Notes

Course Code: 304-Fin **Course Name: Advanced Financial Management**

UNIT I – Financial Planning and Shareholder Value

1.1 INTRODUCTION TO FINANCIAL PLANNING AND SHAREHOLDER VALUE

Financial planning is the process of managing your finances in line with your life goals. Life goals can include buying a home, managing your and your children's wellbeing, saving for their education or planning for your retirement.

1.2 Definition of Financial Planning

"Financial Planning is the process of estimating the capital required and determining its competition. It is the process of framing financial policies in relation to procurement, investment and administration of funds of an enterprise."

1.3 Objectives of Financial Planning

Financial Planning has got many objectives to look forward to:

A. **Determining capital requirements-** This will depend upon factors like cost of current and fixed assets, promotional expenses and long- range planning. Capital requirements have to be looked with both aspects: short- term and long- term requirements.
B. **Determining capital structure-** The capital structure is the composition of capital, i.e., the relative kind and proportion of capital required in the business. This includes decisions of debt- equity ratio- both short-term and long- term.
C. **Framing financial policies-** with regards to cash control, lending, borrowings, etc.

A finance manager **ensures that the scarce financial resources are maximally utilized in the best possible manner** at least cost in order to get maximum returns on investment.

1.4 Importance of Financial Planning

Financial Planning is process of framing objectives, policies, procedures, programmes and budgets regarding the financial activities of a concern. This ensures effective and adequate financial and investment policies. The importance can be outlined as-

1. Adequate funds have to be ensured.
2. Financial Planning helps in ensuring a reasonable balance between outflow and inflow of funds so that stability is maintained.

3. Financial Planning ensures that the suppliers of funds are easily investing in companies which exercise financial planning.
4. Financial Planning helps in making growth and expansion programmes which helps in long-run survival of the company.
5. Financial Planning reduces uncertainties with regards to changing market trends which can be faced easily through enough funds.
6. Financial Planning helps in reducing the uncertainties which can be a hindrance to growth of the company. This helps in ensuring stability and profitability in concern.

