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**17CCU603A      FUNDAMENTALS OF FINANCIAL MANAGEMENT**

**SCOPE:**

Financial Management represents how the finances are managed and their reflections on the fundamental decisions to be taken by the corporate and finance world. This paper presents the basics of finance functions, cost of capital and working capital management.

**OBJECTIVE:**

- To familiarize the students with the principles and practices of financial management.

**UNIT -I**

**Introduction:** Nature, Scope and objectives of Financial Management, Time value of money, Risk and Return (including Capital Assets Pricing Model), Valuation of Securities- Bonds and Equities.

**UNIT- II**

**Investment Decision:** The Capital Budgeting Process, Cash flow Estimation, Payback Period Method, Accounting Rate of Return, Net Present Value (NPV), Net Terminal Value, Internal Rate of Return (IRR), Profitability Index, Capital Budgeting Under Risk- Certainty Equivalent Approach and Risk- Adjusted Discount Rate.

**UNIT- III**

**Financing Decisions:** Cost of Capital and Financing Decision: Sources of Long-term financing Estimation of components of cost of capital, Methods for Calculating cost of Equity capital, Cost of Retained Earnings, Cost of Debt and Cost of Preference Capital, Weighted Average Cost of Capital (WACC) and Marginal cost of capital. Capital Structure- Theories of Capital Structure (Net Income, Net Operating Income, MM Hypothesis, Traditional Approach). Operating and Financial Leverage, Determinants of Capital Structure.

**UNIT- IV**

**Dividend Decisions:** Theories for Relevance and Irrelevance of Dividend Decision for Corporate valuation; cash stock Dividends policies in Practices.

## UNIT-V

**Working Capital Decisions:** Concepts of Working capital, the risk – return trade off, sources of short-term finance, working capital estimation, cash management, receivables management, inventory management and Payable Management.

### **Suggested Readings:**

1. S.N.Maheswari (2008). Financial Management. New Delhi, Sultan Chand & Sons

### **Reference Books:**

1. James C.Van Horn and Sanjay Dhamija. (2012). *Financial Management policy*. (12<sup>th</sup> Ed). New Delhi, Pearson Education.
2. Levy H. and M.Sarnat(2004). *Principles of Financial management*. New Delhi, Pearson Education.
3. Joy.O.M(2007). *Introduction to financial management*. New Delhi, TataMC Graw Hill Education
4. Singh. J.K. *Financial Management-text and Problems*. [ 2<sup>nd</sup> Ed] New, Dhanpat Rai and Company.
5. Rustagi, R.P. *Fundamentals of Financial Management*. New Delhi, Taxmann Publication Pvt. Ltd.
6. Pandey,I.M. *Financial Management*. [9<sup>th</sup> Edition]. New Delhi, Vikas Publications.

**KARPAGAM ACADEMY OF HIGHER EDUCATION**

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(For the candidates admitted from 2018 onwards)

**LECTURE PLAN****DEPARTMENT OF COMMERCE (CA)**

S. No.	Lecture Duration (Period)	Topics to be Covered UNIT-I	Support Materials
1	1	Introduction, Meaning & Definition of Financial Management,	R <sub>6</sub> : 1.1 -1.2
2	1	Nature and Scope of FM	R <sub>6</sub> : 1.3
3	1	Objectives and importance of FM	R <sub>6</sub> :1.3-1.6
4	1	Functions of FM	R <sub>6</sub> :1.7-1.9
5	1	Functions or Modern function of FM	R <sub>6</sub> :1.9-1.10
6	1	Goals of FM	R <sub>6</sub> : 1.11
7	1	Approaches of FM	R <sub>6</sub> :1.12
8	1	Time value of Money	R <sub>6</sub> :1.15-1.19
9	1	Risk and Return (including Asset Pricing Model)	R <sub>6</sub> :1.22-1.25
10	2	Valuation of Securities & Bonds and Equities	R <sub>6</sub> : 3.16-3.119
11	1	Recapitulation and Discussion of important questions	
		<b>Total No. of Hours Planned for Unit-I</b>	12

S. No.	Lecture Duration (Period)	Topics to be Covered UNIT-II	Support Materials
1	1	Meaning of investment decisions	R <sub>6</sub> : 2.32-33
2	1	Capital budgeting: Meaning, Definition, Nature	R <sub>6</sub> :2.34-35
3	1	Significance & objectives of Budgeting	R <sub>6</sub> :2.35-37
4	1	Methods of Capital Budgeting	R <sub>6</sub> :2.39-41
5	1	Cash flow estimation, payback period method,	R <sub>6</sub> :2.41-44
6	1	Accounting Rate of Return, NPV	R <sub>6</sub> :2.45-46
7	1	Net terminal value, IRR	R <sub>6</sub> :2.46-47
8	1	Difference between NPV & IRR	R <sub>6</sub> :2.47-55
9	1	Profitability index, Capital budgeting under Risk	R <sub>6</sub> :2.51-53
10	1	Certainty Equivalent Approach	R <sub>6</sub> :2.61-67
11	1	Risk Adjusted Discount Rate	R <sub>6</sub> :2.59-61
12	1	Recapitulation and Discussion of important questions	
		<b>Total No. of Hours Planned for Unit-II</b>	12

## Lecture Plan 2017-2020

S. No.	Lecture Duration (Period)	Topics to be Covered <b>UNIT-III</b>	Support Materials
1	1	Financing Decisions: meaning of Cost of Capital	R <sub>6</sub> :3.105-3.107
2	1	Source of long-term financing	R <sub>6</sub> :3.107-110
3	1	Components of cost of capital	R <sub>6</sub> :3.132-133
4	1	Methods for calculating cost of Equity capital	R <sub>6</sub> :3.138-140
5	1	Cost of retained earnings, cost of debt, cost of preference shares	R <sub>6</sub> :3.134-136
6	1	WACC- Weighted Average Cost of Capital, Marginal cost of capital	R <sub>6</sub> :3.145-148
7	1	Capital Structure: Introduction, Meaning and Definition	R <sub>6</sub> :3.120-121
8	1	Net Income Approach, Net Income Approach	R <sub>6</sub> :3.121-123
9	1	Modigliani-Miller Approach, Tradi Approach	R <sub>6</sub> :3.124-128
10	1	Financial Leverage , Meaning, Definition, Function, Significant,	R <sub>6</sub> :2.169-175
11	1	Problems of FL, Determinants of CS	R <sub>6</sub> :2.175-180
12	1	Recapitulation and Discussion of important questions	
		<b>Total No. of Hours Planned for Unit-III</b>	12

S. No.	Lecture Duration (Period)	Topics to be Covered <b>UNIT-IV</b>	Support Materials
1	1	Dividend Decisions: Introduction, Concepts of Dividend	R <sub>6</sub> :4.160-163
2	1	Types of Dividend n Bonus Share, Factors affecting Dividend policy	R <sub>6</sub> :163-165
3	1	Types of Dividend Policy	R <sub>6</sub> :165-168
4	1	Relevance of Dividends for corporate valuation	R <sub>6</sub> :168-169
5	1	Walter's model	R <sub>6</sub> :172-176
6	1	Gordon Model	R <sub>6</sub> :177-179
7	1	Residual theory of dividends	R <sub>6</sub> :179-180
8	1	MM Hypothesis	R <sub>6</sub> :169-172
9	1	Irrelevance of Dividends for corporate valuation	R <sub>6</sub> :172-185
10	1	Cash and stock dividends	R <sub>6</sub> :185-184
11	1	Dividend policies in practices	R <sub>6</sub> :186
12	1	Recapitulation and Discussion of important questions	
		<b>Total No. of Hours Planned for Unit-IV</b>	12

S. No.	Lecture Duration (Period)	Topics to be Covered UNIT-V	Support Materials
1	1	Working Capital: Introduction, Meaning, Definition of WC	R <sub>6</sub> :179-189
2	1	Concepts of Working Capital- Gross, Net WC	R <sub>6</sub> :181-184
3	1	The risk-return trade off,	R <sub>6</sub> :185
4	1	Types of WC- Permanent and Temporary of WC	R <sub>6</sub> :181-184
5	1	Determinants of WC	R <sub>6</sub> :184-157
6	1	Computation of Working Capital-Problems	R <sub>6</sub> :187-189
7	1	Short-term finance , working capital estimation	R <sub>6</sub> :189-191
8	1	Cash Management, Receivables management. Inventory Management & Payable Management	R <sub>6</sub> :195-199
9	1	Recapitulation and Discussion of important questions	
10	1	<b>Discussion of Previous Year ESE Question paper</b>	
11	1	<b>Discussion of Previous Year ESE Question paper</b>	
12	1	<b>Discussion of Previous Year ESE Question paper</b>	
		<b>Total No. of Hours Planned for Unit-V</b>	12

**FINANCIAL MANAGEMENT**

**UNIT -I**

**SYLLABUS**

**Introduction:** Nature, Scope and objectives of Financial Management, Time value of money, Risk and Return (including Capital Assets Pricing Model), Valuation of Securities- Bonds and Equities.

**Definition of Financial Management:** It refers to the mobilization of the funds and putting the same into an efficient and effective use (utilization) in the form of productive investments where the objectives of wealth maximization of the shareholders are accomplished. Thus the objective is not only to maximize the wealth of the Equity shareholders but also to create Value to them via;

- Economic Value Addition to the shareholders
- Making sure that Free Cash Flows are available to the equity investors cum
- To ensure that the Free cash flows are also available to the firm.

