7 CONTROLLING

What will you learn in this chapter ?

Introduction

A business enterprise is established for the achievement of specific objectives. Objectives can be for long term or short term. For the achievement of these objectives, various activities are planned. In order to implement these plans an organization is established. But, however perfectly or carefully planning may be done or an ideal organization may be established, many obstacles may arise while implementing the plans. The function of controlling is to remove these obstacles and to see that the work is performed exactly in conformity with the plan. Controlling is the process of checking the performance of the staff, to find out the deviations and remove the deviations by necessary corrective measures for the implementation of the plan.

7.1 Controlling

In the order of the management process, planning is the first step and controlling is the last step. Activities are planned and after that duties and responsibilities are assigned. In this way from the time that the work begins, the function of controlling also begins. The function of controlling is to check the progress of managerial tasks, compare the same with set standards through plans and to find the deviations thereof. The function of controlling is also to get information about such deviations, remove them and take corrective actions.

7.1.1 Meaning :

- In ordinary sense, controlling means to decide the activities to be carried out, evaluate, the same and if required, take corrective measures so that they are done in confirmity with plan.
- Planning determines objectives and controlling makes them effective.
- Control of an undertaking consists of ensuring that everything is being carried out in accordance with the plan which has been adopted, the orders which have been given and the principles which have been laid down. Its objective is to point out the mistakes in order that they may be rectified and prevented from recurring.
- The implementation of control affects things, people and functions, and all other factors.
- According to **Peter F. Drucker**, “Controlling is to maintain a balance between efforts and results and between resources and objectives.”

The essence of controlling is to see that functions are carried out according to predetermined standards and to regulate the activities.

7.1.2 Characterstics :

(1) **Related to Planning :** Planning and control are like two sides of the same coin. Planning performs the function of making plans while controlling ensures that activities are carried out according to the plan. Planning and controlling are like twins. Controlling is impossible without planning.

(2) **Functions at every Level of Management :** Controlling is performed at every level of

management. It is not confined to one department or section. Managers control their subordinates at every level. The extent of control depends on the level of management.

(3) **Continuous Process :** It is wrong to think that once control is exercised on the activities of the enterprise, work will always be done according to the plan. By keeping constant supervision over the activities of the personnel, constant efforts must be made to remove deviations. Quality control and cost control are important and constant activities.

(4) **It is an End Activity of Management :** In the management process planning decides objectives, organizing implements them, directing gives direction for the same and after this, the function of control begins. It is essential that all managerial functions are performed before control is exercised. Thus the function of controlling is that of regulating which begins only after the activities get initiated. Thus control is the end activity of management.

(5) **Related to Future :** Controlling is related to future. The manager has no control over past activities. But he can examine past activities and analyse them so that he can take benefit in future. The objective of control is to see that errors, wastage and losses which occured in the past are not repeated. Controlling is thus related to improvements in future.

(6) **It is a Constructive Activity :** Controlling is generally regarded as an attack on workers freedom. In fact this belief in incorrect. The function of control is to see that workers work as per the planning and that they are guided properly. Thus, controlling is not a negative, but a positive activity. Controlling rectifies mistakes and takes steps to ensure that mistakes are not repeated. Thus it is a constructive activity.

(7) **Internal Process :** Controlling is an internal process. Various activities of the business enterprise like production, sales, purchase, financial matters, financial accounts and working method of employees etc are an integral part of the control system. Due to these various activities, it becomes possible to have control over the business. Whereas, external factors like change in government policy, depression, inflation, changes in the psychology of people etc can not be controlled.

(8) **Dynamic Process :** The process of control is related to planning. It is an intellectual process based on planning and foresight. As the assumptions of different factors change, the goals of planning change and accordingly, fast changes are made in the controlling process.

(9) **Controlling is a Person-Oriented or Subjective Activity :** It is done for the improvement of the activities of workers, by the workers and for the workers. The person is at the centre of controlling. Controlling is exercised on workers by workers (managers). Every activity is performed ultimately by the persons. The errors and deviations are also due to human weaknesses. That is why we can say that control is very much person-oriented or subjective.

(10) **Controlling can be Formal or Informal :** In the context of the organization and production activities, control process is established formally. But with the passage of time an informal system of controlling can also the established. At times, such an informal system of controlling can also be more effective.

7.1.3 Importance : Controlling is an important stage of management. Controlling is necessary for the achievement of managerial objectives. But without controlling, an organization is like a chariot without a charioteer. Controlling does the work of verifying whether all the activities of the enterprise are being carried out in accordance with the plan which has been adopted, the orders which have been given and the principles which have been laid down. The main objective of controlling is to check the errors or short comings of the past and stop their recurrence.

(1) **Helpful in the Achievement of Objectives :** Controlling finds out errors in the enterprise

and takes corrective measures. As a result achievement of objectives becomes easy, as all activities are performed according to a plan.

(2) **Control on Activities :** Various activities of an undertaking and functional areas like organization, production, sales, employees, financial and quality aspects etc can be controlled.

(3) **Makes Planning Effective :** According to an expert, planning lays down the path and controlling helps to find the deviations and improve them. Thus due to controlling, achievement of objectives is possible and planning becomes successful.

(4) **Co-ordination between Various Activities :** Controlling is helpful in co-ordinating various activities of the business enterprise. It is only because of control that co-ordination is possible.

(5) **Evaluation of Activities :** The activities are compared with pre-determined standards and evaluated.

