in every business decision. It may be a decision of buying a machine, single machine, replacing the older technology with the new technology or maybe sometimes hiding some specialized skilled workers and say replacing the old workers with the new workers.

Whatever the decision you take a every decision is going to come with the risk and you have to think about that if the risk is means outward by that or turns, then certainly we are going to be in a win win situation. Otherwise sometimes we lose also in the business.

So, the see because of that risk, sometime your returns are not up to the mark so there is nothing to worry about. So these are that six business decision area. I am discussing this all in a very summarized form investment analysis.

We will discuss in detail working capital management is itself a independent area of learning. I have offered another course specialized on the working capital management, which is already going on. If you want to have a detailed knowledge about the working capital management, you can join that course. Then you will be learning in detail in this course about sourcing and cost of the funds and about the decision making in this area.

Determination of capital structure is a very very important decision. I gave you just flare off that in the morning that what component of the total fund should come as a debt, what should come as an equity and what should be the mix of debt and equity. So, that all will be learning in detail.

Dividend policy I just discussed with you that dividend policy has to be very clear if you need the funds internally first, reinvest the funds back, distribute the minimum amount of the profit as dividend. Otherwise the firm will have bad name, bad repetition and last is the analysis of risk and returns very important decision because every business decision goes with the risk.

If you take a risk only, then you can have that higher amount of the returns. So, finally if we look at this arrow, this arrow says that if you take these 6 proper business decision in the proper manner, then the result will be the shareholder's wealth maximization and there is an ultimate objective that why we are starting the business, why we are into the business because we want to maximize the shareholder's wealth.

We want to maximize the shareholder's investment. If people buy the stocks of the companies, why they buy the stocks of the companies in the wake of that, they will be able to maximize their returns on their investment. It may be possible that sometime when you buy share from the market, the price of the share may go down. It may be possible that sometimes you lose investment in the market also or sometime investor increases.

But not at the desire place or sometime overnight the, your means 100 rupee investment becomes an investment of 1000 rupees. So, everything is possible but ultimately when we are into the business, ultimate purpose of every business is to maximize the shareholder's wealth.

So, that the shareholders, promoters of the firm when they start a business and when at any later stage when the business is closed. There has to be the difference in that initial capital and the capital of the firm at the time of the dissolution or the closer of the firm. So, whatever the decision you take here right from the first to the sixth decision ultimately that is going to be in terms of the maximization of the shareholder's wealth and that is going to be the reflection of the better financial management.

Now, be moved to the other areas that to have the better financial management of any organization, any company. You have to have the other supportive areas, also supportive disciplines also and you have to carefully means manage those areas also because everybody is supportive discipline can be translated in terms of finance. For example the primary disciplines are which go hand in hand with the finance are accounting, macroeconomics and the microeconomics.

Accounting and finance is the one department in the companies with the help of accounting, you get to know that whatever the investment be made in the business, what is the end result of that? Because whatever their sources of the say finance we invest into the firms, we convert that into the financial statements and financial statements are possible to be created with the help of accounting.

At the end of the year, one accounting period of 12 months, you come to know whether the business has ended up with the profit or the loss and that all becomes possible if you know accounting or you convert that raw information into the profit and loss account.

Similarly, we prepare the balance sheet, balance sheet tells us about the financial position of the business on the last day of the year or the last day of the accounting period, and that also becomes possible with the help of accounting. So, accounting is the one important say, basic discipline, which is the prerequisite for the efficient management of the funds or the finances in the organizations. And accounting helps in the reporting of the firms operations and the business results.

Similarly, the other disciplines are macroeconomics. He tells you about the trade position in the market, tells you about the supply and demand position in the market sorry, that is in the microeconomics but to the government policies, government budgets then as a international environment, everything is the part of the macroeconomics and every firm these days is subject to the all these external factors, government policies, government budgets, international environments, foreign exchange, all of these things and largely they are the part of macroeconomics. Microeconomics, demand and supply functions are the most important functions, money, market, capital markets.