2.1 What Is Shareholder Value?

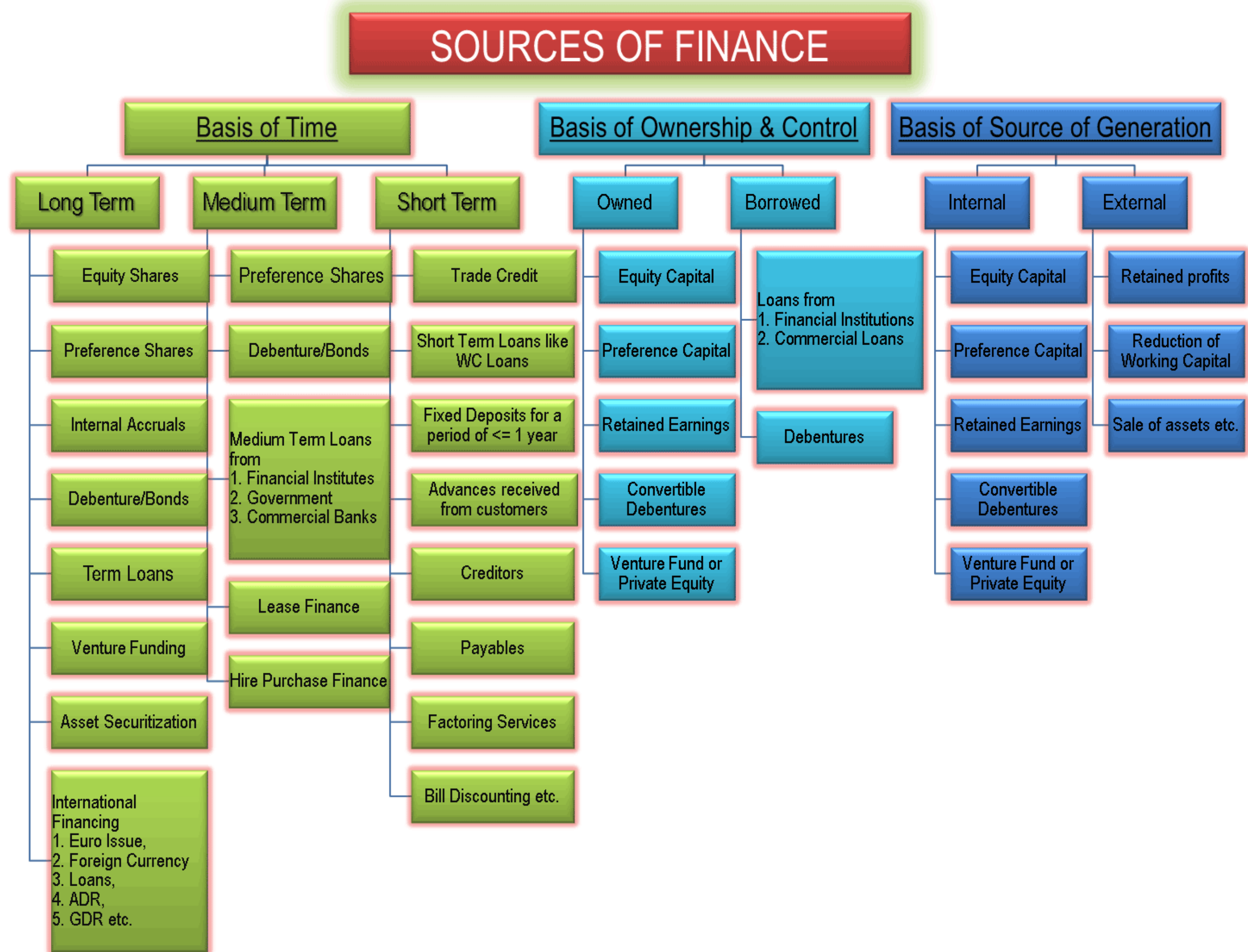
A company's shareholder value depends on strategic decisions made by its board of directors and senior management, including the ability to make wise investments and generate a healthy return on invested capital. If this value is created, particularly over the long term, the share price increases and the company can pay larger cash dividends to shareholders. Mergers, in particular, tend to cause a heavy increase in shareholder value.

Definition of Shareholder Value

"Shareholder value is the value delivered to the equity owners of a corporation due to management's ability to increase sales, earnings, and free cash flow, which leads to an increase in dividends and capital gains for the shareholders."

2.2. Long term and short-term sources of finance

Sources of finance for business are equity, debt, debentures, retained earnings, term loans, working capital loans, letter of credit, euro issue, venture funding etc. These sources of funds are used in different situations. They are classified based on time period, ownership and control, and their source of generation.



Long-Term Financing: -

Long-term financing is usually needed for acquiring new equipment, R&D, cash flow enhancement, and company expansion. Some of the major methods for long-term financing are discussed below.

Equity Financing:

Equity financing includes preferred stocks and common stocks. This method is less risky in respect to cash flow commitments. However, equity financing often results in dissolution of share ownership and it also decreases earnings. The cost associated with equity is generally higher than the cost associated with debt, which is again a deductible expense. Therefore, equity financing can also result in an enhanced hurdle rate that may cancel any reduction in the cash flow risk.

Corporate Bond:

A corporate bond is a special kind of bond issued by any corporation to collect money effectively in an aim to expand its business. This tern is usually used for long-term debt instruments that generally have a maturity date after one year after their issue date at the minimum. Some corporate bonds may have an associated call option that permits the issuer to redeem it before it reaches the maturity. All other types of bonds that are known as **convertible bonds** that offer investors the option to convert the bond to equity.

Capital Notes:

Capital notes are a type of convertible security that are exercisable into shares. They are one type of equity vehicle. Capital notes resemble warrants, except the fact that they usually don't have the expiry date or an exercise price. That is why the entire consideration the company aims to receive, for the future issuance of the shares, is generally paid at the time of issuance of capital notes. Many times, capital notes are issued with a debt-for-equity swap restructuring. Instead of offering the shares (that replace debt) in the present, the company provides its creditors with convertible securities – the capital notes – and hence the dilution occurs later.