(6) **Removes Deviations :** Controlling aims at taking corrective action. It examines the causes of deviation and then takes corrective measures so that deviations can be reduced.

(7) **Necessary for Delegation of Authority :** Controlling is essential for the delegation of authority. After the work of delegation, it is the responsibility of the supervisor to supervise. He can delegate authority but not accountability.

(8) **Find out Errors :** Supervision and evaluation of activities of subordinates is necessary and this is done by controlling. Activities are observed by control. Controlling also helps to find out errors, difficulties, defects and deviations and remove them so that they are not repeated in future.

(9) **Long Term Planning :** Controlling helps to make long term plans. On the basis of the information which is gathered about present organizational activities, control can be used to make long term assumptions.

(10) **Helpful in Directing :** Controlling simplifies directing. It supervises the personnel, gives guidance and direction in their difficulties, so that activities are performed as planned.

(11) **Barometer of Efficiency :** In business enterprises if control is exercised efficiently, management becomes more efficient. So controlling is called the barometer of efficiency of management.

7.2 Relation between Planning and Controlling

Planning refers to a systematic and intellectual programme to achieve objectives. Planning clarifies the goals behind future activities. It is also an outline or plan of which activities are to be undertaken, when and in how much time they are to be completed and for that what resources are required so that goals can be achieved. Control is a process to monitor whether business activities are carried out according to the plan, set standards and given instructions; and if deviations are found, then corrective actions are taken. Whenever there is planning there is controlling and conversely whenever there is controlling planning pre-exists. Thus planning and controlling are interrelated.

(1) **Planning and Controlling are Two Sides of the Same Coin :** Planning and controlling are two very important and interdependent functions of the management process. The success of planning depends on controlling. Controlling finds out the deviations, takes necessary corrective action and also takes business activities in the right direction. Controlling is also not possible without planning. This is because, through controlling, it can be ascertained whether the objectives of planning are achieved or not. So where there is no planning, there is no need of controlling. Thus planning and controlling are two sides of the same coin.

(2) **Protection Against Change :** Implementation of the programmes of a plan depends on internal and external factors. Internal factors can be regulated where as control is needed for external factors like government policy, competition, inflation, depression, scarcity of raw materials, change in the choices of people, change in fashion, etc. Thus taking into consideration the effect of external factors; controlling sees to it whether activities are carried out according to plan or not. Thus planning and controlling give protection against changes.

(3) **Planning is a Pre-condition for Controlling :** The function of planning is to make programmes to achieve the objectives of the business enterprise. While the function of controlling is to see whether the activities are performed according to the plan or not. The function of controlling is also to compare the actual performance with the set standards. If deviations are found the corrective action is taken. Thus planning is the pre-condition of controlling.

(4) **Planning is the Father of Controlling :** Controlling exists because of planning. Controlling keeps a check on activities decided in planning. So controlling does not exist without planning. Keeping this in mind planning is considered to be the father of controlling.

7.3 The Stages of the Controlling Process

Controlling is a universal and continuous process. Each business enterprise has its own specialities. So controlling process cannot be the same for all organizations. Still there are certain common stages of controlling mechanism which are as follows :

Stages of Control Process

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↓	↓	↓	↓	↓
(1)	(2)	(3)	(4)	(5)
Setting Standards	Gathering Information	Measuring Performance	Comparing Actual Performance with set Standards	Corrective Measures

7.3.1 Setting Standards : Controlling process starts with the establishment of standards. Standards are measures of efficiency. In this the actual performance is compared and evaluated. The basis of controlling is pre-determined standards. Controlling sees to it whether activities are carried out in the organization according to these set standards or not. These standards can be qualitative or quantitative. The standards should be such that they can be understood by those who have to achieve them. The standards include physical, cost price, income, capital etc. Over and above this, standards can be profit targets, production targets, cost targets etc. Standards may be of long term or short term. Standards are decided at the top level management. Employees and subordinates are informed about the same. The employees then plan their work according to the given targets and they constantly strive to maintain these standards.

7.3.2 Gathering of Information : At this stage, information is gathered about the work done and the actual situation. Information is gathered by personal observation, oral reports and written reports.

7.3.3 Measuring Performance : Performance is to be measured to find out whether activities have been undertaken according to set standards. Such a measurement can be qualitative or quantitative or both.

7.3.4 Comparison of Work done with Set Standard : At this stage of controlling, information about actual work done is sought or acquired. After that, it is compared with set standards. From this comparison it can be known whether the set standards have been achieved or not.

7.3.5 Corrective Measures : Corrective measures is the last stage in the controlling process. The activities are compared against set standards to find out deviations. If deviations are found out, necessary corrective measures can be taken. Any of the following three measures can be taken :

(1) No Change in the Condition : No corrective measures is to be taken when deviations are found to be normal or acceptable, as compared to set standards means there is no change in the condition.

(2) Change the Condition to Remove Deviation : If deviation from actual performance is more when compared to set standards, such deviations are to be examined and necessary corrective measure is to be taken.

(3) Change the Condition and Establish Fresh (New) Standards : When the established standards are not attained continuously, it means they are extraordinarily high and a change has become essential. In such a situation fresh or new standards are to be set by making required changes. Likewise when better results as compared to the established standards are continuously obtained, the set standards are changed and new higher standards are set.

The function of control is not only to find out deviations but also to take organizational activities towards the achievement of objectives. So controlling is a constructive process.

What did you learn in this chapter ?

Introduction :

Meaning of Control : In general control, means to find out which functions are carried out and evaluate them and if required to take necessary corrective measures so that work can be done according to the plan.