**Objectives of Financial Management:**

The aims of financial management should be useful to the firm's proprietors, managers, employees and consumers. For this purpose the only way is maximization of firm's value. The following aspects have place in maximizing firm's value:

**(i) Raise in profits:**

If the firm wants to maximize its value, it should increase its profits and revenues. For this purpose increase of sales volume or other activities can be taken up. It is the general feature of any firm to increase profits by proper utilization of all opportunities and plans.

Theoretically, firm gets maximum profits if it is under equilibrium. At that stage the average cost is minimal and the marginal cost and the marginal revenues are equal. Here, we can't say the sales because there must be suitable market for the increased sales. Further, the above costs must also be controlled.

**(ii) Reduction in cost:**

Capital and equity funds are utilized for production. So all types of steps should be taken to reduce firm's cost of capital.

**(iii) Sources of funds:**

It should be decided by keeping in view the value of the firm to collect funds through issue of shares or debentures.

**(iv) Reduce risks:**

There won't be profits without risk. But for this reason if more risk is taken, it may become danger to the existence of the firm. Hence risk should be reduced to minimum level.

**(v) Long run value:**

It should be the feature of financial management to increase the long-run value of the firm. To earn more profits in short time, some firms may do the activities like releasing of low quality goods, neglecting the interests of consumers and employees.

(vi) To ensure regular and adequate supply of funds to the concern.

(vii) To ensure adequate returns to the shareholders this will depend upon the earning capacity, market price of the share, expectations of the shareholders.

(viii) To ensure optimum funds utilization. Once the funds are procured, they should be utilized in maximum possible way at least cost.

(ix) To ensure safety on investment, i.e, funds should be invested in safe ventures so that adequate rate of return can be achieved.

**Scope of Financial management:**

The scope of financial management includes three groups.

(i) Relating to finance and cash

(ii) Raising of fund and their administration

(iii) Efficient and effective utilization of the funds



Thus the Financial management plays two main roles;

- a) Participating in funds utilization and controlling productivity
- b) Identifying the requirements of funds and selecting the sources for those funds. Liquidity, profitability and management are the functions of financial management.

**a) Liquidity :**

Liquidity can be ascertained through the three important considerations.

**(i) Forecasting of cash flow:** Cash inflows and outflows should be equalized for the purpose of liquidity.

**(ii) Rising of funds:** Finance manager should try to identify the requirements and increase of funds.

**(iii) Managing the flow of internal funds:** Liquidity at higher degree can be maintained by keeping accounts in many banks. Then there will be no need to depend on external loans.

**b) Profitability:**

While ascertaining the profitability the following aspects should be taken into consideration:

**a) Cost of control:** For the purpose of controlling costs, various activities of the firm should be analyzed through proper cost accounting system,

b) **Pricing:** Pricing policy has great importance in deciding sales level in company's marketing. Pricing policy should be evolved in such a way that the image of the firm should not be affected.

c) **Forecasting of future profits:** Often estimated profits should be ascertained and assessed to strengthen the firm and to ascertain the profit levels.

d) **Measuring the cost of capital:** Each fund source has different cost of capital. As the profit of the firm is directly related to cost of capital, each cost of capital should be measured.

**C) Management:** It is the duty of the financial manager to keep the sources of the assets in maintaining the business. Asset management plays an important role in financial management. Besides, the financial manager should see that the required sources are available for smooth running of the firm without any interruptions.

A business may fail without financial failures. Financial failures also lead to business failure. Because of this peculiar condition the responsibility of financial management increased. It can be divided into the management of long run funds and short run funds.

Long run management of funds relates to the development and extensive plans. Short run management of funds relates to the total business cycle activities. It is also the responsibility of financial management to coordinate different activities in the business. Thus, for the success of any firm or organization financial management is said to be a must.

**APPROACHES TO FINANCIAL MANAGEMENT** Financial management approach measures the scope of the financial management in various fields, which include the essential part of the finance. Financial management is not a revolutionary concept but an evolutionary. The definition and scope of financial management has been changed from one period to another period and applied various innovations. Theoretical points of view, financial management approach may be broadly divided into two major parts.

**(I) Traditional Approach:** Traditional approach is the initial stage of financial management, which was followed, in the early part of during the year 1920 to 1950. This approach is based on the past experience and the traditionally accepted methods. Main part of the traditional approach is rising of funds for the business concern. Traditional approach consists of the following important area and arrangement of funds from lending funds through various financial instruments.

**(II) Modern Approach:** Finance function is one of the major parts of business organization, which involves the permanent and continuous process of the business concern. Finance is one of the interrelated functions which deal with personal function, marketing function, production function and research and development activities of the business concern. At present, every business concern concentrates more on the field of finance because, it is a very emerging part which reflects the entire operational and profit ability position of the concern. Deciding the proper financial function is the essential and ultimate goal of the business organization. Finance manager is one of the important role players in the field of finance function. He must have entire

knowledge in the area of accounting, finance, economics and management. His position is highly critical and analytical to solve various problems related to finance.

**Functions of finance manager**

A person who deals finance related activities may be called finance manager. Finance manager performs the following major functions:

**a) Forecasting Financial Requirements:** It is the primary function of the Finance Manager. He is responsible to estimate the financial requirement of the business concern. He should estimate, how much finances required to acquire fixed assets and forecast the amount needed to meet the working capital requirements in future.

**b) Acquiring Necessary Capital After deciding the financial requirement:** the finance manager should concentrate how the finance is mobilized and where it will be available. It is also highly critical in nature.

**C) Investment Decision:** The finance manager must carefully select best investment alternatives and consider the reasonable and stable return from the investment. He must be well versed in the field of capital budgeting techniques to determine the effective utilization of investment. The finance manager must concentrate to principles of safety, liquidity and profitability while investing capital.

**(d) Cash Management Present days:** cash management plays a major role in the area of finance because proper cash management is not only essential for effective utilization of cash but it also helps to meet the short-term liquidity position of the concern.

**E) Interrelation with Other Departments:** Finance manager deals with various functional departments such as marketing, production, personnel, system, research, development, etc. Finance manager should have sound knowledge not only in finance related area but also well versed in other areas. He must maintain a good relationship with all the functional departments of the business organization.

**Functions of Financial Management :**

**(i) Estimation of capital requirements:** A finance manager has to make estimation with regards to capital requirements of the company. This will depend upon expected costs and profits and future programs and policies of a concern. Estimations have to be made in an adequate manner which increases earning capacity of enterprise.

**(ii) Determination of capital composition:** Once the estimation have been made, the capital structure have to be decided. This involves short- term and long- term debt equity analysis. This will depend upon the proportion of equity capital a company is possessing and additional funds which have to be raised from outside parties.

**(iii) Choice of sources of funds:** For additional funds to be procured, a company has many choices like

- Issue of shares and debentures
- Loans to be taken from banks and financial institutions
- Public deposits to be drawn like in form of bonds.

Choice of factor will depend on relative merits and demerits of each source and period of financing.

**(iv) Investment of funds:** The finance manager has to decide to allocate funds into profitable ventures so that there is safety on investment and regular returns is possible.

**(v) Disposal of surplus:** The net profits decision have to be made by the finance manager. This can be done in two ways:

**(vi) Dividend declaration:** It includes identifying the rate of dividends and other benefits like bonus.

**(vii) Retained profits** - The volume has to be decided which will depend upon expansional, innovational, diversification plans of the company.

**(viii) Management of cash:** Finance manager has to make decisions with regards to cash management. Cash is required for many purposes like payment of wages and salaries, payment of electricity and water bills, payment to creditors, meeting current liabilities, maintenance of enough stock and the purchase of raw materials.

**(ix) Financial controls:** The finance manager has not only to plan, procure and utilize the funds

but he also has to exercise control over finances. This can be done through many techniques like ratio analysis, financial forecasting, cost and profit control.

**(x) To plan a sound capital structure:** There should be sound and fair composition of capital so that a balance is maintained between debt and equity capital.

**Contemporary Scenario:** Contemporary organizations need to practice cost control if they are to survive the recessionary times. Given the fact that many top tier companies are currently mired in low growth and less activity situations, it is imperative that they control their costs as much as possible. This can happen only when the finance function in these companies is diligent and has a hawk eye towards the costs being incurred. Apart from this, companies also have to introduce efficiencies in the way their processes operate and this is another role for the finance function in modern day organizations.

There must be synergies between the various processes and this is where the finance function can play a critical role. Lest one thinks that the finance function, which is essentially a support function, has to do this all by themselves, it is useful to note that, many contemporary organizations have dedicated project office teams for each division, which perform this function.

In other words, whereas the finance function oversees the organizational processes at a macro level, the project office teams indulge in the same at the micro level. This is the reason why finance and project budgeting and cost control have assumed significance because after all, companies exist to make profits and finance is the lifeblood that determines whether

organizations are profitable or failures.

**Goals of Finance Function:** The Goals of finance functions are as follows.

(I)Investment Decision (II) Financing Decision (III) Dividend decision

**a)Investment Decision** : Investment decisions includes investment in fixed assets (called as capital budgeting). Investment in current assets are also a part of investment decisions called as working capital decisions. One of the most important finance functions is to intelligently allocate capital to long term assets. This activity is also known as capital budgeting. It is important to allocate capital in those long term assets so as to get maximum yield in future. Following are the two aspects of investment decision.

- a)Evaluation of new investment in terms of profitability
- b) Comparison of cut off rate against new investment and prevailing investment.