Short-Term Financing

Short-term financing with a time duration of up to one year is used to help corporations increase inventory orders, payrolls, and daily supplies. Short-term financing can be done using the following financial instruments –

Commercial Paper:

Commercial Paper is an unsecured promissory note with a pre-noted maturity time of 1 to 364 days in the global money market. Originally, it is issued by large corporations to raise money to meet the short-term debt obligations. It is backed by the bank that issues it or by the corporation that promises to pay the face value on maturity. Firms with excellent credit ratings can sell their commercial papers at a good price. Asset-backed commercial paper (ABCP) is collateralized by other financial assets. ABCP is a very short-term instrument with 1- and 180-days' maturity from issuance. ACBCP is typically issued by a bank or other financial institution.

Promissory Note:

It is a negotiable instrument where the maker or issuer makes an issue-less promise in writing to pay back a pre-decided sum of money to the payee at a fixed maturity date or on demand of the payee, under specific terms.

Asset-based Loan:

It is a type of loan, which is often short term, and is secured by a company's assets. Real estate, accounts receivable (A/R), inventory and equipment are the most common assets used to back the loan. The given loan is either backed by a single category of assets or by a combination of assets.

Repurchase Agreements:

Repurchase agreements are extremely short-term loans. They usually have a maturity of less than two weeks and most frequently they have a maturity of just one day! Repurchase agreements are arranged by selling securities with an agreement to purchase them back at a fixed cost on a given date.

Letter of Credit:

A financial institution or a similar party issues this document to a seller of goods or services. The seller provides that the issuer will definitely pay the seller for goods or services delivered to a third-party buyer. The issuer then seeks reimbursement to be met by the buyer or by the buyer's bank. The document is in fact a guarantee offered to the seller that it will be paid on time by the issuer of the letter of credit, even if the buyer fails to pay.

2.3 Financial Statements including Funds Flow and Cash Flow Statements

INTRODUCTION:

The separation of management from ownership in modern business calls for the use of some form of connection between the managers and the owners and other interested parties. Financial reporting is the most efficient and extensively used medium of communicating the operating results as well as latest financial position of a concern for the management. Constancy and achievement of any 211 business largely depend on its capacity to generate enough cash. As part of conveying an end result of company’s operation managements use financial statement as an important vehicle through which financial information is furnished to the stakeholders. But the three basic financial statements present only fragmentary information about a company’s cash flows (cash receipt and cash payments)