According to Peter F. Drucker controlling is to maintain a balance between efforts and results and between resources and objectives.

Characteristics : (1) Related to planning (2) Functions at every level of management (3) Continuous process (4) End activity of management (5) Related to future (6) Constructive activity (7) Internal process (8) Dynamic process (9) Person-oriented (10) Can be formal or informal

Importance : (1) Helpful in achievement of objectives (2) Controlling on activities (3) Makes planning effective (4) Co-ordination between various activities (5) Evaluation of activities (6) Removes deviations (7) Necessary for delegation of authority (8) Finds out errors (9) Long term planning (10) Helpful in directing (11) Barometer of efficiency

Relation between Planning and Controlling : (1) Planning and controlling are two sides of the same coin (2) Protection against changes (3) Planning is the pre-condition for control (4) Planning is the father of controlling

Stages of Controlling Mechanism : (1) Setting standards (2) Gathering of information (3) Measuring performance (4) Comparing work done with set standards (5) Corrective measures – (A) No change in condition (B) Change the condition to remove deviation (C) Change the condition and establish new standards.

Exercise

1. Select the correct alternative and write answer to the following questions :

(1) Which function of the management process sees that the work is performed according to planning ?

(A) Organization (B) Training (C) Directing (D) Controlling

(2) Controlling is not a .... process.

(A) Continuous (B) Internal (C) Rigid (D) Dynamic

(3) .... is the process of maintaining balance between efforts and results and between resources and objectives.

(A) Directing (B) Staffing (C) Co-ordinating (D) Controlling

(4) Controlling takes place at .... level.

(A) Every (B) Top (C) Middle (D) Bottom

(5) Which is not the function of controlling ?

(A) Progress of activities (B) Comparison with set standards

(C) Determining objectives (D) Getting information about deviations

(6) Which function of management is known as the father of controlling ?

(A) Organization (B) Staffing (C) Directing (D) Planning

(7) .... is the last function of management.

(A) Planning (B) Organization (C) Staffing (D) Controlling

(8) .... is the first stage of the controlling process.

(A) Measuring performance

(B) Comparing actual performance against set standards

(C) Corrective action (D) Setting standards

(9) After knowing the deviations, what type of measures does the management take ?

(A) Give training (B) Remove the staff

(C) Corrective action (D) Appoint experts

(10) What should be done when the organization obtains better results than set standards ?

(A) Improve and set lower standards (B) Improve and set higher standards

(C) No change in set standards (D) To remove standards

2. Answer the following questions in one sentence each :

(1) With which functions of management is planning closely related ?

(2) At which level of management function does controlling take place ?

(3) Before which fucntion must all functions of management be performed ?

(4) Why is it necessary to measure performance ?

(5) What is deviation ?

(6) Which external factors jeopardize the very existence of a business ?

3. Answer the following questions in short :

(1) Give the meaning of controlling.

(2) 'Controlling is a continuous process' - Explain.

(3) How is controlling an internal process ?

(4) 'Controlling is a dynamic process' - Explain.

(5) 'Planning is the father of controlling' - Explain.

4. Answer the following questions in brief :

(1) Explain the relation between planning and controlling.

(2) 'Planning and controlling are two sides of the same coin' - Explain.

(3) 'Controlling is not a negative function.' - Justify the statement.

(4) Is controlling an end activity of management ? Why ?

5. Answer the following questions in detail :

(1) Explain the characteristics of controlling giving its meaning.

(2) Explain the importance of controlling.

(3) Explain in detail the various stages of the controlling process.

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8 FINANCIAL MANAGEMENT

Introduction

In simple words management of finance means financial management. Finance is the blood of business. The existence of human life is not possible without the circulation of blood. In the same way, existence of business unit is not possible without finance. Business can not be started without adequate finance, it means finance is like foundation stone of each business. Finance is required to continue the business transactions regularly. In fact, money is the pivot around which all economic activities rotate. Financial management is a managerial activity which is related to planning and controlling of financial resources. Financial management utilizes financial resources in a such a manner that a satisfactory return is earned along with the optimum utilization of finance. The scope of financial management has widened with the passage of time.

8.1 Concept and Definition of Financial Management :

Financial management means management of finance functions in routine activities. Financial management includes all the aspects of financial activities of business. Finacial management takes decisions related to finance and executes them.

Definitions :

- According to **F. W. Paish** "In the modern economy, based on utilization of funds, financial management means acquiring of required funds at the required time."

- According to **Raymond J. Chambers** "Financial management means to take decisions about financial matters to implement then smoothly and to review, them."

- According to **Prof. M. Kimbal** "Financial management means acquisition of fund, its optimum utilization and its appropriate allocation."

All the above definitions clarify that the field of financial management is so wide that it covers all the financial decisions of business, right from the inception of business to its end.

8.1.1 Characterstics :

(1) **Branch of Management :** Financial management is a branch of management which includes the function of planning and controlling for the use of finance.

(2) **Wide Scope :** The scope of financial management is so wide that it includes estimating the need of finance, acquirement, maximum utilization, proper allocation and its planning and controlling. It covers all financial operations, right from the inception of business to its end.

(3) **Base of the Managerial Decisions :** Financial management provides a base for managerial decisions. Decisions regarding production, sales, research, development etc. are based on financial management.

(4) **Relation with Financial Decisions :** Financial management is related with decision-making of investment, capital structure and dividend policy. In the process of decision making, financial management uses the modern mathematical techniques.