Since the future is uncertain therefore there are difficulties in calculation of expected return. Along with uncertainty comes the risk factor which has to be taken into consideration. This risk factor plays a very significant role in calculating the expected return of the prospective investment. Therefore while considering investment proposal it is important to take into consideration both expected return and the risk involved.

Investment decision not only involves allocating capital to long term assets but also involves decisions of using funds which are obtained by selling those assets which become less profitable



and less productive. It wise decisions to decompose depreciated assets which are not adding value and utilize those funds in securing other beneficial assets. An opportunity cost of capital needs to be calculating while dissolving such assets. The correct cut off rate is calculated by using this opportunity cost of the required rate of return (RRR)

**(II) Financial Decision:** Financial decision is yet another important function which a financial manger must perform. It is important to make wise decisions about when, where and how should a business acquire funds. Funds can be acquired through many ways and channels. Broadly speaking a correct ratio of an equity and debt has to be maintained. This mix of equity capital and debt is known as a firm's capital structure.

A firm tends to benefit most when the market value of a company's share maximizes this not only is a sign of growth for the firm but also maximizes shareholders wealth. On the other hand the use of debt affects the risk and return of a shareholder. It is more risky though it may increase the return on equity funds.

A sound financial structure is said to be one which aims at maximizing shareholders return with minimum risk. In such a scenario the market value of the firm will maximize and hence an optimum capital structure would be achieved. Other than equity and debt there are several other tools which are used in deciding a firm capital structure.

**(III) Dividend Decision:**

Earning profit or a positive return is a common aim of all the businesses. But the key function a

financial manager performs in case of profitability is to decide whether to distribute all the profits to the shareholder or retain all the profits or distribute part of the profits to the shareholder and retain the other half in the business.

It's the financial manager's responsibility to decide an optimum dividend policy which maximizes the market value of the firm. Hence an optimum dividend payout ratio is calculated. It is a common practice to pay regular dividends in case of profitability. Another way is to issue bonus shares to existing shareholders.

#### **(IV) Liquidity Decision :**

It is very important to maintain a liquidity position of a firm to avoid insolvency. Firm's profitability, liquidity and risk all are associated with the investment in current assets. In order to maintain a tradeoff between profitability and liquidity it is important to invest sufficient funds in current assets. But since current assets do not earn anything for business therefore a proper calculation must be done before investing in current assets.

Current assets should properly be valued and disposed of from time to time once they become non profitable. Current assets must be used in times of liquidity problems and times of insolvency.

**PROFIT MAXIMIZATION** - As one of the Principle Objective of the Firm :

In the conventional theory of the firm, the principle objective of a business firm is to maximize

profit. Under the assumptions of given taste and technology, price and output of a given product under competition are determined with the sole objective of maximization of profit. Profit maximization refers to the maximization of income of the firm. Under profit maximization objective, business firms attempt to adopt those investment projects, which yields larger profits, and drop all other unprofitable activities. In maximizing profits, input-output relationship is crucial, either input is minimized to achieve a given amount of profit or the output is maximized with a given amount of input. Thus, this objective of the firm enhances productivity and improves the efficiency of the firm.

**Arguments towards Profit Maximization:**

The conventional theory of the firm defends profit maximization objective on the following grounds

- (i) In a competitive market only those firms survive which are able to make profit. Hence, they always try to make it as large as possible. All other objectives are subjected to this primary objective.
- (ii) Profit maximization objective is a time-honored objective of a firm and evidence against this objective is not conclusive or unambiguous.
- (iii) Though not perfect, profit is the most efficient and reliable measure of the efficiency of a firm.

(iv) Under the condition of competitive market, profit can be used as a performance evaluation criterion, and profit maximization leads to efficient allocation of resources.

(v) Profit maximization objective has been found extremely accurate in predicting certain aspect of firm's behavior and trends; as such the behavior of most firms are directed towards the objective of profit maximization.

**Arguments against Profit Maximization:**

(i) There are quantitative difficulties associated with profit. Maximization of profits as a financial objective requires the profit to be defined and measured accurately, and that all the factors contributing to it are known and can be taken into account. It is very doubtful that this requirement can be met on a regular basis.

(ii) The second problem is in terms of timescale over which the profit should be maximized. Should profit be maximized in the short term or the long term? Given that profit considers one year at a time, the focus is likely to be on short-term profit maximization at the expense of long-term investment, putting the long-term survival of the company into doubt. There are many examples of companies going into liquidation shortly after declaring high profits. Therefore it would be inappropriate to concentrate efforts on maximizing the accounting profit.

**WEALTH MAXIMIZATION:** As one of the principle objective of the firm

The wealth maximization objective is almost universally accepted goal of a firm. According to

this objective, the managers should take decisions that maximize the shareholders' wealth. In other words, it is to make the shareholders as rich as possible. Shareholders' wealth is maximized when a decision generates net present value. The net present value is the difference between present value of the benefits of a project and present value of its costs. A decision that has a positive net present value creates wealth for shareholders and a decision that has a negative net present value destroys wealth of shareholders. Therefore, only those projects which have positive net present value should be accepted. The Projects likely to have a positive net present value increases their wealth. Investors pay higher price for shares of a company which undertakes projects with positive net present value. As a result, wealth maximization is reflected in the market price of shares. Based on this logic, stock price maximization is equivalent to shareholders wealth maximization.

**SUPERIORITY OF WEALTH OVER PROFIT MAXIMIZATION:** The following are the arguments that supports that the wealth is far superior to that of the profit maximization objective and the arguments are as follows.

(i)Wealth maximization is based on cash flows and not profits. Unlike the profits, cash flows are exact and definite and therefore avoid any ambiguity associated with accounting profits.

(ii)Profit maximization presents a narrow spectrum when it is compared to wealth maximization. Short term profit maximization can be achieved by the managers at the cost of long term sustainability of the business.

(iii) Wealth maximization considers the time value of money. It is important as well to know about that an INR today and an INR dollar one year latter do not have the same value. In wealth maximization, the future cash flows are discounted at an appropriate discounted rate to represent their present value.

(iv) Wealth maximization criterion considers the risk and uncertainty factor while considering the discounting rate. The discounting rate reflects both time and risk. Higher the uncertainty, the discounting rate is higher and vice-versa.

(v) The Objective of the business concern is to improve the value or wealth of the shareholder

(vi) The Wealth Maximization compares the value to cost associated with the business concern.

(vii) Wealth maximization consider both the factors namely the Time and the Risk

(viii) Wealth Maximization provides efficient allocation of resource

(ix) Wealth Maximization ensures the economic interest of the society

State the Points of Distinction Between Profit and Wealth Maximization :

**Profit Maximization:**

(i) It talks volume about the maximum profit to be earned during the time period .

(ii) The Investment , Financing and Dividend decision are all centered towards maximization of the profit only

(iii) It ignores the Time Value of money

(iv) It ignores the risk Factor also

(v) In the Long run it proves disastrous and also unviable for the firms

(vi) In a new business environment this objective is rather unrealistic, difficult and also inappropriate

(vii) The concept is vague

(viii) The focus is only for short term

**Wealth Maximization:**

(i) To maximize the market value of the firm's shares

(ii) Maximizes the Net Present value of a course of action to the shareholders

(iii) The Time value of money and the risk is given due weight age prior to making the Investment decision

(iv) The benefits are measured in terms of Cash Flows

(v) It takes gives due consideration in the areas of Shareholder, Employees and Lender's interest

(vi) It facilities fair return to the Shareholders

(vii) It also brings Financial discipline in the management in terms of building up enough

reserves towards investing the same via Expansion (or) Modernization program of the firm.

(viii) It maintains the market price of the share of the firms

(ix) It emphasis on the concept of regular dividend payment to the equity shareholders of the corporate. Thus the Focus is on Long term.

**IMPORTANCE OF FINANCIAL MANAGEMENT:** Finance is the lifeblood of business organization. It needs to meet the requirement of the business concern. Each and every business concern must maintain adequate amount of finance for their smooth running of the business concern and also maintain the business carefully to achieve the goal of the business concern. The business goal can be achieved only with the help of effective management of finance.

**(I)Financial Planning:** Financial management helps to determine the financial requirement of the business concern and leads to take financial planning of the concern. Financial planning is an important part of the business concern, which helps to promotion of an enterprise.

**(II)Acquisition of Funds:** Financial management involves the acquisition of required finance to the business concern. Acquiring needed funds play a major part of the financial management, which involve possible source of finance at minimum cost.

**(III)Proper Use of Funds:** Proper use and allocation of funds leads to improve the operational efficiency of the business concern. When the finance manager uses the funds properly, they can reduce the cost of capital and increase the value of the firm. Financial Decision Financial



management helps to take sound financial decision in the business concern. Financial decision will affect the entire business operation of the concern. Because there is a direct relationship with various department functions such as marketing, production personnel.

**(IV)Improve Profitability:** The Profitability of the concern purely depends on the effectiveness and proper utilization of funds by the business concern. Financial management helps to improve the profitability position of the concern with the help of strong financial control devices such as budgetary control, ratio analysis and cost volume profit analysis.

**(V)Increase the Value of the Firm:** Financial management is very important in the field of increasing the wealth of the investors and the business concern. Ultimate aim of any business concern will achieve the maximum profit and higher profitability leads to maximize the wealth of the investors as well as the nation.