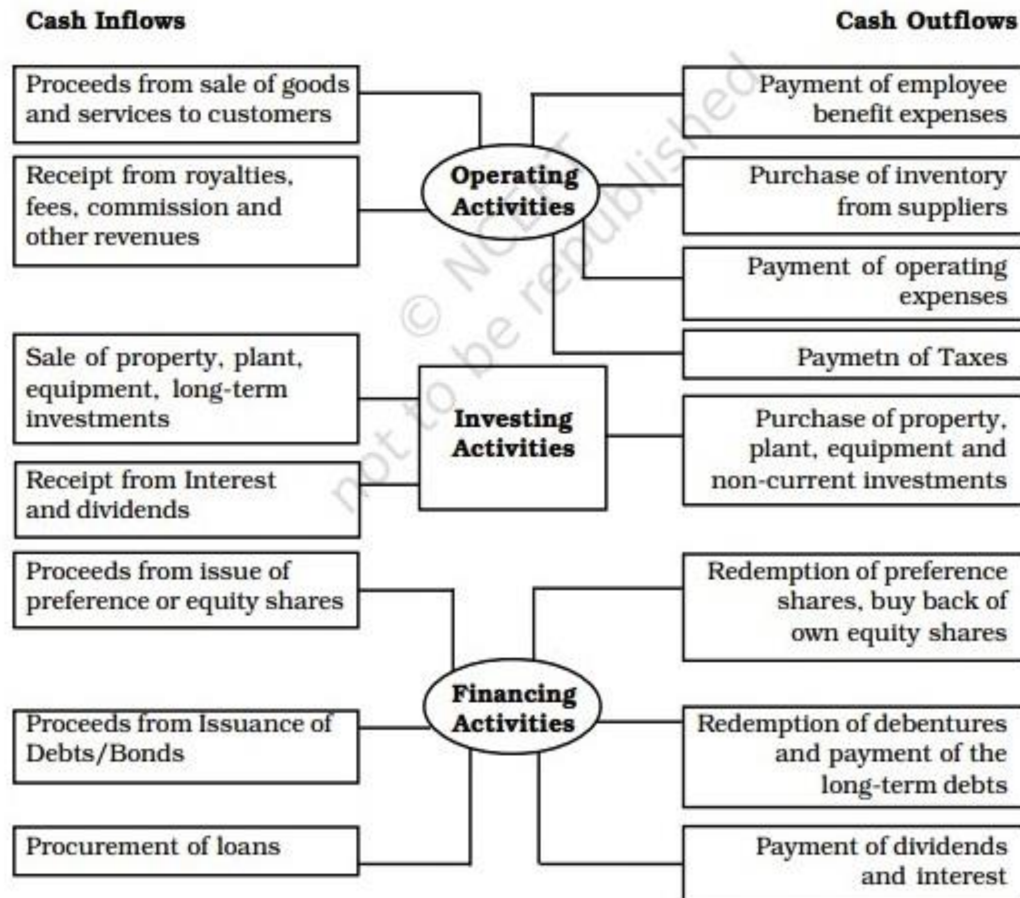


Exhibit 6.1: *Classification of Cash inflows and Cash Outflows Activities*

Objectives of Cash Flow Statement:

A Cash flow statement shows inflow and outflow of cash and cash equivalents from various activities of a company during a specific period. The primary objective of cash flow statement is to provide useful information about cash flows (inflows and outflows) of an enterprise during a particular period under various heads, i.e., operating activities, investing activities and financing activities. This information is useful in providing users of financial statements with a basis to assess the ability of the enterprise to generate cash and cash equivalents and the needs of the enterprise to utilise those cash flows. The economic decisions that are taken by users require an evaluation of the ability of an enterprise to generate cash and cash equivalents and the timing and certainty of their generation.

Cash Flow Statement
(Main heads only)

(A) Cash flows from operating activities	xxx
(B) Cash flows from investing activities	xxx
(C) Cash flows from financing activities	xxx
Net increase (decrease) in cash and cash equivalents (A + B + C)	xxx
+ Cash and cash equivalents at the beginning	xxx
= Cash and cash equivalents at the end	xxxx

Exhibit 6.2 : *Sharing Specimen Cash Flow Statement*

Test your Understanding - I

Classify the following activities into operating activities, investing activities, financing activities, cash equivalents.

1.	Purchase of machinery.	2.	Proceeds from issue of equity share capital.
3.	Cash revenue from operations.	4.	Proceeds from long-term borrowings.
5.	Proceeds from sale of old machinery.	6.	Cash receipt from trade receivables.
7.	Trading commission received.	8.	Purchase of non-current investment.
9.	Redemption of preference shares.	10.	Cash purchases.
11.	Proceeds from sale of non-current investment.	12.	Purchase of goodwill.
13.	Cash paid to supplier.	14.	Interim dividend paid on equity shares.
15.	Employee benefits expenses paid.	16.	Proceeds from sale of patents.
17.	Interest received on debentures held as investments.	18.	Interest paid on long-term borrowings.
19.	Office and administrative expenses paid.	20.	Manufacturing overheads paid.
21.	Dividend received on shares held as investment.	22.	Rent received on property held as investment.
23.	Selling and distribution expenses paid.	24.	Income tax paid.
25.	Dividend paid on preferences shares.	26.	Under-writing commission paid.
27.	Rent paid.	28.	Brokerage paid on purchase of non-current investment.
29.	Bank overdraft.		
30.	Cash credit.	31.	Short-term deposit.
32.	Marketable securities.	33.	Refund of income-tax received.