(5) **Goal of Maximisation of Owner's Economic Welfare :** Financial management adopts two approaches for the maximisation of owner's economic welfare : (i) Profit maximisation and (ii) Wealth maximisation.

(6) **Key Position :** Financial management is a managerial acitivity and holds key position in organisational structure of business unit.

(7) **Relation with Other Areas of Management :** Most of the activities of business such as production, sales, marketing research etc. are connected with finance. Financial management will be more flexible in formulating production policy, sales policy etc., if the financial management has sufficient funds. According to this interpretation financial management is related with different areas of management such as production management, marketing management, personnel management.

(8) **Division into Two Parts :** Financial management can be divided into two parts e.g., Management of long term fixed capital and management of working capital. Fixed capital management includes planning for expansion of fixed assets such as building, machines, land etc., while working capital management is necessary for day-to-day expenses.

8.1.2 Objectives of Financial Management : The objective of financial management should be "maximisation of the owner's economic welfare." Through the use of financial resources financial management aims at economic maximisation of the owners who are the shareholders of the company. Following are its two approaches for this as follows :

(A) Objective of profit maximisation (B) Objective of wealth maximisation

(A) Objective of Profit Maximisation : Profit maximisation means maximising income of the company. Investors purchase the shares of company hoping to get maximum dividend. According to this approach, company should earn maximum profit out of its available resources and dividend policy should be based on maximisation of profit. In addition, this approach suggests that company should accept profitable projects only. Company can increase earning per share through the objective of maximisation of profit.

(B) Objective of Wealth Maximisation : The objective of wealth maximisation is also known as 'Net Present Value'. The net present value creates wealth for the shareholders. Hence, the financial decisions resulting in increasing net present value should only be accepted by the company. The wealth maximisation approach is based on the concept of cash flow. Only cash flow is considered as a measurement and the accounting profit is ignored.

The net present value of wealth is the difference between present value of wealth and investment required.

Net present value of wealth = Present value of wealth − investment required.

Financial management should take such financial decisions by which wealth of the company is maximised. If the wealth of the company is maximised, it will be reflected in the price of the share of the company in the stock exchange. Market price of the share will increase in the share market. As a result, shareholders' wealth will be maximised. Due to this, shareholders' asset increases.

The objective of wealth maximisation is appropriate and universally accepted. The objective of wealth maximisation is superior to that of profit maximisation. **Prof. Solomon** has favoured the objective of wealth maximisation.

8.1.3 Importance of Financial Management : The importance of financial management has increased due to the current changes in business environment and contempory economic flows at Global level after 1950.

(**1**) **Estimation of Financial Needs :** Financial management estimates how much long term capital and short term capital will be required for the business.

(**2**) **Acquring Finance :** Financial management acquires finance at the minimum cost by selecting the sources economically.

(**3**) **Planning and Controlling :** Planning is combined with effective controlling to make economic utilization of finance.

(**4**) **Distribution of Finance :** It distributes finance among different departments in such a way that every department gets adequate finance.

(**5**) **Maintaining Liquidity :** It maintains liquidity by preparing cash flow statement and cash budget so that a definite cash balance can be maintained on hand.

(**6**) **Distribution of Income :** It determines what part of profit is to be distributed as dividends among the shareholders and what part of profit is to be reinvested in the business.

(**7**) **Management of Current Assets :** Cash, debtors, inventory, marketable securities, bank balance etc. are included in current assets. It formulates investment policy for these current assets.

(**8**) **Financial Decisions :** Financial management takes important decisions regarding capital budget, dividend policy, reinvestment of profit etc. and maintains co-ordination among various financial decisions e.g., Co-ordination between dividend policy and reinvestment of profit.

(**9**) **Raising Credit of Business :** Financial management significantly contributes in the progress and development of business. Efficient financial management generates financial facilities. So that employees, salary and creditors payment can be made in time. As a result, credit of the business increases.

8.2 Financial Decisions

Financial management is also known as finance function as it is related with the finance function. In this context financial management has to take important decisions with regards to the following three problems :

(A) Decisions related to investment (B) Decisions related to financing (C) Decisions related to dividend

8.2.1 Decisions Related to Investment : Long term fixed capital is invested in the fixed assets of the business. Financial manager has to take decisions regarding the selection of those assets in which capital fund is to be invested in future. Investment decision is called capital budgeting. Element of risk is involved in decisions related to investment. Hence investment decision should be evaluated in terms of expected return and risk. Various methods of capital budgeting are being used such as pay-back method, rate of return method, discounted cash flow method etc. for taking investment decision when there are more than one alternatives with financial manager for the investment of finance.

Factors Affecting Investment Decision : (1) Need of total capital. (2) Estimated rate of return and profitability receivable in future from investment. (3) Estimated cash flow receivable from investment. (4) Element of risk involved in investment. (5) Requirement of working capital after investment. (6) Useful economic life of investment and its estimated life. (7) Significance of investment. (8) Capital rationing. (9) Certainity or uncertainity of earning in future.

8.2.2 Decisions Related to Financing : Investment decisions are connected with the assets of the company while financing decisions are connected with capital structure. Capital structure of the company consists of (a) equity shares (b) equity shares and preference shares (c) equity shares and debentures (d) equity shares, preference shares and debentures.

Capital structure is a mixture of owner's capital and debt. Financial manager has to take decision regarding the portion to be maintained between equity and debt in capital structure. A balance between equity capital and debt is necessary. Capital structure having a proper proportion of equity capital and debt is called optimum capital structure. Optimum capital structure is less risky and ensures maximum return.

