

FINANCE MANAGEMENT

What is Finance Management?

Definition

- The management process of getting funds from suitable sources & investing them effectively to maximize the owner's wealth is called finance management

What are the objectives & functions of finance management?

Objectives	Functions
✓ Maximize owner's wealth	✓ Plan the fund requirement
✓ Maximize the business' profits	✓ Get the required funds from appropriate sources
✓ Increase the earnings per share	✓ Use the funds effectively
✓ Ensure long term financial stability	
✓ Maintain the optimum level of liquidity	

What are the main decisions made in finance management?

1. **Investment Decisions** - the way of investing the funds (where & what to put your money in)
2. **Financing Decisions** - the way of obtaining the needed funds (where to get your money from)

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Finance Management Decisions				
Investment Decisions		Financing Decisions		
Short term	Long term	Short term	Long term	
Money mgt. Debtors Stocks Short term investments	Business modernizing Business reinstatement Business improvement Business diversification	Trade creditors Bank O/D Short term loans Payables	Capital Structure Equity Capital Loan capital Ratio on debt to equity	Dividends Retained profits Dividend allotment Internal funding sources

What are the finance planning & control instruments used?

1. Budgeting
 - I. Cash budget
 - II. Capital budgeting
2. Cash-flow statement

What is a Cash Budget & what are its sources?

The *statement prepared by indicating the expected inflows [Cash receipts] & outflows [Cash payments] of cash during a future specific time period.* The sources are;

Receipt Sources	Payment Sources
<ul style="list-style-type: none"> ✓ Cash sales ✓ Sale of non-current assets ✓ Receipts from debtors ✓ Bank loans 	<ul style="list-style-type: none"> ✓ Purchases of stocks ✓ Payment of salaries ✓ Payment of interest ✓ Purchase of non-current asset

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What are the advantages of preparing a cash budget?

- ✓ Can make effective investments if any cash surplus arising can be predicted in advance.
- ✓ Ability to prepare in advance for any anticipated cash deficits
- ✓ Finance planning through variance analysis (difference between the planned & actual cash-flow)
- ✓ Able to confirm the future financial status when obtaining loans.

What is Capital budgeting?

This is *the process of planning for the investment of existing funds most effectively in long term assets or projects expecting future returns*. In other words planning decision to maximize the future returns of current funds in long term investments.

Ex- Buying a new machine or construction of a building

What is Cash-flow statement?

This is *the statement that analyses & indicates the inflow & outflow of cash & cash equivalent during a given financial period*. A cash-flow statement can be prepared for the past (most common) & future.

What are financial needs?

These are the *fund requirements of a business arising in both short & long term*. It can be classified into 2 as;

Working capital needs	Fixed capital needs
These are <i>funds needed</i> by the business to run its <i>day to day business activities</i> . Ex- Purchase of stocks, payment of salaries & expenses	These are the <i>funds needed</i> by the business to <i>acquire non-current assets to start & run operations</i> . Ex- Purchase of building

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What are the types of working capital?

1. Gross working capital = Current Assets
2. Net working capital = Current Assets – Current liabilities

What are the factors affecting the working capital of a business?

- ✓ Nature & capacity of the business
- ✓ Production cycle
- ✓ Growth & decline of sales
- ✓ Trends & situation of demand
- ✓ Production policies
- ✓ Changes in price levels
- ✓ Policies on loans
- ✓ Availability & ability to get loans
- ✓ Efficiency of operations
- ✓ Conditions of suppliers
- ✓ Sales promotions

What are the problems arising in a business for not maintaining the appropriate working capital?

- ✓ Stagnation of business activities
- ✓ Stagnation of business growth
- ✓ Difficulties in settling current liabilities
- ✓ Being unable to implement plans
- ✓ Increased costs due to urgent borrowings at higher interest
- ✓ Loss of customers – due to lack of stocks
- ✓ Being unable payback short term debt
- ✓ Being unable to pay short term expenses
- ✓ Loss of business goodwill

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What are the steps that can be taken by a business to increase working capital?

- ✓ Increase cash sales
- ✓ Collect the receivables from debtors quickly
- ✓ Delay payments to creditors
- ✓ Reduce level of stock maintenance
- ✓ Debt factoring
- ✓ Obtain bank O/D facilities
- ✓ Reduce credit sales

How to classify sources of finance?

Based on Method	
Direct sources	Indirect sources
Share issue	Bank O/D
Debenture issue	Bank loan
Retained profits	Leasing
Accumulated depreciation	Factoring

Based on Source	
Internal sources	External sources
Retained profits	Bank O/D
Accumulated depreciation	Bank loan
Tightened control of WC	Business loan
Sale of assets	Factoring
	Share issue
	Debenture issue
	Leasing
	Hire purchase

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Based on Time	
Short term sources	Long term sources
Bank O/D	Share issue
Commercial papers	Debenture issue
Trade loans	Long term bank loans
Factoring	Mortgage loans
Credit cards	
Tightening payables	

What are the factors considered when fulfilling financial needs?