**(VI) Promoting Savings:** Savings are possible only when the business concern earns higher profitability and maximizing wealth. Effective financial management helps to promoting and mobilizing individual and corporate savings.

### **CAPITAL ASSETS PRICING MODEL (CAPM)**

**Definition of CAPM :** The required rate of return of an asset is having a linear relationship with asset's beta value which represents the un diversifiable (or) systematic risk .

#### **Assumptions of CAPM Model:**

1. An individual seller (or) buyer cannot affect the price of a stock. This assumption is the basic assumption of the perfectly competitive market.
2. Investors make their decisions only on the basis of the expected returns , standard deviations and co-variances of all pairs of securities.
3. Investors are assumed to have homogeneous expectations during the decision making period The investor can lend (or) borrow any amount of funds at the riskless rate of interest. The riskless rate of interest is the rate of interest offered for Treasury bills (or) Government securities.
4. Assets are infinitely divisible. The investor could buy any quantity of share
5. There is no transaction costs
6. There is no personal income tax
7. Un-limited quantum of short sales is allowed. Any amount of shares an individual can sell short.

**CAPM MODEL:** All investors hold only the market portfolio and riskless securities. The market portfolio is a portfolio consists of all stocks in the market. Each asset is held in proportion to its market value to the total value of all risky assets . The investors have the ability to borrow (or) lend any amount of money at the riskless rate of interest.

**Efficient Frontier:** The investor prefers any point between B & C because with the same level of risk they face on line BA , they are able to get superior profits. The ABC line shows the

investor's portfolio of risky assets . The investors can combine riskless asset either by lending (or) borrowing .

### **CAPITAL MARKET LINE (CML)**

Analysis: The line  $R_f S$  represents all possible combination of riskless and risky asset. The "S" portfolio does not represent any riskless asset but the line  $R_f S$  gives the combination of the both. The Portfolio along the path  $R_f S$  is called as Lending portfolio . This is some money is invested in the riskless asset (or) may be deposited in the bank for a fixed rate of interest. If it crosses the point "S" it becomes the borrowing portfolio . Money is borrowed and invested in the risky asset. The straight line is called as CML. It gives the desirable set of investment opportunities between the risk free and risky investments . The CML represents a Linear relationship between the required rates of return for efficient portfolios and their standard deviations . Thus for a portfolio on the CML the expected rate of return in excess of the risk free rate is in proportion to the standard deviation of the market portfolio . The price of the risk is given by the slope of the line. The slope equals the risk premium for the market portfolio .  $(R_m - R_f) / \text{standard deviation of the market}$  .

**Bonds:** Bond is a Long term debt instrument that promises to pay a fixed annual sum of interest for a specified period of time .

**Features (or) the Attributes of Bond :**

1. Bond has a Face value. The Face value is called as Par value. The bonds may be issued at par (or) at Discount (or) at Premium.
2. The interest rate is fixed. Sometimes it may be variable as in the case of floating rate bond. Interest is paid semi-annually (or) annually. The Interest rate is termed as coupon rate . The interest rate is specified in the certificate.
3. The maturity date of the bond is usually specified at the time of issue except in case of perpetual bonds. d)The redemption value is also stated in the bonds. The redemption value may be at par value (or) at a Premium. e) Bonds are traded in the stock market. When they are traded the market value may be at par (or) at Premium (or) at discount . The market and the redemption value need not be one at the same.

**Characteristics of a Bond**

- A bond is generally a form of debt which the investors pay to the issuers for a defined time frame. In a layman's language, bond holders offer credit to the company issuing the bond.
- Bonds generally have a fixed maturity date.
- All bonds repay the principal amount after the maturity date; however some bonds do pay the interest along with the principal to the bond holders.

**Definition of Immunization of Bond:** It is a technique that makes the bond portfolio holder to be relatively certain about the promised stream of Cash Flows. The Bond interest Rate risk arises from the changes in the Market Interest Rate. The Market Interest Rate affects the Coupon Rate (Interest Rate) and also the price of the bond. In an Immunization process the Coupon Rate risk and the Price Risk can be made to offset each other. When there is an increase in the Market Interest Rate the Prices of the bond will fall. At the Same time the newly issued Bonds offer higher Interest Rate. The Coupon can be reinvested in the bonds offering higher interest rate and losses that occur due to the fall in the price of the bond can be offset and the portfolio is said to be Immunized.

**Interest Rate Sensitivity:** Investors are concerned about the sensitivity of bond prices to changes in market rates. The following Bond- Pricing relationships throw light on the determinants of that sensitivity.

- (i) There is an inverse relationship between bond prices and yields. (ii) An increase in Yield causes a proportionately smaller price change than a decrease in yield of the same magnitude.
- (iii) Prices of Long term bonds are more sensitive to interest rate changes than prices of Short term bonds (iv) As maturity increases, Interest rate risk increases but at a decreasing rate (v) Prices of Low-coupon bonds are more sensitive to interest rate changes than prices of high coupon bonds. (vi) Bond prices are more sensitive to yield changes when the bond is initially selling at a Lower yield.

**Duration:** Duration is a measure of the weighted average Life of a bond which considers the Size and timing of each Cash flow. The weight assigned to each time period is the present value of the Cash flow paid at that time as a proportion of the price of the bond. This is mathematically expressed as

$$\text{Duration} = (PV(c1) * 1 + PV(c2) * 2 + \dots + PV(c_n) * n) / P_0.$$

Where PV (c1) is the present value of the Cash Flow receivable at the end of Year t ( where t= 1,2,...n) and P<sub>0</sub> is the current value of the bond.

For computing the Present value of Cash flow the Yield to Maturity (The Internal Rate of Return) of the bond is used as a Discount Rate.

The Duration of a bond in effect represents the Length of time that elapses before the “Average” rupee of present value from the bond is received .

**Process of immunization:** The bond Portfolio manager (or) Investor has to calculate the duration of the promised Outflow of the funds and invest in a portfolio of bonds which has an identical duration . The bond Portfolio duration is the weighted average of the durations of the individual bonds in the portfolio . For example if an investor has invested equal amount of money in three bonds namely A, B &C with a duration of 2, 3 and 4 years respectively then the bond portfolio duration is

$$\text{Duration} = 1/3 (2) + 1/3(3) + 1/3(4) = 0.66 + 1 + 1.33 = 2.99 \text{ (or) } 3 \text{ Years.}$$

By matching the Out Flow duration with Cash Inflow duration from Bond investment the bond Manager can offset the Interest Rate Risk and Price Risk. The Portfolio of Money to be invested between the different types of bonds can also be found out . The equation is

Investment Out Flow =  $(X_1 * \text{Duration of Bond} - I) + (X_2 * \text{Duration of Bond}_2)$  where  $X_1, X_2$  are the proportion of Investment in Bond I & II

### **BOND – PRICE CONVEXITY**

A small changes in Yield , The price change is proportional to the modified duration and it is given by the formula

$\Delta P / P = - D * \Delta Y$  . where  $\Delta P / P$  is the percentage Change in Price ,  $- D *$  is the modified duration with a Negative Sign and  $\Delta Y$  is the change in yield in Decimal form.

Assume that the modified duration is 3.608 , Assume a Change in the Yield of 20 % (20/200 basis points) the Percentage Change in Price would be

$$\Delta P/P = -3.606 * 0.002 = - 0.007204 \text{ (or) } -0.7204 \%$$

The Percentage Price change is directly proportional to the Change in Yield. If this were precisely so the Percentage Change in Price would be Linearly related to the Change in Yield .Thus the Bond – Pricing relationship is curvilinear. The Duration Rule provides an approximation which is fairly close for small changes in the Yield .However as the yield Change becomes larger the approximation becomes poorer.

Consider a 20 year maturity , 9 % bond selling at an initial YTM of 9 % . The modified duration of this bond is 9.95 years. Thus the equation is  $-D * \Delta Y = -9.95 * \Delta Y$  as well as the curved line reflecting the Actual Relationship between Yield Change and Price Change . Note that for small changes in the Yield the duration rule is fairly accurate . However as the Yield change increases the duration rule becomes less accurate .

Thus it is clear that the straight Line (the Duration approximation ) always understates the value of the bond. This is because the True Price –Yield relationship is convex. Meaning that it opens upward. Clearly convexity is a desirable feature in bonds. Prices of bonds with greater convexity (Curvature) increase more when Yield falls and declines less when Yield raise.

### **YIELD TO MATURITY (YTM)**

Concept of YTM : YTM is the single discount factor that makes present value of future Cash flows from a bond equal to the current Price of the bond. YTM is the Rate of Return which an investor can expect to earn if the bond is held till Maturity.

The YTM is calculated based on certain Assumptions and they are as follows.

1. There should not be any default . coupon and Principal amount should be paid as per the schedule
2. The Investor has to hold the bond till its maturity.



3. All the Coupon Payments should be re-invested immediately at the same interest rate as the same yield to maturity of the bond . This is very crucial for better investment decisions.

### **YIELD TO CURVE (YTC)**

The Bond portfolio manager is often concerned with the following two aspects of Interest Rate. Namely The Level of Interest Rate and the term Structure of the Interest Rate. The relationship between the Yield and Time (or) Years to Maturity is called as “Term Structure”. The term structure is also termed as Yield Curve. In analyzing the effect of Maturity on Yield all other influences are held constant. Usually Pure Discount Instruments are selected to eliminate the effect of Coupon Payments (Interest Rate). The bond chosen do not have early redemption features. The Maturity Dates are different but the risks , tax Liabilities and redemption possibilities are similar.