Factors Affecting Financing : (1) Internal factors and (2) External factors.

(1) Internal Factors : Type or nature of business, size of business, growth of business, financial requirement, nature of assets and requirement, attitude of directors.

(2) External Factors : Condition of capital market, floatation cost of securities issue, attitude of investors, rate of interest prevailing in market, legal restrictions, institutional investors.

8.2.3 Decisions Related to Dividend : Dividend is a part of profit of a company which is distributed among its shareholders. Dividend is a return to shareholders on their investment. As per Companies Act, dividend can be paid in cash or cheque on paidup capital of share. The payment

Financial manager has to decide what part of profit should be distributed as dividend and what part of profit should be retained in business. Retained earning in business is a significant internal source of finance.

Payment of dividend affects the market value of share of the company. If a major portion of profit is distributed as dividend, it decreases the ploughing back of profit. On the other hand if a major portion of profit is reinvested then less amount is left for dividend.

Factors Affecting Dividend : (1) Divisible profit of the company during the current financial year. (2) Estimation of income in future. (3) Rate of dividend paid by the company in the past years. (4) Need of ploughing back of profit in business. (5) Financial condition and financial needs of company at present. (6) Ratio of reserves with company. (7) Future planning of profitable investment. (8) Attitude of directors of company. (9) Taxation policy. (10) Legal restrictions. (11) Expectation of shareholders of the company. (12) Condition of capital market. (13) Growth rate of company. (14) Liquidity position of the company.

8.3 Capital Structure

8.3.1 Concept and Definition : There are two important aspects of financial plan : (1) To estimate need of capital. Problem of capitalisation. (2) To determine sources of capital. Problem of capital structure.

Company can obtain necessary capital funds from various sources. Company procures capital by issuing various type of securities such as equity share, preference share, debenture etc. In what proportion will the various type of securities be issued is determined by the financial manager.

Capital structure means the combination of different sources of capital like equity share, preference share, debenture, reserve and loan fund. With reference to this, accoding to **Gesternberg,** "Decisions regarding type of securities are reflected in the capital structure of the company."

Definitions :

● In simple words, "Capital structure" means the combination of different sources utilized by the company to raise necessary capital.

● According to **Hogland,** "Capital structure means proportion and magnitude of different securities issued and sources utilized by a company to raise its finance."

8.3.2 Characterstics of Ideal Capital Structure :

(1) **Simplicity :** Capital structure becomes easy in terms of administration, if lesser type of securities are issued.

(2) **Profitability :** The plan of capital structure should be such that profit remains optimum.

(3) **Adequate Finance :** Various sources should be combined in a such way that adequate finance can be obtained.

(4) **Flexibility :** Capital structure of the company should be flexible so that it can be changed as per the requirements and circumstances.

(5) **Economy :** Various sources should be combined in such a manner so that cost of capital is minimised.

(6) **Balancing :** There should be a proper equilibrium between owner's capital and borrowed capital.

(7) **Liquidity :** There should be such type of provision in capital structure that the liability and debt can be paid in time.

(8) **Attractiveness :** It should be attractive so that various types of investors invest in the company.

(9) **Solvency :** The proportion of borrowed capital should not be so large that burden of interest can not be borne and risk of insolvency is raised.

8.3.3 Types of Capital Structure :

Types of Capital Structure

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(A)	**(B)**	**(C)**	**(D)**
↓	↓	↓	↓
Capital structure of only equity shares	Capital structure of preference shares with equity shares	Capital structure of debentures with equity shares	Capital structure of preference shares and debentures with equity shares

8.3.4 Factors Affecting Capital Structure :

Factors Affecting Capital Structure

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(A) Internal Factors	(B) External Factors
(1) Type of business	(1) Condition of boom-depression in capital market
(2) Size of business	(2) Present rate of interest in capital market
(3) Estimation of business income	(3) Cost of capital expenses of issuing securities
(4) Nature and requirement of assets	(4) Legal restrictions
(5) Attitude of directors	(5) Taxation policy
(6) Financial requirements	(6) Institutional investors
(7) Duration of capital requirement	(7) Foreign institutional investors

(A) Internal Factors :

(1) **Type of Business :** More fixed capital is required in the large scale manufacturing units, while less fixed capital is required in trading units. In service unit, the fixed capital investment is determined on the basis of service.

(2) **Size of Business :** Due to large scale activities, big business units require fixed capital in large proportion. Small size industrial units require comparatively less fixed capital. Trading units require less fixed capital comparatively.

(3) **Estimation of Business Income :** Earning of business may be certain or uncertain. Company can depend on borrowed capital if future estimated earning is fixed and handsome.

(4) **Nature and Requirement of Assets :** If requirements of fixed assets are on large scale in business then the ratio of equity share will be high in capital structure Due to high investment in fixed assets, it is also considered whether fixed assets are to be purchased or to be acquired on hire-purchase or on lease.

(5) **Attitude of Directors :** If the directors of the company desire to retain the managerial control on company they do not issue equity shares in greater proportion and depend more on preference shares and debentures.

(6) **Financial Requirements :** Capital can be raised only by issue of equity shares if requirement of capital is on the small scale. Various types of securities are to be issued if large scale capital fund is necessary. Apart from this, how much finance will be required in future for long term objective, plans, possibility of future growth is also to be considered while formulating capital structure.

(7) **Duration of Capital Requirement :** If capital is required permanently company will prefer to issue equity shares. On the other hand, if capital is required for a short period, company will procure capital through debentures and preference shares.