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Indirect Method:

Indirect method of ascertaining cash flow from operating activities begins with the amount of net profit/loss. This is so because statement of profit and loss incorporates the effects of all operating activities of an enterprise. However, Statement of Profit and Loss is prepared on accrual basis (and not on cash basis). Moreover, it also includes certain non-operating items such as interest paid, profit/loss on sale of fixed assets, etc.) and non-cash items (such as depreciation, goodwill written-off, dividend declared, etc. Therefore, it becomes necessary to adjust the amount of net profit/loss as shown by Statement of Profit and Loss for arriving at cash flows from operating activities. Let us look at the example:

Statement of Profit and Loss Account for the year ended March 31, 2017

Statement of Profit and Loss Account for the year ended March 31, 2017

	Particulars	Note	Figures in (Rs.)
i)	Revenue from Operations		1,00,000
ii)	Other Income	1	2,000
iii)	Total Revenues (i+ii)		1,02,000
iv)	Expenses		
	Cost of Materials Consumed		30,000
	Purchases of stock-in-trade		10,000
	Employees Benefits Expenses		10,000
	Finance Costs		5,000
	Depreciation		5,000
	Other Expenses		12,000
			72,000
v)	Profit before Tax (iii-iv)		30,000

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Note: Other income includes profit on sale of land.

FUNDS FLOW STATEMENT:

The funds flow statement helps the financial analyst to get a more detailed analysis and understanding of changes in the distribution of resources between two balance sheet dates. In case such a study is required regarding the future working capital position of the company, a projected funds flow statement can be prepared. The uses of a funds flow statement are as follows: It explains the financial consequences of business operations

The funds flow statement provides a ready answer to so many conflicting situations, such as:

(a) Why is the liquid position of the business becoming more and more unbalanced in spite of business making more and more profits?

(b) How was it possible to distribute dividends in excess of current earnings or in the presence of a net loss for the period?

(c) How does the business could have good liquid position in spite of business making losses or acquisition of fixed assets?

(d) Where have the profits gone?

KEY TAKEAWAYS:

A company's cash flow and fund flow statements reflect two different variables during a specific period of time.

The cash flow will record a company's inflow and outflow of actual cash (cash and cash equivalents).

The fund flow records the movement of cash in and out of the company.

Both help provide investors and the market with a snapshot of how the company is doing on a periodic basis.

What is a Funds Flow Statement Analysis?

Funds Flow Statement analysis is a comparison between various aspects of a Balance Sheet. While evaluating this statement, it is also vital to understand all the aspects.

Assets

If the asset section of a Balance Sheet experiences increment, it implies that the concerned institution has purchased assets by spending funds. These assets might thus result in the inflow of funds in the future. Here are some examples –

- **Fixed assets**
- **Short-term loans**
- **Long-term loans**
- **Inventory**
- **Cash and cash equivalents**
- **Receivables**
- **Present investments**

Contrarily, if the assets section shows a decline, it means that the company has sold some of its assets to maintain fund inflow.

Liabilities

In a **Funds Flow Statement**, any increase in liabilities means the organization has funds inflow which needs to be paid. Some of the examples are-

- **Lenders**
- **Customers**
- **Vendors**
- **Employees**

- **Shareholders**

And, a decline in liabilities implies that the current obligations have been satisfied.

How is a Funds Flow Statement Prepared?

Preparation of Funds Flow Statement is done in the following three steps –

Statement depicting differences in working capital

According to the formula for working capital calculation,

Working capital = Current assets – Current liabilities

This particular statement focuses on the effects that modify working capital. Here are some reasons that are responsible for a change in the company's working capital.

If the company keeps investing in fixed assets or long-term business avenues without accumulating any long-term funds, the working capital can reduce significantly.

If the company is spending most of its profit in paying dividends and not accumulating any assets.

Working capital can also change with an over-extension in lending.

Again, without any advancement of long-term funds, if the firm needs to repay a long-term obligation or preferred stockholders, the concerned firm can come across working capital deficiency.