**Bond CONVEXITY:** Bond's Price and Yield are inversely related. The raise in the Bond Price would cause a fall in Yield and Vice –Versa. The relationship is not Linear. The Quantum increase in the bond's price for a given decline in yield is higher than the decline in bond's price for a similar amount of increase in bond's yield. Hence the relationship is not Linear. This relationship is often referred as Convexity. The Convexity concept is applicable to all types of bonds. The Degree of Convexity differs from bond to bond depending upon the size of the bond, The years to Maturity and the Current Market Price.

**DEFAULT RISK:** It is the failure to pay the agreed value of the Debt Instrument by the issuer in full on time (or) both are termed as “ Default Risk”. Treasury Bills and Bonds issued by the Central Government are devoid of this risk. The same cannot be assured of Bonds/ Debentures issued by any other corporate bodies. The Default Risk occurs because of Macro Economic factors (or) the firm’s specific factors. The Macro Economic factors affect the overall system. When the Interest Rates raises the resultant is Bankruptcy. This has more to do with the firm’s specific factors. Example : In efficient Management , Industrial Unrest, Absence of Professional Management.

QUESTION	OPTION 1	OPTION 2	OPTION 3	OPTION 4	ANSWER
A ----- is the allocation of funds to assets and securities after considering their return and risk features	gambling	Investment	Speculation	Bonds	Investment
Investment in gold and silver is considered ----- investment	real investment	risk free	risk	certain	real investment
The stock that higher rate of growth than the industrial growth rate in profitability are referred to as -----	growth shares	equity	preference	debenture	growth shares
Gambling is a	very long term investment	very short term investment	medium investment	average investment	very short term investment
The securities issued by the central , state and quasi-government are known as -----	face value	real investment	government securities	intrinsic securities	government securities
A -----is an activity that is engaged in by people who have savings	gambling	Investment	Speculation	Bonds	investment
An example of money market instrument is	bond	debenture	stock certificate	certificate of deposit	certificate of deposit
Government bond is a	Long-term security	short-term security	medium-term securities	neither long-term or short-term	Long-term security
Investing money in a private business is known as -----	financial investment	economic investment	business investment	social investment	business investment
LIC is primarily a	broker	money market intermediary	secondary market intermediary	lenders	money market intermediary
Financial systems includes	financial market	share market	financial and share market	capital market	financial market
The differences between the sale price and the purchase price is called -----	depreciation	capital appreciation	investment	gambling	capital appreciation

Money market is a market for purely	long term funds	medium term funds	short term funds	certain period	short term funds
The term structure is also known as	yield curve	profit curve	term curve	sales curve	yield curve
The shape of the yield curve can be explained by the expectations of the investor about the future interest rates	liquidity preference theory	segmentation theory	expectation theory	motivational theory	expectation theory
Investment is the	net addition made to the nation's capital stock	person's commitment to buy a flat	employment of funds on assets to earn return	monetary system	employment of funds on assets to earn return
Supply and demand for fund are segmented in sub markets because of the preferred habitats of the individuals.	liquidity preference theory	segmentation theory	expectation theory	motivational theory	segmentation theory
If the investment is properly undertaken, then	the return will commensurate with the risk	the return will be certain	it will be liquid	not commensurate	the return will commensurate with the risk
Investors buy	high grade securities	low grade securities	securities for short-term purposes	cost of purchase	high grade securities
The negotiable financial investment differs from non-negotiable financial investment in terms of	face value	transferability	maturity period	interest rate	transferability
Investors would prefer to hold short term bonds to minimize the possible variation in their portfolio	liquidity preference theory	segmentation theory	expectation theory	motivational theory	liquidity preference theory
Which one of the following is not a fixed income bearing security ?	debentures	bonds	fixed deposits	equity shares	equity shares
Which one the following scheme helps in reducing tax liability ?	investment in real estate	national saving certificate	equity shares	savings bank account	national saving certificate
Which one of the following is a contingent investment?	recurring deposit	bonds	equity shares	life insurance policy	life insurance policy
A current account is a	liquid period	running account	mutual	temporary	running account

The component of a capital market is	treasury bill market	govt. securities market	commercial bill market	RBI	govt. securities market
Government securities are issued in the form	risky securities	not risky securities	expected securities	mutual securities	not risky securities
Long term loan market is	capital market	money market	primary market	secondary market	capital market
Government securities are issued in the form	pledge	new method	promissory note	prepaid	promissory note
_____includes the financial markets and the financial institutions	financial system	fiscal policy	economy rates	nature of the firm	financial system
_____Includes call money market, treasury bills market, commercial bills, and short term loan market	Insurance company	LIC	RBI	the imperial bank of India	the imperial bank of India
_____risks are non-divertible and arise out of the market, nature of the industry, state of the economy.	unsystematic risk	systematic risk	market risk	economic risk	systematic risk
_____ Risk is that portion of total risks that is unique, or peculiar to a firm or an industry	unsystematic risk	systematic risk	market risk	economic risk	unsystematic risk
_____is arrived at by dividing the annual coupon price by purchase price	price earnings ratio	purchasing power	current yield	interest rate	current yield
_____is arrived at by dividing market price per share by earnings per share	price earnings ratio	current yield	interest rate	dividend	price earnings ratio
_____The risk affects the market as a whole	unsystematic risk	market risk	current yield	systematic	systematic
_____risk is the variation in return caused by the changes in the market interest rate	interest rate	intrinsic value	dividend policy	mutual value	interest rate
_____ Risk is caused by inflation	purchasing power	current yield	price earnings ratio	mutual value	purchasing power
_____Risk is unique to the particular industry or company	unsystematic risk	market risk	current yield	systematic	unsystematic risk

Which of the following risks emerges from the debt component of the capital structure	financial risk	business risk	purchasing power risk	market risk	financial risk
Interest rate risk is a -----	systematic risk	unsystematic risk	internal risk	market risk	systematic risk
A ----- is a pessimistic speculator	bull	bear	stag	lame duck	bear
Identify the uncontrollable risk of a company	technological obsolescence	cut in subsidy	labor problem	increase in loan services charges	cut in subsidy
In the weak form of market stock prices reflect	the past prices and traded volumes	the demand for the scrip	the country economic conditions	the past price of the scrip	the past prices and traded volumes
Risk is influenced by the	internal or external risk	internal	external	market risk	internal or external risk
Risk is	certainty	uncertainty	appreciable	no appreciable	uncertainty
Market risk arises out of the changes in the pattern of	demand and supply	supply	demand	profit	demand and supply
Internal business risk is associated with the	external environment	internal environment	organization	management	internal environment
External Risk is associated with the	external environment	internal environment	organization	management	external environment
Risk is also arise due to changes in the	company policy	market rules	dividend policy	government policies	government policies
Principal amount and terminal value are known with certainty	Fixed principal investments	Variable investments	Indirect alternatives	Direct alternatives	Fixed principal investments
The price of preference shares is determined by _____	Demand	Supply	Demand and Supply	Return	Demand and Supply
The terminal value of real estate is	Certain	Uncertain	Risk	Return	Uncertain
_____ are the integral part of an investment decision	Risk	Uncertainty	Risk & Uncertain	Return	Risk & Uncertain
_____ risk is also called as operating risk	Financial risk	Business risk	Management risk	Political risk	Business risk
The objectives of any investments made by an investor	Maximization of return	Maximization of return and Maximum of risk	Minimization of return	Minimization of risk	Maximization of return and Maximum of risk
A voluntary provident fund scheme called Public Provident Fund is operated by	Post office	Certain authorized Banks	Employee Provident fund	Post office and Certain authorized Banks	Post office and Certain authorized Banks

			organization		
Fixed income securities are subject to _____ risk	Interest rate	Performance	Capital	Dividends	Interest rate
_____ is operated by Post office and Certain authorized Banks	Public Provident Fund	LIC Scheme	Employee Provident fund	Equity capital fund	Public Provident Fund
building , machinery & land are considered as	Tangible properties	Intangible properties	Tangible and Intangible properties	Visible properties	Tangible properties

FINANCIAL MANAGEMENT

UNIT -2

SYLLABUS

**Investment Decision:** The Capital Budgeting Process, Cash flow Estimation, Payback Period Method, Accounting Rate of Return, Net Present Value (NPV), Net Terminal Value, Internal Rate of Return (IRR), Profitability Index, Capital Budgeting Under Risk- Certainty Equivalent Approach and Risk- Adjusted Discount Rate.

INTRODUCTION

The word Capital refers to be the total investment of a company of firm in money, tangible and intangible assets. Whereas budgeting defined by the “Rowland and William” it may be said to be the art of building budgets. Budgets are a blue print of a plan and action expressed in quantities and manners. Investment decision is the process of making investment decisions in capital expenditure. A capital expenditure may be defined as an expenditure the benefits of which are expected to be received over period of time exceeding one year. The main characteristic of a capital expenditure is that the expenditure is incurred at one point of time whereas benefits of the expenditure are realized at different points of time in future. The examples of capital expenditure:

1. Purchase of fixed assets such as land and building, plant and machinery, good will, etc.
2. The expenditure relating to addition, expansion, improvement and alteration to the fixed assets.



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3. The replacement of fixed assets.
4. Research and development project.

### **MEANING – Capital Budgeting**

The process through which different projects are evaluated is known as capital budgeting. Capital budgeting is defined “as the firm’s formal process for the acquisition and investment of capital. It involves firm’s decisions to invest its current funds for addition, disposition, modification and replacement of fixed assets”.