All these are related to the microeconomics and without money market, without demand supply functions, you cannot run any business and there every at every step you need the help of the microeconomics. Then we have the other related areas like marketing, production, then your quantitative methods. For example, marketing without finance marketing is not possible, without finance marketing is not possible.

Why you go for marketing? Because you want to maximize the sales of your product or the service in the market and why you want to maximize the sales? Because you want to have the maximized revenue and maximized revenue means maximized profits and maximized profits means the maximum is return to the shareholders.

Similarly, the production why you want go for the production? Without finance production is not possible at every step you need finance. So, if you want to have the proper well managed production function, you first have to discipline yourself in terms of finance. If you do not have the required amount of finance, then you do not have the required amount of the material.

You do not have the required amount of the people, so who will on your plant. So, these are related areas supportive areas. And in nutshell, you can say that finance is such a diverse area that with the help of other areas, whether it is accounting, economics, both macro and micro marketing, production, distribution, human resource management, these all functions are facilitated by the finance and then finance becomes the backbone of the business that is why I started in the morning.

The discussion in the previous class when I started the discussion, I told you finance plays the roll off a blood as the blood plays, the role in the human body that if the blood is equally being supplied to the different organs of the body, then all organs remain healthy, all organs remains working, all organs keep on responding and a human being remains a perfect human being, a healthy human being.

But if there is a shortage of the blood in the human body, in overall person becomes anaemic. If the blood circulation is not proper in any part of the body or sub part of the body, that part also stops functioning or sometimes they are come serious problems.

So, if the finances flowing property properly within the organization and the financial requirements of the different units and subunits of the firm are being taken care of properly, you can see the firm is growing just to delivering value and ultimately the ultimate purpose of the business is going to be attained and the final objective of the maximization of the shareholder's wealth or the value maximization of the farm is going to be attained.

So, we have to learn to manage the funds, the finances in the best possible manner. So, that within the minimum financial resources we can have the maximum and the best possible results. Now, we go ahead with the next part. Scope of the financial management, what it involves.

When we talk about the financial management, what it involves, what are the different decision areas. Which show that they are the 6 decision areas, but in the scope when we talk about the scope we in a very crisp manner we can escape and we can say that in the scope of the financial management.

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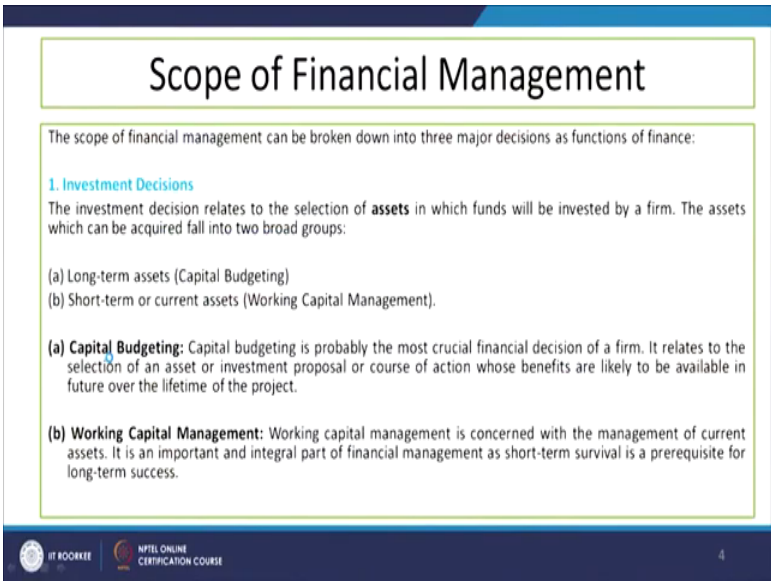