- ✓ The amount of funds needed ‘
- ✓ Period for which funds are required (long term or short term)
- ✓ Cost of financing (to obtain & maintain funds)
- ✓ Expenses incurred for keeping assets as collaterals
- ✓ Charges for advocates (legal charges)
- ✓ Nature of the business (sole, partnership, companies)
- ✓ Types of securities to be provided
- ✓ Influence on the capital structure of the business.
- ✓ Nature of the project for which the funds are invested & the expected benefits.
- ✓ Influence & impact on the management of the business.

What are the factors considered when investing money in either working or fixed capital needs?

- ✓ Returns on investment
- ✓ Risk of the investment
- ✓ Liquidity
- ✓ Environment factors
- ✓ Uncertainty
- ✓ Policies of the organization

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- ✓ Cost of the investment
- ✓ Legal conditions
- ✓ Influence on operations.

What is financial statements analysis?

This is the *process of analyzing financial statements & the information provided in it using ratios in order to make decisions by the users.*

A ratio is an index which indicates the performance & relationship of a given business. A ratio can be a percentage, fraction, simple comparison, days, time etc.

Ratios are used to help the decisions since the information as it is in the absolute figures may not project the true idea.

What are such financial statements analyzed?

- ✓ Statement of financial performance
- ✓ Statement of financial position
- ✓ Statement of changes in equity
- ✓ Statement of changes in cash-flows

What are the types of ratios calculated?

1. Profitability ratios

- Gross profit ratio*
- Net profit ratio*
- Return on investment (ROI)*
- Return on capital employed (ROCE)*

2. Performance ratios

- Stock turnover ratio*
- Debtors turnover ratio*
- Total assets turnover ratio*
- Average debt collection period*

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3. Gearing ratios

- A. Debt ratio
- B. Debt to equity ratio
- C. Interest cover

4. Liquidity ratios

- A. Current ratio
- B. Quick ratio

5. Market based ratios

- A. Earnings per share
- B. P/E ratio
- C. Earning yield

Ratio	Meaning	Calculation
Current ratio		
Quick ratio		
Inventory turnover ratio		
Debtors turnover ratio		

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Total assets turnover ratio		
Average debt collection period		
Debt ratio		
Debt to equity ratio		
Interest cover		
Gross profit ratio		
Net profit ratio		
Return on investment		

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Return on equity		
Earnings per share		
Price earnings ratio		
Earning yield		

High Gearing vs Low Gearing

High Gearing	Low Gearing
This is a situation where the <i>debt capital exceeds the equity capital</i> . IOW loan capital is higher than owner's capital	This is a situation where the <i>equity capital exceeds the debt capital</i> . IOW the owner's capital is higher than loan capital

What is the outcome of high gearing?

- ✓ High gearing is beneficial for a business with a higher level of profitability since a higher portion of profit per share can be distributed or vice-versa.
- ✓ Increased pressure & impact from loan creditors
- ✓ Difficulties in acquiring further loans

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What are the limitations of ratio analysis?

- ✓ Impact on the ratios due to limitations in financial statements
- ✓ Data & information not tallying when transactions are recorded in different ways.
- ✓ Ratios based on estimations may be wrong
- ✓ Continuous changes in the environment & figures causing negative impact on decision making.

What is financial system?

This is the *system comprising financial markets, financial institutions, financial instruments & financial infrastructure that affects & influences a country's economic decisions*. The main function under the financial system is being a “financial middleman”.

What are the elements of the financial system?

- ✓ Central bank of Sri Lanka
- ✓ Financial markets
- ✓ Financial institutions
- ✓ Financial instruments
- ✓ Financial infrastructure

What is a financial Market?

This is a *situation connecting finance borrowers & finance lenders to fulfill each other's financial requirements*.

How to classify the financial market?

1. Based on maturity of time period of financial instruments
 - +.
 - +.
2. Based on the creation of financial instruments
 - +.
 - +.

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3. Based on the nature of financial instruments
 - +
 - +
4. Based distribution of financial instruments
 - +
 - +
5. Based on the structure of the finance market
 - +
 - +
 - +

Who are financial intermediaries?

These are the *set of middleman parties that exist in the financial market to assist in the funds flow activities between borrowers & lenders*. Their income would be the difference between borrowing & lending interest rates.

What are the financial institutions functioning in the financial market?