### **DEFINITION**

Capital budgeting (investment decision) as, “Capital budgeting is long term planning for making and financing proposed capital outlays.” ----- **Charles T.Horngreen**

“Capital budgeting consists in planning development of available capital for the purpose of maximizing the long term profitability of the concern” – **Lynch**

“Capital budgeting is concerned with the allocation of the firm source financial resources among the available opportunities. The consideration of investment opportunities involves the comparison of the expected future streams of earnings from a project with the immediate and subsequent streams of earning from a project, with the immediate and subsequent streams of expenditure”. ---- **G.C. Philippatos**

**NEED AND IMPORTANCE OF CAPITAL BUDGETING :**

**Huge investments:** Capital budgeting requires huge investments of funds, but the available funds are limited, therefore the firm before investing projects, plan and control its capital expenditure.

**Long-term:** Capital expenditure is long-term in nature or permanent in nature. Therefore financial risks involved in the investment decision are more. If higher risks are involved, it needs careful planning of capital budgeting.

**Irreversible:** The capital investment decisions are irreversible, are not changed back. Once the decision is taken for purchasing a permanent asset, it is very difficult to dispose of those assets without involving huge losses.

**Long-term effect:** Capital budgeting not only reduces the cost but also increases the revenue in long-term and will bring significant changes in the profit of the company by avoiding over or more investment or under investment. Over investments leads to be unable to utilize assets or over utilization of fixed assets. Therefore before making the investment, it is required carefully planning and analysis of the project thoroughly.

**PROJECT EVALUATION TECHNIQUES (OR) CAPITAL BUDGETING TECHNIQUES**

At each point of time a business firm has a number of proposals regarding various projects in which it can invest funds. But the funds available with the firm are always limited and it is not possible to invest funds in all the proposals at a time. Hence, it is very essential to select

from amongst the various competing proposals, those which give the highest benefits. The crux of the capital budgeting is the allocation of available resources to various proposals.

There are many methods of evaluating profitability of capital investment proposals. The various commonly used methods are as follows:

**(A) Traditional methods:**

- (1) Pay-back Period Method or Pay out or Pay off Method.
- (2) Improvement of Traditional Approach to pay back Period Method.(post payback method)
- (3) Accounting or Average Rate of Return Method.

**(B) Time-adjusted method or discounted methods:**

- (4) Net Present Value Method.
- (5) Internal Rate of Return Method.
- (6) Profitability Index Method.

**TRADITIONAL METHODS: PAY-BACK PERIOD METHOD :**

The 'pay back' sometimes called as pay out or pay off period method represents the period in which the total investment in permanent assets pays back itself. This method is based on the principle that every capital expenditure pays itself back within a certain period out of the additional earnings generated from the capital assets. Under this method, various investments are ranked according to the length of their payback period in such a manner that the investment within a shorter payback period is preferred to the one which has longer pay back period. (It is one of the non-discounted cash flow methods of capital budgeting). The

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### **MERITS**

The following are the important merits of the pay-back method:

1. It is easy to calculate and simple to understand.
2. Pay-back method provides further improvement over the accounting rate return.
3. Pay-back method reduces the possibility of loss on account of obsolescence.

### **DEMERITS**

1. It ignores the time value of money.
2. It ignores all cash inflows after the pay-back period.
3. It is one of the misleading evaluations of capital budgeting.

### **ACCEPT /REJECT CRITERIA**

If the actual pay-back period is less than the predetermined pay-back period, the project would be accepted. If not, it would be rejected.

## **2. POST PAY-BACK PROFITABILITY METHOD:**

One of the serious limitations of Pay-back period method is that it does not take into account the cash inflows earned after pay-back period and hence the true profitability of the project cannot be assessed. Hence, an improvement over this method can be made by taking into account the return receivable beyond the pay-back period.

Post pay-back profitability = Cash inflow (Estimated life – Pay-back period)

Post pay-back profitability index = Post pay-back profitability / original investment

## **3. AVERAGE RATE OF RETURN:**

This method takes into account the earnings expected from the investment over their whole life. It is known as accounting rate of return method for the reason that under this method, the Accounting concept of profit (net profit after tax and depreciation) is used rather than cash inflows. According to this method, various projects are ranked in order of the rate of earnings or rate of return. The project with the higher rate of return is selected as compared to the one with lower rate of return. This method can also be used to make decision as to accepting or rejecting a proposal. Average rate of return means the average rate of return or profit taken for considering

### **(a) Average Rate of Return Method (ARR):**

Under this method average profit after tax and depreciation is calculated and then it is divided by the total capital outlay or total investment in the project. The project evaluation. This method is one of the traditional methods for evaluating

The project proposals

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$ARR = \frac{\text{Total profits (after dep \& taxes)}}{\text{(Net Investment in the project X No. of years of profits)}} \times 100$

OR

$ARR = \frac{\text{Average Annual profits}}{\text{(Net investment in the project)}} \times 100$

**(b) Average Return on Average Investment Method:**

This is the most appropriate method of rate of return on investment. Under this method, average profit after depreciation and taxes is divided by the average amount of investment; thus:

$\text{Average Return on Average Investment} = \frac{\text{(Average Annual Profit after depreciation and taxes)}}{\text{(Average Investment)}} \times 100$

**Merits**

1. It is easy to calculate and simple to understand.
2. It is based on the accounting information rather than cash inflow.
3. It is not based on the time value of money.
4. It considers the total benefits associated with the project.

**Demerits**

1. It ignores the time value of money.
2. It ignores the reinvestment potential of a project.
3. Different methods are used for accounting profit. So, it leads to some difficulties in the calculation of the project.

Accept/Reject criteria

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If the actual accounting rate of return is more than the predetermined required rate of return, the project would be accepted. If not it would be rejected.

**(B) TIME – ADJUSTED OR DISCOUNTED CASH FLOW METHODS: or MODERN**

**METHOD :**

**1. NET PRESENT VALUE**

Net present value method is one of the modern methods for evaluating the project proposals. In this method cash inflows are considered with the time value of the money. Net present value describes as the summation of the present value of cash inflow and present value of cash outflow. Net present value is the difference between the total present values of future cash inflows and the total present value of future cash outflows.

$$NPV = \text{Total Present value of cash inflows} - \text{Net Investment}$$

If offered an investment that costs \$5,000 today and promises to pay you \$7,000 two years from today and if your opportunity cost for projects of similar risk is 10%, would you make this investment? You Need to compare your \$5,000 investment with the \$7,000 cash flow you expect in two years. Because you feel that a discount rate of 10% reflects the degree of uncertainty associated with the \$7,000 expected in two years, today it is worth:

By investing \$5,000 today, you are getting in return a promise of a cash flow in the future that is worth \$5,785.12 today. You increase your wealth by \$785.12 when you make this investment.

**Merits**

1. It recognizes the time value of money.
2. It considers the total benefits arising out of the proposal.

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3. It is the best method for the selection of mutually exclusive projects.

4. It helps to achieve the maximization of shareholders' wealth.

### **Demerits**

1. It is difficult to understand and calculate.

2. It needs the discount factors for calculation of present values. 3. It is not suitable for the projects having different effective lives.

Accept/Reject criteria

If the present value of cash inflows is more than the present value of cash outflows, it would be accepted. If not, it would be rejected.

### **2. PROFITABILITY INDEX METHOD**

The *profitability index* (PI) is the ratio of the present value of change in operating cash inflows to the present value of investment cash outflows:

Instead of the *difference* between the two present values, as in equation PI is the *ratio* of the two present values. Hence, PI is a variation of NPV. By construction, if the NPV is zero, PI is one.

### **3. INTERNAL RATE OF RETURN METHOD**

This method is popularly known as time adjusted rate of return method/discounted rate of return method also. The internal rate of return is defined as the interest rate that equates the present value of expected future receipts to the cost of the investment outlay. This internal rate of return is found by trial and error. First we compute the present value of the cash-flows from an investment, using an arbitrarily elected interest rate. Then we compare the present value so obtained with the investment cost. If the present value is higher than the cost figure,



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we try a higher rate of interest and go through the procedure again. Conversely, if the present value is lower than the cost, lower the interest rate and repeat the process. The interest rate that brings about this equality is defined as the internal rate of return. This rate of return is compared to the cost of capital and the project having higher difference, if they are mutually exclusive, is adopted and other one is rejected. As the determination of internal rate of return involves a number of attempts to make the present value of earnings equal to the investment, this approach is also called the Trial and Error Method. Internal rate of return is time adjusted technique and covers the disadvantages of the Traditional techniques. In other words it is a rate at which discount cash flows to zero. It is expected by the following ratio .

**Steps to be followed:**

Step1. Find out factor Factor is calculated as follows:

Step 2. Find out positive net present value

Step 3. Find out negative net present value

Step 4. Find out formula net present value

Base factor = Positive discount rate

DP = Difference in percentage

**Merits**

1. It considers the time value of money.
2. It takes into account the total cash inflow and outflow.
3. It does not use the concept of the required rate of return.
4. It gives the approximate/nearest rate of return.

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**SUBJECT NAME: FUNDAMENTAL OF FINANCIAL MANAGEMENT**

**COURSE CODE: 17CCU603A**

**UNIT-II**

**BATCH: 2017-2020**

**Demerits**

1. It involves complicated computational method.
2. It produces multiple rates which may be confusing for taking decisions.
3. It is assume that all intermediate cash flows are reinvested at the internal rate of return.