(B) External Factors :

(1) **Condition of boom-depression in capital market** : For steady income in depression period the investors prefer to invest in debentures but not in equity shares. While in the period of boom investors

will prefer to invest in equity shares with expectation of higher dividend. Thus, formulation of capital structure based on present trends of capital market.

(2) **Present Rate of Interest in Capital Market :** If the present rate of interest is high in capital market, the trend is to issue equity shares to procure fund, because payment of high interest on borrowed capital becomes a burden on company. Debentures are also given a place in the capital structure, if present rate of interest is low.

(3) **Cost of Capital-Expenses of Issuing Securities :** When securities are issued to raise capital company has to incur expenses for issue of prospectus, underwriting commission, brokerage etc. Cost of capital is more as the expenses are more. The expenses incurred in issuing different types of securities are different. Although the expense on issuing debenture is lower than the issue of other securities.

(4) **Legal Restrictions :** Legal restrictions are also to be considered at the time of selecting capital structure. As per Companies Act, the company raising capital fund through securities has to issue equity shares compulsorily. In addition to this, rules of SEBI and RBI and provision of Companies Act are to be considered.

(5) **Taxation Policy :** Company follows the trend of issuing debenture to acquire more capital fund if taxation ratio is high, because the amount of interest paid on debentures is deductible from the income in lieu of taxation purpose. Naturally, equity shares become more popular if the income of dividend is tax free or the rate is lower on the dividend income.

(6) **Institutional Investors :** Insurance companies, banks, financial institutions of state and central government etc. invest in shares and debentures of the companies as per their established rules and conditions. Trends and conditions of all these institutions are considered at the time of formulating capital structure or at the time of alteration of capital structure.

(7) **Foreign Institutional Investors :** Foreign investor institution is such an institution which is established and registered out of India and whose objective is to invest in prescribed securities in India in primary and secondary markets. Foreign investment institution has to make registration with SEBI. Such institutions are permitted to purchase shares and debentures of Indian company.

8.4 Working Capital

8.4.1 Meaning and Definition : Fixed capital and working capital are required in all types of business. Fixed capital is required to purchase fixed assets such as land, building, machines etc. while working capital is required to pay day-to-day expenses. Working capital is generally employed in current assets of business such as raw materials, debtors, bill receivables, etc. It remains constantly circulating in business, therefore, working capital is called the life-blood.

Definitions :

- According to **Lincoln, Doris and Stevens,** "Working capital is the excess of current assets over current liabilities."

- According to **J. S. Mill,** "The sum of the current assets means the working capital."

8.4.2 Concept of Working Capital :

(1) **Gross Working Capital :** Working capital means sum of total investment in current assets of business such as stock of raw material and finished goods, debtors, bills receivable, short term securities etc.

Gross Working Capital = Total Current Assets

(2) **Net Working Capital :** Net working capital means current assets minus current liabilities.

Net Working Capital = Current Assets − Current Liabilities

When current liabilities are less than current asset, it is called positive working capital and when current assets are less than current liabilities, it is called negative working capital.

8.4.3 Difference between Gross Working Capital and Net Working Capital :

Sr. No.	Points of Differences	Gross Working Capital	Net Working Capital
(1)	**Meaning**	Gross Working Capital means sum total of current assets such as bill receivables, debtors, short term marketable securities, bank balance, cash, etc.	Net Working Capital means current assets minus current liabilities.
(2)	**Liquidity Position**	This concept does not indicate the liquidity position of the company.	This concept indicates liquidity position of the company.
(3)	**Financial Position and Measurement**	Does not give a true idea of the financial position of the company.	Gives the true idea of financial position of the company.
(4)	**Increase in Current Liabilities**	Increase in current liabilities increases the gross working capital.	Increase in current liabilities does not increase in net working capital.

8.4.4 Characteristics of Working Capital :

(1) **Short Term Capital :** Working capital is a short term capital.

(2) **Investement in Current Assets :** In working capital debtors, bill receivables, short term securities are included in current assets.

(3) **Liquidity :** Liquidity is the basic feature of working capital. All the current assets in which working capital is employed are converted into cash easily.

(4) **Less Risk :** Working capital circulates, for short term and it is convertible into cash easily, so the element of risk is less.

(5) **Changing Form :** The form is constantly changing in which working capital is employed. e.g., Raw materials converted into semi-finished goods and further into finished goods. Finished goods is converted into debtors if it is sold on credit, and into cash, if sold on cash basis.

(6) **To Pay Day-to-Day Expenses :** Working capital is required constantly to pay day-to-day expenses.

(7) **No Depreciation :** Depreciation is not calculated due to circulating capital in business and its form is constantly changing.

(8) **Requirement According to Type and Form of Business :** Requirement of working capital is dependent upon the form and type of business. Thus its ratio is different in each business.

8.4.5 Factors Affecting Working Capital :

(1) **Type and Nature of Business :** The need of working capital is dependent on type and nature of business. e.g., The trading units maintaining large stock of goods and selling the goods on credit require more working capital. The ratio of working capital changes as per the nature of industry. e.g., Gas company, electricity company require less working capital while in labour intensive industry larger working capital is required.

(2) **Size of Business :** The smaller the size of business unit, the lesser working capital is required and the greater the size and width of business the greater is the requirement of working capital.

(3) **Production Cycle :** Production cycle means time period between the procurement of raw materials and manufacturing of finished goods. As the production cycle get longer between raw materials and semi finished goods, the need of working capital is more. e.g., Cotton industry and jute industry require larger working capital as the production cycle period is long while bakery and dairy industry require comparatively less working capital because the duration of manufacturing process is short.