Financial institutions are all the **banking & non-banking institutions** that are implemented in a financial market of a country. They provide a monetary & related service. Those financial institutions are classified as;

1. Bank Sector

- A. *Central Bank of Sri Lanka*
- B. *Licensed Commercial banks*
- C. *Licensed Specialized banks*

2. Other deposit taking financial institution

- A. *Licensed finance companies*
- B. *Co-operative Rural banks*
- C. *Thrift & credit co-operative societies.*

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3. Other Special financial institutions

- A. *Specialized leasing companies*
- B. *Primary Dealers*
- C. *Stock Broking Companies*
- D. *Unit Trusts / Unit Trust Management companies*
- E. *Market Intermediaries*
- F. *Venture Capital Companies*
- G. *Credit Rating Agencies*

4. Contractual Savings Institutions

- A. *Insurance Companies*
- B. *Employees' Provident Fund*
- C. *Employees' Trust Fund*
- D. *Approved Private Provident Funds*
- E. *Public Service Provident Fund*

What are the instruments exchanged in the financial market?

- ✓ Treasury Bills
- ✓ Treasury Bonds
- ✓ Ordinary Shares
- ✓ Preference Shares
- ✓ Commercial Papers
- ✓ Deposit Certificates
- ✓ Corporate Debentures

What is financial infrastructure?

This is *the payment & settlement systems* which support to ensure the proper *functioning & stability of the financial system of a country*. It comprises of;

1. Real Time Gross Settlement System (RTGS)
2. Image cheque clearing / cheque transaction system (CTS)

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3. Script less Securities Settlement System (SSSS)
4. Society for World Wide Interbank Financial Telecommunication (SWIFT)

What are the sub markets of the financial market?

1. Inter-bank call money market
2. Internal foreign exchange market
3. State securities market (Government securities)
 - A. *Treasury bills market*
 - B. *Treasury bonds market*
4. Corporate debt securities market
 - A. *Commercial paper market*
 - B. *Corporate bond market*
 - C. *Share market*

What is money market?

This is the *place or space connecting short term borrowers & short term lenders* to fulfill each other's short term financial requirements. Their requirements here don't exceed one year.

What are the sub markets of the money market?

- ✓ Inter-bank call money market
- ✓ Internal forex market
- ✓ Treasury bills market
- ✓ Commercial papers market

What is inter-bank call money market?

The market where the *short term loan demands & short-term loan supplies take place among licensed commercial banks*. The transactions are made using the reserves maintained by these banks at CBSL where banks having liquidity crisis obtaining short term loans from the banks

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having excess liquidity to fulfill their requirements under the payment condition within one day overnight is known as Inter-bank quick debt transaction.

What is internal forex market?

This is the market where *short term borrowing & lending of loans takes place using forex*. Licensed commercial banks provide this service.

Ex- issuing L/C's, releasing forex for imports etc.

What is Treasury bills market?

This is the *market dealing with treasury bills issued by CBSL*. Treasury bills are short term financial instruments issued by the CBSL to raise funds for the government. They are issued with maturity periods of 91 days, 182 days & 364 days. The market can be classified into 2 as;

1. Primary TB market

This is the market where **CBSL would sell TB's to LCB's & PD's**. Since it's sold for the first time, it's called the primary market.

2. Secondary TB market

This is the market where **LCB's & PD's who bought TB's** in the primary market from CBSL would **re-sell them to the general public** without keeping them behind till maturity.

What are the features of TB's?

- ✓ Short term financial instrument
- ✓ A script-less security
- ✓ Issued by online auctions
- ✓ Issued in Sri Lankan rupees (LKR)
- ✓ A government certified security
- ✓ Issued subject to discount

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What are the benefits of purchasing TB's?

- ✓ Comparatively higher return
- ✓ Lower level of risk
- ✓ Higher level of liquidity
- ✓ Can be discounted before maturity
- ✓ Guaranteed returns at the point of investment

What is Commercial Paper Market?

This is the *market dealing with commercial papers issued by PLC's*. A commercial paper is a collateral free short term loan borrowed by PLC's. They are negotiable instruments.

What is Capital market?

This is the *market dealing with the exchange of long term financial securities*. IOW the market dealing with long term equity & debt securities issued by PLC's & CBSL to fulfill their long term financial requirements. Here these securities mature above a period exceeding 1 year.

What are the sub markets of the capital market?

- ✓ Share market
- ✓ Corporate bond market
- ✓ Treasury bond market

What are the financial instruments traded in the capital market?

- ✓ Shares
- ✓ Debentures
- ✓ Treasury bonds
- ✓ Share warrants
- ✓ Sovereign bonds

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What is the treasury bonds market?

This is the *market dealing with treasury bonds issued by CBSL*. Treasury bonds are medium & long term financial securities issued in script-less form by the CBSL to fulfill medium & long term financial requirements for the government. The features of treasury bonds can be;

- ✓ Being medium to long term instrument
- ✓ Issued by CBSL on behalf of the government
- ✓ Being script-less
- ✓ Interest is paid bi-annually
- ✓ Being a safe loan security

What is corporate bond market?