**Accept/Reject criteria**

If the present value of the sum total of the compounded reinvested cash flows is greater than the present value of the outflows, the proposed project is accepted. If not it would be rejected.

PV vs. IRR Methods:

Key differences between the most popular methods, the NPV (Net Present Value) Method and IRR (Internal Rate of Return) Method, include:

- NPV is calculated in terms of currency while IRR is expressed in terms of the percentage return a firm expects the capital project to return;
- Academic evidence suggests that the NPV Method is preferred over other methods since it calculates additional wealth and the IRR Method does not;
- The IRR Method cannot be used to evaluate projects where there are changing cash flows (e.g., an initial outflow followed by in-flows and a later out-flow, such as may be required in the case of land reclamation by a mining firm);
- However, the IRR Method does have one significant advantage -- managers tend to better understand the concept of returns stated in percentages and find it easy to compare to the required cost of capital; and, finally,
- While both the NPV Method and the IRR Method are both DCF models and can even reach similar conclusions about a single project, the use of the IRR Method can lead

to the belief that a smaller project with a shorter life and earlier cash inflows, is preferable to a larger project that will generate more cash.

- Applying NPV using different discount rates will result in different recommendations. The IRR method always gives the same recommendation. Recent variations of these methods include:
- The Adjusted Present Value (APV) Method is a flexible DCF method that takes into account interest related tax shields; it is designed for firms with active debt and a consistent market value leverage ratio;
- The Profitability Index (PI) Method, which is modelled after the NPV Method, is measured as the total present value of future net cash inflows divided by the initial investment; this method tends to favour smaller projects and is best used by firms with limited resources and high costs of capital;
- The Bailout Payback Method, which is a variation of the Payback Method, includes the salvage value of any equipment purchased in its calculations.

QUESTION	OPTION 1	OPTION 2	OPTION 3	OPTION 4	ANSWER
Which of the following is used in economic analysis?	gross domestic product	surveys	labor cost	diffusion indexes	gross domestic product
A growth industry is	an industry with 10% growth per annum	an industry where demand for its product is exceeding supply	a capital intensive industry	an industry whose average growth is higher than the growth of economy	an industry whose average growth is higher than the growth of economy
The investor wants to study those fundamental factors	that affect profit and dividend of a company	that influence the interest and dividend characteristics of a company	that affect the risk and return characteristics of a security	affect profitability	that affect the risk and return characteristics of a security
An analysis of the whole market of securities are termed as -----	macro analysis	micro analysis	general analysis	particular analysis	macro analysis
Analysis of only scrip is called as -----	macro analysis	micro analysis	particular analysis	general analysis	micro analysis
Dividing profit after tax by the number of equity shares is equal to -----	preference share	earnings per share	equity share	differed share	earnings per share
An investors focus on a company's basics is called ----- approach	upward	bottom up	forward	downward	bottom up
----- consists of personal consumption expenditure, gross private domestic investment and government expenditure on goods and services and net export of goods and services	NAV	GDP	EIC	GNP	GDP
GDP reflects the overall performance of the -----	economy	industry	company	fundamental	economy

A _____is a method of finding out the future price of a stock which an investor to buy	fundamental analysis	technical analysis	economic analysis	industrial analysis	fundamental analysis
_____is really a logical and systematic approach for estimating the future dividends and share price	fundamental analysis	secondary analysis	stock analysis	bond analysis	fundamental analysis
The _____has been defined as a homogeneous group of people doing a similar kind of activity	economy	business	industry	office	industry
The investor should verify whether a company follows a stable ----- policy	dividend	interest	appreciation	depreciation	dividend
mobilizing funds through issue of equity shares is known as	debt financing	financial institution	funds	equity financing	equity financing
Return on equity is helpful in ascertaining the ----- value	market value	intrinsic value	extrinsic value	depreciable value	intrinsic value
Earnings per share represents the profit earned by -----	dividend	each share	interest	market price	each share
Profitability ratio measures -----	liquidity	interest	profitability	all the above	profitability
Expenses ratio establish the relationship between -----	expenses and sales	expenses and cost	liquidity position	financial position	expenses and sales
Profitability ratio based on -----	assets or investment	assets or revenue	liability or loan	all the above	assets or investment
The development of the industry mostly depends upon the -----	government	communication	productivity of labor	transportation	productivity of labor
----- indicates what is going to happen in the economy	lagging indicators	leading indicators	coincidental indicators	sensex indicators	leading indicators
The first and foremost stage in the industrial life cycle is the -----	growth stage	decline stage	introduction stage	all the above	introduction stage

_____Stage stabilize their prices, develop a market of their own strategies	expansion stage	decline stage	introduction stage	all the above	expansion stage
The factors which have to be carefully analyzed are regarding the _____of the project	stability	soundness	functions	defunct ion	stability
There are lot of financial and non-financial aspects in _____and the investor should familiarize with themselves	economy	company	industry	technical	economy
the financial statements of a company provide the best possible information about the	profitability	stability	employee	policy of the company	profitability
Financial ratios provide a standardized measure of a firm's	dividend	liquidity	stability	financial position	financial position
Financial ratios are helpful in -----	soundness	identify the weakest area	identify the accounts department		identify the weakest area
Fundamentalists have developed certain valuation models for calculating	dividend	share price	future price	market price	share price
Ratio analysis can be used to analyses the -----	market value	financial position	liquidity	solvency	financial position
Economic forecasting is usually based on a -----	scientific theory	modern theory	specific theory	mm theory	specific theory
If the market share is _____the company would be able to meet the competition successfully	Low	high	medium	decline	high
A study of _____ ratios will be helpful in understanding the relationship between sales and earnings	profitability	current	liquidity	solvency	profitability
The _____ affects return on equity shareholders' investment	working capital	capital structure	short term profit	long term profit	capital structure

Equity shareholders return can be increased by using more debts than	bonds	share price	equity	preference	equity
A company must make adequate _____ for payment of tax on its earnings	profit	provision	working capital	share	provision
Under this method, the inventory is priced at cost price or market price, whichever is lower	FIFO	LIFO	Cost or market value method	straight line method	Cost or market value method
FIFO method will shows the inventory at a -----	lower cost	higher cost	average cost	medium cost	higher cost
LIFO method will shows the inventory at a -----	lower cost	higher cost	average cost	medium cost	lower cost
under _____ method a fixed percentage of original cost is charged as depreciation throughout the life of asset	straight line method	diminishing balance method	depreciation fund method	insurance policy method	straight line method
In _____ method , the amount of depreciation will reduce from year to year	straight line method	diminishing balance method	depreciation fund method	insurance policy method	diminishing balance method
In _____method, the amount of depreciation is calculated with reference to sinking fund tables.	straight line method	diminishing balance method	depreciation fund method	insurance policy method	depreciation fund method
Stability of sales ensures _____ to the company	variation	fixed	difficult	stable earning	stable earning
Debentures used for -----	long term	short term	very short term	medium term	long term
An efficient management of a company will ensure _____ investment	change	fixed	failure	successful	successful
Planning, organizing, directing, coordinating and controlling are the important functions of the -----	management	administration	firm	industry	management
The company should strive to increase the return on investments and their	appropriation	appreciation	profitability	stable earning	appreciation

Ability to maintain _____ of the company within the industry, shows efficient investment decision	Director	dividend	interest	competitiveness	competitiveness
Ability to maintain _____ role in the market for growth of the industry	manager	director	competitiveness	leadership	leadership
Financial statement of the company include -----	profit and loss account	shareholders document	debenture holders documents	employees records	profit and loss account
The outsider's liabilities other than current liabilities are known as -----	long term liabilities	short term liabilities	outsider's liabilities	medium term liabilities	long term liabilities
The profit and loss account is called -----	income statement	expenditure statement	operation statement	cost statement	income statement
ta	historical	present	future	convention	historical
The preparation of financial statement is based on certain _____ concept	accounting	product	purchase	sales	accounting
Annual reports of companies provide -----	financial information	economic information	market information	sales information	financial information
Daily security prices are quoted in -----	stock exchange	leading dailies	investment week	government report	stock exchange
The primary market for securities is -----	stock exchanges	new issue market	national market	OTCEI	new issue market
The _____ analysis is based on security price quotation	technical	economic	industry	company	technical
The _____ of share means the value of net asset available per equity share of the company	intrinsic value	standard value	national market value	real value	intrinsic value



The -----analysis refers to an evaluation of the relative strengths and weakness of particular industry	company	economic	industry	political	industry
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FINANCIAL MANAGEMENT  
UNIT -3  
SYLLABUS

**Financing Decisions:** Cost of Capital and Financing Decision: Sources of Long-term financing Estimation of components of cost of capital, Methods for Calculating cost of Equity capital, Cost of Retained Earnings, Cost of Debt and Cost of Preference Capital, Weighted Average Cost of Capital (WACC) and Marginal cost of capital. Capital Structure- Theories of Capital Structure (Net Income, Net Operating Income, MM Hypothesis, Traditional Approach). Operating and Financial Leverage, Determinants of Capital Structure.

**MEANING OF COST OF CAPITAL**

The cost of capital of a firm is the minimum rate of return expected by its investors. It is the weighted average cost of various sources of finance used by a firm. The capital used by a firm may be in the form of debt, preference capital, retained earnings and equity shares. The concept of cost of capital is very important in the financial management. A decision to invest in a particular project depends upon the cost of capital of the firm or the cut off rate which is the minimum rate of return expected by the investors.