(4) **Production Policy and Type of Demand :** Larger working capital is required if the demand of produced goods is seasonal and business unit follows the steady production policy through out the year, e.g., Company manufacturing woollen clothes continues the production mostly for twelve months but the sales remains in winter season.

(5) **Stockpile of Rawmaterials :** Quantity of stockpile of raw materials becomes a must its sources are limited or supplying is irregular or available in a certain season only.

(6) **Credit Policy :** The need of working capital is less if the policy of sales of finished goods is on cash basis. But need of working capital increases if credit sales policy is adopted. In the same way less working capital is required if raw materials are easily available on credit and if purchase of raw materials are in cash it requires large working capital.

(7) **Conversion of Current Assets into Cash :** Less working capital is required in case of prompt collection from the debtors, sales of finished goods on cash, collection of bills receivable on the date of maturity. In converse condition, large working capital is required.

(8) **Stock Turn Over Ratio :** Less working capital is required if stock turn over rate is higher and more working capital is required if stock turn over rate is lower because working capital is blocked up in finished goods.

(9) **Operating Efficiency :** The managerial operating efficiency means getting maximum result with minimum efforts. The need of working capital can be reduced by efficient utilization of available resources and reducing or removing wastage by prompt collection.

(10) **Distribution of Profit :** The distribution of profit as dividend affects the cash because dividend is paid in cash. If company allots a major part of its profit as dividend more working capital will be required due to larger outflow of cash.

8.5 Fixed Capital

Meaning and Concept : Fixed capital means long term capital which is generally invested in business for five years or above. It is invested in fixed assets like land, building, machinery, plant, furniture etc. Thus existence of fixed capital is continued for a long period.

8.5.1 Characterstics :

(1) **Long Period :** It is invested in business for a long peirod of 5 years or above.

(2) **Different Ratio in Different Types of Business :** In the heavy industries like machinery-equipments and chemical industries the ratio of fixed capital is high. The ratio of fixed capital is relatively low in trading units.

(3) **Components :** Land, building, plant, machinery, vehicles, furniture etc. components are included in fixed capital.

(4) **Less Liquidity :** Ratio of liquidity is low as this type of capital is invested for long term in fixed assets so it can not be easily converted into cash.

(5) **Risk :** Fixed capital is blocked up in fixed assets for a longer period so risk of obsoleteness remains in it. Apart from this, changes in political, social and economic factors also tend to raise the ratio of risk.

(6) **Depreciation :** Depreciation is charged on the fixed assets in which fixed capital is invested. So the book value of fixed assets reduces.

(7) **Sources :** The sources of fixed capital are many. They can be promotors of the business, owner's of the business, various types of securities, financial institutions and ploughing back of profit, etc.

8.5.2 Factors Affecting the need of Fixed Capital :

(1) **Type and Nature of Business :** Industrial units involved in industrial activity such as shipping industry, iron and steel industry, mining industry, etc. require large fixed capital. Units providing services require comparatively less fixed capital.

(2) **Size of Unit :** Small sized units require comparatively less fixed capital than large size industrial units. Cottage industry requires less fixed capital than sugar industry or textile industry. While the units manufacturing vehicles require comparatively huge fixed capital as their size is large.

(3) **Use of Ownership/Lease :** If fixed assets like land, building, machinery are to be obtained on lease instead of purchasing, the investment of fixed capital decreases upto that extent and the risk of fixed capital also can be decreased.

(4) **Research Expense :** Industrial units have to undertake research in order to make their product more useful, to reduce the cost of production, to make the design or shape of the product attractive. Fixed capital is required for all these expenditures.

(5) **Modern Technology :** With the passage of time technology changes. Because of new inventions and modern technology old machinery has to be discarded and new machinery has to be installed.

(6) **Government Assistance and Taxation Policy :** Government provides help in form of grant or subsidy to encourage industries and for balanced growth of various regions e.g., Government may provide assistance of land and industrial shade, so, to that extent requirement of fixed capital decreases.

Taxation policy of the government also affects the need of fixed capital. There will be an attraction to purchase new machinery in place of old machinery if government imposes the liberal policy of depreciation on machinery. For this requirement of additional fixed capital becomes prompt.

(7) **Establishment Expenses :** The establishment expense of sole properietorship, partnership firm and co-operative society is less as compared to that of the formation of a company. Company has to bear expenses on preparing documents such as registration fees, fees of experts, legal expenses etc. for which fixed capital is required.

8.5.3 Difference between Fixed Capital and Working Capital :

Sr. No.	Points of Differences	Fixed Capital	Working Capital
(1)	**Meaning**	Capital invested in fixed assets such as land, building, machinery, furniture is called fixed capital.	Capital invested in current assets such as stock of raw materials and finished goods, debtors, bills receivable etc. is called working capital.
(2)	**Period**	Blocked up for a long period in business.	Blocked up for a short period in business.
(3)	**Liquidity**	Ratio of liquidity is less as it is invested for a long period in fixed assets.	Ratio of liquidity is high as converted into cash easily.
(4)	**Risk**	Ratio of risk is high.	Ratio of risk is low.
(5)	**Requirement**	Required to purchase fixed assets such as land, building, plant and machinery.	Required for day-to-day expenses like wages, salary and to purchase rawmaterials.
(6)	**Sources**	This capital is obtained through issue of shares and debentures or obtained from financial institutions.	This capital is obtained through trade credit, bank overdraft, indigenous bankers.
(7)	**Depreciation**	Depreciation is calculated on fixed assets.	Depreciation is not calculated on working capital

What did you learn in this chapter ?

