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BASICS OF FINANCE

MEANING OF FINANCE

Finance is called as lifeblood of an enterprise.

Money required for carrying out business activities is called business finance. Almost all business activities require some finance. Finance is needed to establish a business, to run it, to modernise it, to expand, or diversify it. Availability of adequate finance is, thus, very crucial for the survival and growth of a business.

BUSINESS FINANCE

It usually deals with financial planning, acquisition of funds, use and allocation of funds and financial controls.

FINANCIAL MANAGEMENT

Financial Management is concerned with optimal procurement as well as usage of finance.

- Financial Management aims at reducing the cost of funds procured, keeping the risk under control and achieving effective deployment of such funds.
- It also aims at ensuring availability of enough funds whenever required as well as avoiding idle finance.
- It is also called as resource management.

DEFINITIONS BY EXPERTS

- **Ezra Soloman :** "Financial Management is concerned with effective use of an important economic resource, namely capital, funds."
- **Kuchal S.C.** : "Financial Management deals with procurement of funds and their effective utilization in business

MEANING OF FINANCIAL STATEMENTS

Financial statements are the summarized statements of accounting data produced at the end of the accounting process by an enterprise. It comprises following –

- **Balance Sheet :** Also called as "Position Statement". It is statement of Assets and Liabilities at a given Date.
- **Profit and loss Account :** Also called as "Income Statement". It shows the net result of business operations during an accounting period.
- **Statement of Changes in Owner's Equity:** It shows appropriations of earnings
- **Statement of Changes in Financial Position**
  - **Cash Flow Statement:** It Shows inflow and Outflow of Cash & Cash Equivalents during an accounting period.
  - **Fund Flow Statement :** It is designed to analyse the changes in the financial condition of the enterprise.
- **Schedules and Notes to Accounts:** Schedules have details of items in the Balance Sheet and Profit & Loss a/c while Notes to Accounts are the statement of Accounting policies and explanation to material items.

SOME IMPORTANT TERMS TO BE USED-

1. **ACCOUNTING:** A systematic way of recording and reporting financial transactions**.**
2. **ASSETS :** Assets are resources with economic value that are owned by an individual or entity, with the expectation that these will generate future benefit.

3. **LIABILITIES :** Liabilitiesare legal obligation that binds an individual or entity to transfer economic benefits including money, goods, services to another individual or entity over time.
4. **CREDIT :** An Accounting entry that may either decrease assets or increase liabilities and equity on the company's Balance Sheet
5. **DEBIT :**An Accounting entry that may either increase assets or decrease liabilities and equity on the company's Balance Sheet
6. **EXPENSES :** Business expenses are the costs the company incurs to remain financially solid. For example – Rent, salaries, legal fees, audit fees etc.
7. **CAPITAL :**The Money a business has in its accounts, assets and investments is known as capital. It may be Debt Capital and Equity Capital.
8. **DEPRECIATION :**Decrease in value of assets due to normal wear & tear, obsolence etc is called as Depreciation.
9. **SHAREHOLDER'S FUNDS :** It is the value of shareholder investment in a particular company.

FINANCIAL DECISIONS

it means the selection of best financing alternative or best investment alternative. Three Broad Financial decisions are as follows –

1. **INVESTMENT DECISION -** The investment decision relates to how the firm's funds are invested in different assets. It can be Short- term or Long- Term.

- **Long – Term Investment Decision** : also called *Capital Budgeting Decision*. It involves committing the finance on a long-term basis. For example, making investment in a new machine to replace an existing one or acquiring a new fixed asset or opening a new branch etc. These decisions are very crucial for any business since they affect its earning capacity over the long run.
- **Short-Term Investment Decision :** also called *working capital decisions* are concerned with the decisions about the levels of cash, inventories and debtors. These decisions affect the day to day working of a business.

2. **FINANCING DECISIONS -** This decision is about the quantum of finance to be raised from various long-term and short-term sources of finance. It involves identification of various available sources. The main sources of funds for a firm are shareholders funds and borrowed funds.
   - Shareholders funds refer to equity capital and retained earnings.
   - Borrowed funds refer to finance raised as debentures or other forms of debt.

   A firm has to decide the proportion of funds to be raised from either source based on their basic characteristics.

3. **DIVIDEND DECISIONS -** The third important decision that every financial manager has to take relates to the distribution of dividend.
   - Dividend is that portion of profit which is distributed to shareholders.

   The decision involved here is how much of the profit earned by company (after paying tax) is to be distributed to the shareholders and how much of it should be retained in the business for meeting the investment requirements.

FINANCIAL PLANNING

A financial plan is a statement estimating the amount of capital and determining its composition.

OBJECTIVES OF FINANCIAL PLANNING

- Adequate Funds
- Balancing of Costs and Risks
- Flexibility
- Simplicity
- Long-Term View
- Liquidity
- Optimum use
- Economy

CAPITAL STRUCTURE

Capital structure means 'mix-up of various sources of funds in desired proportion'.
Capital refers to Investment of funds in the business while structure means arrangement of different components in proper proportion.

COMPONENTS OF CAPITAL STRUCTURE

Four Basic Components of Capital Structure are as follows :

1. **EQUITY SHARE CAPITAL :**
   - It is the basic source of financing activities of business.
   - Equity share

   Capital is provided by equity shareholders. They buy equity shares and help a business firm to raise necessary funds. They bear ultimate risk associated with ownership. Equity shares carry dividend at fluctuating rate, depending upon profit. Equity Shareholders are called as the "***owners of the company***".
2. **PREFERENCE SHARE CAPITAL :** Preference shares carry preferential right as to payment of dividend and have priority over, equity shares for return of capital when the company is liquidated. These shares carry dividend at a fixed rate. They have limited voting rights.
3. **RETAINED EARNINGS :** It is an internal source of financing.It is nothing but ploughing back of profits.
4. **BORROWED CAPITAL :** It consists of following –
   - DEBENTURES: A debenture is an acknowledgement of loan raised by company. Company has to pay interest at an agreed rate.
   - TERM LOANS : Term loans are provided by bank and other financial institutions. They carry fixed rate of interest .

FIXED CAPITAL

MEANING

It refers toany kind of real or physical capital i.e. fixed assets. It is not used for the production of goods. Fixed capital is that portion of total capital which is invested in fixed assets such as land, building, equipment, etc.

FACTORS AFFECTING FIXED CAPITAL REQUIREMENT

- Nature of business
- Size of business
- Growth and expansion of business
- Stage of development of business
- Business cycle

WORKING CAPITAL

MEANING

- The current assets minus current liabilities approach refers to 'net working capital'
- It is also called as **'Circulating Capital'.**

FACTORS AFFECTING WORKING CAPITAL REQUIREMENT

- Nature of business
- Size of business
- Volume of sale
- Production cycle
- Business cycle
- Terms of purchase and Sale
- Credit capital
- Growth and expansion
- Management ability
- External factors
- Requirement of cash
- Seasonal fluctuation