Chapter I

INTRODUCTION
1.1.0 Financial management definition per se has undergone remarkable changes with changes in complexity and scope of business. Initially it was constructed as the function of only raising funds for business as and when required. Now, financial management has engulfed in its fold the effective and efficient deployment of funds in a manner that maximizes firm’s value.

In simple words, Financial Management does not stop at procuring the required finance at right time with minimum cost. It also extends to effective and efficient deployment of funds in order to ensure that desired stream of resources, i.e. maximizing the profits by maximizing the value of the firm; it is also concerned with maintaining adequate level of funds to smoothly carry out the day to day business transactions.

Financial management aims at maximizing firm’s value through efficient and effective mobilization of funds as well as their useful and experimental deployment. Profits earning is like churning butter from the deployment.

1.2.0 Inherently financial management i.e. management of available resources well funds known as management of funds encompasses two broad areas:

(A) Sources of Funds- the areas pertaining to Financing decisions

(B) Application of funds- the areas pertaining to investment decisions
1.2.1 Sources of funds-
This refers to the time frame for which funds are mobilized and accordingly can be categorized as:
(1) Long term Sources- Here the funds are mobilized for the time frame at least beyond a year. Naturally, perpetual funds such as equity and long term debt are included.
(2) Short Term sources- this refers to those funds mobilized which need to be paid back normally within a year ostensibly bank overdraft and trade credit are the examples of short term funds.

1.2.2 Application of funds-
This refers to the time frame for which funds are deployed and accordingly can be categorized as:
(1) Long term application- Normally the funds deployed with intention to utilize them (without the change in the form of business) for a period more than a year are treated as long term application of funds. A fixed asset belongs to this category.
(2) Short term application- the funds deployed in the business with an intention to use them in the same form for a period shorter than one year are treated as short term application of funds. Current assets such as inventory, accounts receivables are the important examples of short term applications.

1.3.0. MANAGEMENT OF FUNDS AFFECTS SURVIVAL-
There exists a general belief that funds procured from a long term sources should be used for a long term applications and funds obtained from short term sources should be used for short term
applications in order to avoid crisis of payment or extra costs otherwise
generated by a mismatch. However, it is widely believed management
of funds, with or without mismatch, affects the profitability and
therefore survival of the business enterprise.

Academia has widely visited the capital structure and working capital
management in order to explain their effects on profitability and
 dividends of business enterprise.

1.3.1. CAPITAL STRUCTURE-

“Capital structure is the proportion of debate instrument and
preferred and common stock on a company’s balance sheet.” In
simple words capital structure can be finance mix adopted by the
business enterprise as per their needs.

Capital structure of the company assumes importance through
its relationship with the cost of capital- which has a direct influence on
the profits of the company. In addition, coast of capital is an important
input element while arriving at series of capital investment decisions
that affects the profitability, so as the dividend decisions, therefore the
market reputation and value of a firm. In this respect the available
literature brings mainly two approaches- one the traditional approach
and another – the modern approach advocating the irrelevance
theorem.

(A) TRADITIONAL APPROACH-

This approach advocates that:

(i) The average cost of capital decreases up to a certain point
for an increase in the debt component.

(ii) The average cost of capital remains more or less unchanged
for moderate increases in the debt component thereafter.
(iii) The average cost of capital raises beyond a certain point for further in the debt components.

The principal implication of this approach can be summarized as “cost of capital is influenced by capital structure and there is an optimal capital structure which minimizes the cost of capital. At the optimal capital structure, the real marginal coast of debt and equity is same.

(B) MODERN APPROACH-

In 1958, Franco Modigliani and Merton Miller laid foundation of capital structure theory advocating that the cost of capital of a company is independent of its capital structure. They explained their theory under the principal assumptions of perfect capital market existence. Means there is no corporate taxation and all business firms can be categorized into different classes based on their risks and return profile. Their capital structure irrelevance theorem advocates that the firm’s choice as long as it does not affect the profitability distribution of total cash flows to the firm should not affect the firm’s market value.

This approach, popularly known as MM approach, in its landmark contribution to modern theory of financial management, clearly dividend the finance arena in to two: One advocating relevance theorem for cost of capital and capital structure, the other advocating irrelevance theorem for cost of capital and capital structure.

In nutshell, management of funds has its influence on the profitability of business enterprise. This study is undertaken to empirically examine whether there exists a relationship between management of funds and profitability of the business enterprise.