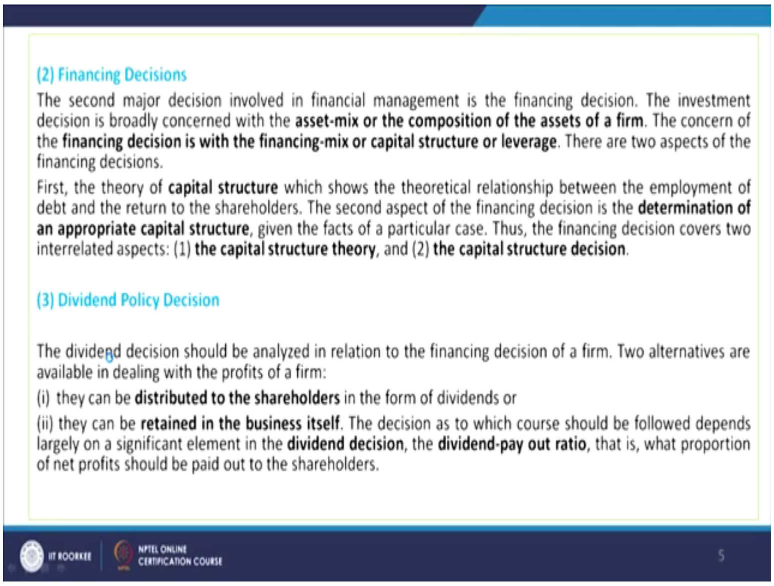

We have three important decisions to take, we have three important decisions to take one decision is the investment this decision, second decision we have to take her is the financing decision and third decision we have to take here is as a dividend policy decision. Three important decisions we have to take here investment decision, financing decision and then is the dividend policy decision. Now, investment decision.

What is investment decision? Investment decision can be that in two possible ways the decision can be taken or then the two different situations the decision can be taken. As I told you to that fresh entrepreneur if he want to a fresh management graduate or any graduate he thinks off that rather than joining a job in any company, I will become entrepreneur.

Why he will become an entrepreneur because he is visionary. He has the risk taking capability. And third important thing is he has got very good idea in his mind. If he means, implement that idea in the business, he can create a very good product or a very good service and if it goes with that product or service in the market that will be accepted by the people in the market. So, this is the investment decision.

Now, whether to go for that he cannot blind fully say that I have conceived this product and I will manufacture and people will out rightly buy it or they will accept a product that is not going to happen.

He has to go for the detailed investment analysis for that and I told you in the previous class also that in a analysis starts with the market and demand analysis. You have to first try to explore that if you manufactured this product or start generating this service. Is there any market for that or not?

Similarly, if the market response is very good, similarly you have to take the input decision. This yes output if it is done, it is acceptable to the people in the market, but what about the input? How can I manufacture this product and then finally he has to make a input output analysis to have the one unit of output, how much input is required, and what is the total cost benefit analysis. This is in case of the new entrepreneur, single entrepreneur. If he wants to become a businessman and invest his funds into the business and try his luck by becoming an entrepreneur by moving into the business.

Second situation can be that an existing firm who is already having manufacturing four products and successfully selling them in the market, they want to introduce a new product in the market, the fifth part of the sixth product into the market. They want to check that and they want to take that investment decision. Again, they have to follow the entire process as any case of the anchor industries I told you that anchor was already existing in the market.

But means, just because of the fear of the liberalization, globalization of Indian economy, they thought that their conventional business of the electrical products may not be as safe as it was when India was a closed economy. So, now they have to look for some other areas and we have to start to diversify.

And then when they went for say taking this decision under diversification and started means, thinking about introducing this product, the fruit beer, they did a thorough analysis investment analysis. And finally they decided that yes, we should go for this investment.

And finally we should, means make this investment and manufacture this product and come out with this product in the market. Finally, the product did not work well, they lost their total investment. There is a different story, but first decision, whether you are a new entrepreneur or you are an existing business, proper investment decisions have to be taken.

So, furthermore what is required in the investment decisions and what are the other prerequisites of the investment decisions, these plus financing decision and that dividend policy diseases. I will discuss with you in the next class. I will stop here. Thank you very much.