This is the *market dealing with debentures issued by mainly PLC's*. In Sri Lanka debentures can be issued through the stock market. This market can be classified into 2 as;

1. Primary bond market
2. Secondary bond market

What is the share market?

This is the *market where shares & debentures of listed PLC's are being traded*. Listed PLC's are the companies registered at the stock market.

The share market can be classified into 2 as;

1. Primary market
 - A. IPO
 - B. SPO
2. Secondary market

What is Colombo Stock Exchange (CSE)?

This is *company limited by guarantee & being responsible for all shares & debentures trading activities of listed PLC's in Sri Lanka*. It is licensed by the security & exchange commission of Sri Lanka (SEC). It function as

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the platform for trading using ATS (automated trading system) which are facilitated through brokers. Previous system was known as DEX system.

What are the parties functioning at the CSE?

- ✓ Securities & exchange commission of Sri Lanka
- ✓ Listed PLC's
- ✓ Investors
- ✓ Stock broker firms
- ✓ Central depository system (CDS)
- ✓ Trustee banks
- ✓ Ministry of finance

What are the methods of registration at the CSE?

1. Through an IPO
2. Through an "offer for sale"
3. Through an introduction

What are the boards to list at the CSE?

Main Board	Dirisavi Board
Board for the companies with larger stated capital	Board for the companies with a limited stated capital
Conditions to list are; <ul style="list-style-type: none">✓ Stated capital not less than Rs. 500 million✓ Issued share capital should exceed 25% to the public✓ Continuous profitability for minimum 3 years✓ Net assets should be confirmed by audited reports for at least the last 2 years	Conditions to list are; <ul style="list-style-type: none">✓ Stated capital not less than Rs. 100 million✓ Issued share capital should exceed 10% to the public✓ Minimum 1 year of being in business operations✓ Net assets should be confirmed by audited reports for at least for 1 year.

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What is watch list board?

This is the *board containing companies which violate or do not follow the conditions of listing* at the CSE. The reasons can be;

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- +
- +
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Note-

What are the benefits of listing at the CSE?

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How important is a stock market to nation?

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What are the securities traded at the CSE?

- ✓ Shares
- ✓ Debentures
- ✓ Share warrants
- ✓ State bonds

What are the benefits of investing in shares?

Direct Benefits	Indirect benefits
+	+
+	+
+	+
+	+
+	+

Bonus issue vs Rights issue

Bonus Issue	Rights Issue
Existing shareholders of the company getting shares for free on a proportionate basis. Here the company's reserves are utilized for this purpose	Existing shareholders of the company getting shares at a discounted rate (price below the market price) on a proportionate basis. Discount is compensated by utilizing company reserves

What is Capitalization of Reserves?

Reserves are basically the profits earned by the company which are undistributed or unutilized. Reserves can be classified as general or specific. The *conversion process of reserves into capital is called capitalization*. The outcome would be either a bonus issue or rights issue.

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What is the central depository system (CDS)?

This is a *private limited company* owned by the CSE to handle clearing activities of transactions from shares & debentures being traded at the CSE. The functions of the CDS are;

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What is a stock market index?

This is an index used to measure & indicate the changes in share prices. The CSE uses the following 3 indices;

1. ASPI
2. S&P SL20
3. TRI

Index	Meaning	Calculation
ASPI	Index that shows the fluctuations of prices of voting ordinary shares of all the listed companies	
S&P SL20	Index that shows the fluctuations of the price levels of 20 largest & highly liquidized companies	

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TRI	Price index that compares dividends income & capital gains against price changes	
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What are the benefits of calculating price indices?

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What are the factors affecting changes in share prices?

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Bull Market vs Bear Market

Bull Market	Bear Market
This is a situation in the stock market where there is a trend of increase in overall share prices . This will encourage investors to buy more expecting further increase in prices.	This is a situation in the stock market where there is a trend of decrease in overall share prices . This will encourage investors to sell more expecting further decrease in prices.

What are the reasons that can create the above situations?

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Who are stock brokers?

These are *intermediary organizations which facilitate all securities & related transaction between listed companies & investors in a given stock exchange*. All buying & selling of securities should be done through the stock broker who earn a standard brokerage from both parties. Currently there are 15 member stock broker firms, 13 equity trading members, 6 debt trading members & 23 internet trading members registered at the CSE.

What are the functions of CSE?

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What is Securities & Exchange Commission (SEC)?

This is the *regulatory body established by the government* through the parliamentary act “**Securities & exchange commission act no-26 of 1991**” to *monitor, supervise, control & regulate the share market* in Sri Lanka. Its functions are;

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