Concept and Definition of Financial Management : Management of finance function, means to take decisions related to financial matter, executes it acquire acquision funds and make its optimum utilization.

Characteristics : (1) Branch of management (2) Wide scope (3) Base of managerial decisions (4) Relation with financial decisions (5) Goal of maximisation of owner's economic welfare (6) Key position (7) Relation with other areas of management (8) Division in to two parts

Objectives of Financial Management :

(a) Objective of Profit Maximisation : According to this approach company should earn maximum profit out of its available resources. Company can increase earning per share through the objective of maximisation of profit.

(b) Objective of Wealth Maximisation : The objective of wealth maximisation is also known as 'Net Present Value'. Decisions resulting in net present value should be accepted by the company. Prof. Solomon has also favoured this approach.

Importance of Financial Management : (1) Estimation of financial needs (2) Acquiring finance (3) Planning and controlling (4) Distribution of finance (5) Maintaining liquidity (6) Distribution of income (7) Management of current assets (8) Financial decisions (9) Raising credit of business

Financial Decisions :

(1) Decisions Related to Investment : Investment decision is called capital budgeting. To take the decisions regarding the selection of those assets in which capital is to be invested in future. Various methods of capital budgeting are being used in investment decisions.

(2) Decisions Related to Financing : Financing decisions are connected with the capital structure. Financial manager has to take the decision regarding the portion to be maintained equity capital and debt. Optimum capital structure is less risky and ensures maximum return.

Factors Affecting Financing Decisions : (1) Internal factors and (2) External factors

(3) Decisions Related to Dividend : Dividend is a part of profit of the company. Dividend is a return to shareholders on their investment. Financial manager has to decide what part of profit should be distributed as dividend among the shareholders and what part of profit should be retained in business. Payment of dividend affects the market value of share.

Capital Structure :

Concept and Definition : Company procures capital by issuing various type of securities. Decisions regarding type of securities are reflected in the capital structure of the company. In what proportion will be the various type of securities to be issued is determined by financial manager.

Definitions : Capital structure means the combination of different sources of capital.

Characteristics of Ideal Capital Structure : (1) Simplicity (2) Profitability (3) Adequate finance (4) Flexibility (5) Economy (6) Balancing (7) Liquidity (8) Attractiveness (9) Solvency

Types of Capital Structure : (A) Capital structure of only equity shares (B) Capital structure of preference shares with equity shares (C) Capital structure of debenture with equity shares (D) Capital structure of preference shares and debentures with equity shares

Factors Affecting Capital Structure :

(A) Internal Factors : (1) Type of business (2) Size of business (3) Estimation of business income (4) Nature and requirement of assets (5) Attitude of directors (6) Financial requirements (7) Duration of capital requirement.

(B) External Factors : (1) Condition of boom-depression in capital market (2) Present rate of interest in capital market (3) Capital cost-expenses of security issue (4) Legal restrictions (5) Taxation policy (6) Institutional investors (7) Foreign institutional investors.

Working Capital :

Meaning and Definition : Working capital is used to pay day-toda expenses. It constantly circulates in business.

Concept of Working Capital :

Definition : Working capital means the excess of current assets over current liabilities.

(1) Gross Working Capital : Sum of total investment in current assets of business means working capital.

(2) Net Working Capital : Net working capital means current assets minus current liabilities.

Difference between Gross Working Capital and Net Working Capital : (1) Meaning (2) Liquidity Position (3) Financial position and measurement (4) Increase in current liabilities

Characteristics of Working Capital : (1) Short term capital (2) Investment in current assets (3) Liquidity (4) Less risk (5) Changing form (6) To pay day-to-day expenses (7) No depreciation (8) Requirement according to type and form of business

Factors Affecting Working Capital : (1) Type of nature of business (2) Size of business (3) Production cycle (4) Production policy and type of demand (5) Stockpile of rawmaterials (6) Credit policy (7) Conversion of current assets into cash (8) Stock turn over ratio (9) Operating efficiency (10) Distribution of profit

Fixed Capital :

Meaning and Concept : Fixed capital means a long term capital which is generally invested for 5 years or above in business.

Characteristics : (1) Long term (2) Different ratio in different types of business (3) Components (4) Less liquidity (5) Risk (6) Depreciation (7) Sources

Factors Affecting the Needs of Fixed Capital : (1) Type and nature of business (2) Size of the unit (3) Use of ownership/lease (4) Research expense (5) Modern technology (6) Government assistance and taxation policy (7) Establishment expense

Difference between Fixed Capital and Working Capital : (1) Meaning (2) Period (3) Liquidity (4) Risk (5) Requirement (6) Sources (7) Depreciation.

Exercise

1. Select the correct alternative and write answer to the following questions :

(1) By which other name is the objective of wealth maximisation known ?

(A) Social Welfare (B) Capital investment (C) Net present value (D) Trading on equity

(2) On which concept is the approach to the wealth maximisation based ?

(A) Profitability (B) Social responsibility

(C) Present value of wealth (D) Cash flow

(3) With what is financial management related ?

(A) Finance function (B) Finance market (C) Capital market (D) Stock exchange

(4) Decisions of investment means ....

(A) Capital cost (B) Capital budgeting

(C) Capital structure (D) Ploughing back of profit