**DEFINITION**

**James C. Van Horne** defines cost of capital as, "a cut-off rate for the allocation of capital to investments of projects. It is the rate of return on a project that will leave unchanged the market price of the stock.

According to **Solomon Ezra**, "Cost of capital is the minimum required rate of earning or the cut-off rate of capital expenditures".

**MEASUREMENT OF COST OF CAPITAL**

The term cost of capital is an overall cost. This is the combination cost of the specific cost associated with specific source of financing. The computation of cost capital therefore,

involves two steps: The computation of the different elements of the cost in term of the cost of the different source of finance.

The calculation of the overall cost by combining the specific cost into a composite cost. From the view point of capital budgeting decisions the long-term sources of fund are relevant as the constitute the major source of financing of fixed cost. In calculating the cost of capital, therefore, the focus is to be on the long-term funds.

In other words the specific cost has to be calculated for: 1) Long term debt 2) Preference Shares 3) Equity Shares 4) Retained earnings

### **COST OF DEBT**

The cost of debt is the rate of interest payable on debt. For example, a company issues Rs.1,00,000 10% debentures at par; the before-tax cost of this debt issue will also be 10%. By way of a formula, before tax cost of debt may be calculated as:

$$K_{db} = I/P$$

where,  $K_{db}$  = before tax cost of debt I = Interest P = Principal

In case the debt is raised at premium or discount, we should consider P as the amount of net proceeds received from the issue and not the face value of securities. The formula may be changed to

$$K_{db} = I/NP \text{ (where, } NP = \text{Net Proceeds)}$$

Further, when debt is used as a source of finance, the firm saves a considerable amount in payment of tax as interest is allowed as a deductible expense in computation of tax. Hence, the effective cost of debt is reduced. The After-tax cost of debt may be calculated with the help of following formula:

$$K_{da} = I/NP(1-t)$$

where,  $K_{da}$  = Aftertax cost of debt  $t$  = Rate of Tax

### **COST OF PREFERENCE CAPITAL:**

A fixed rate of dividend is payable on preference shares. Though dividend is payable at the discretion of the Board of directors and there is no legal binding to pay dividend, yet it does not mean that preference capital is cost free. The cost of preference capital is a function of dividend expected by its investors, i.e., its stated dividend. In case dividend share not paid to preference shareholders, it will affect the fund raising capacity of the firm. Hence, dividends are usually paid regularly of preference shares expect when there are no profits to pay dividends. The cost of preference capital which is perpetual can be calculated as:

$$K_p = D/P$$

Where,  $K_p$  = Cost of preference Capital  $D$  = Annual Preference Dividend  $P$  = Preference Share Capital (Proceeds.) Further, if preference shares are issued at Premium or Discount or when costs of floatation are incurred to issue preference shares, the nominal or par value or preference share capital has to be adjusted to find out the net proceeds from the issue of preference shares. In such a case, the cost of preference capital can be computed with the following formula:

$$K_p = D/NP$$

### **COST OF EQUITY SHARE CAPITAL**

The cost of equity is the, maximum rate of return that the company must earn of equity financed portion of its investments in order to leave unchanged the market price of its stock".

The cost of equity capital is a function of the expected return by its investors. The cost of

equity is not the out-of-pocket cost of using equity capital as the equity shareholders are not paid dividend at a fixed rate every year. Moreover, payment of dividend is not a legal binding. It may or may not be paid. But it does not mean that equity share capital is a cost free capital. Share holders invest money in equity shares on the expectation of getting dividend and the company must earn this minimum rate so that the market price of the shares remains unchanged. Whenever a company wants to raise additional funds by the issue of new equity shares, the expectations of the shareholders have to evaluate. The cost of equity share capital can be computed in the following ways:

**Dividend Yield Method or Dividend/Price Ratio method:**

According to this method, the cost of equity capital is the „discount rate that equates the present value of expected future dividends per share with the new proceeds (or current market price) of a share“. Symbolically,

$$K_e = D/NP \text{ or } D/MP$$

**Where,**

**$K_e$  = Cost of Equity Capital**

**$D$  = Expected dividend per Share**

**$NP$  = Net proceeds per Share**

**$MP$  = Market Price per Share**

**b) Dividend Yield plus Growth in Dividend Method:** When the dividends of the firm are expected to grow at a constant rate and the dividend-pay-out ratio is constant this method may be used to compute the cost of equity capital. According to this method the cost of equity capital is based on the dividends and the growth rate.

$$K_e = DI/NP + G$$

Further, in case cost of existing equity share capital is to be calculated, the NP should be changed with MP (market price per share) in the above equation.

$$K_e = DI/MP + G$$

### **COMPUTATION OF WEIGHTED AVERAGE COST OF CAPITAL**

Weighted average cost of capital is the average cost of the costs of various sources of Financing. Weighted average cost of capital is also known as composite cost of capital, overall cost of capital or average cost of capital. Once the specific cost of individual sources of finance is determined, we can compute the weighted average cost of capital by putting weights to the specific costs of capital in proportion of the various sources of funds to the total. The weights may be given either by using the book value of the source or market value of the source. The market value weights suffer from the following limitations: It is very difficult to determine the market values because of frequent fluctuations. With the use of market value weights, equity capital gets greater importance. For the above limitations, it is better to use book value which is readily available. Weighted average cost of capital can be computed as follows:

$$K_w = \Sigma XW / \Sigma W$$

Where,  $K_w$  = Weighted average cost of capital

$X$  = Cost of specific source of finance

$W$  = Weight, proportion of specific source of finance

**MARGINAL COST OF CAPITAL:** Sometimes, we may be required to calculate the cost of additional funds to be raised, called the marginal cost of capital. The marginal cost of capital is the weighted average cost of new capital calculated by using the marginal weights. The marginal weights represent the proportion of various sources of funds to be employed in raising additional funds. In case, a firm employs the existing proportion of capital structure and the component costs remain the same the marginal cost of capital shall be equal to the weighted average cost of capital

### **CAPITAL STRUCTURE**

Capital structure refers to the kinds of securities and the proportionate amounts that make up capitalization. It is the mix of different sources of long-term sources such as equity shares, preference shares, debentures, long-term loans and retained earnings. The term capital structure refers to the relationship between the various long-term sources financing such as equity capital, preference share capital and debt capital. Deciding the suitable capital structure is the important decision of the financial management because it is closely related to the value of the firm. Capital structure is the permanent financing of the company represented primarily by long-term debt and equity.

### **DEFINITION OF CAPITAL STRUCTURE**

According to the definition of **Gerestenbeg**, “Capital Structure of a company refers to the composition or make up of its capitalization and it includes all long-term capital resources”.

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According to the definition of **James C. Van Horne**, “The mix of a firm’s permanent long-term financing represented by debt, preferred stock, and common stock equity”.

According to the definition of **Persona Chandra**, “The composition of a firm’s financing consists of equity, preference, and debt”.

### **FINANCIAL STRUCTURE**

The term financial structure is different from the capital structure. Financial structure shows the pattern total financing. It measures the extent to which total funds are available to finance the total assets of the business.  $\text{Financial Structure} = \text{Total liabilities}$

### **OPTIMUM CAPITAL STRUCTURE**

Optimum capital structure is the capital structure at which the weighted average cost of capital is minimum and thereby the value of the firm is maximum. Optimum capital structure may be defined as the capital structure or combination of debt and equity that leads to the maximum value of the firm.

Objectives of Capital Structure Decision of capital structure aims at the following two important objectives:

1. Maximize the value of the firm.
2. Minimize the overall cost of capital.

Forms of Capital Structure Capital structure pattern varies from company to company and the availability of finance.

- Equity shares only.
- Equity and preference shares only.



- Equity and Debentures only.
- Equity shares, preference shares and debentures.

**CAPITAL STRUCTURE THEORIES:** Capital structure is the major part of the firm's financial decision which affects the value of the firm and it leads to change EBIT and market value of the shares. There is a relationship among the capital structure, cost of capital and value of the firm. The aim of effective capital structure is to maximize the value of the firm and to reduce the cost of capital. There are two major theories explaining the relationship between capital structure, cost of capital and value of the firm.

### 1. **NET INCOME (NI) APPROACH**

Net income approach suggested by the Durand, According to this approach, the capital structure decision is relevant to the valuation of the firm. In other words, a change in the capital structure leads to a corresponding change in the overall cost of capital as well as the total value of the firm. According to this approach, use more debt finance to reduce the overall cost of capital and increase the value of firm.

Net income approach is based on the following three important assumptions:

1. There are no corporate taxes.
2. The cost debt is less than the cost of equity.
3. The use of debt does not change the risk perception of the investor.

Where  $V = S + B$

$V$  = Value of firm  $S$  = Market value of equity  $B$  = Market value of debt  
Market value of the equity can be ascertained by the following formula:

$$S = \frac{NI}{K_e}$$

NI = Earnings available to equity shareholder  $K_e$  = Cost of equity/equity capitalization rate

## **2. NET OPERATING INCOME (NOI) APPROACH**

Another modern theory of capital structure, suggested by Durand, This is just the opposite of the Net Income approach. According to this approach, Capital Structure decision is irrelevant to the valuation of the firm. The market value of the firm is not at all affected by the capital structure changes. According to this approach, the change in capital structure will not lead to any change in the total value of the firm and market price of shares as well as the overall cost of capital. NI approach is based on the following important assumptions; The overall cost of capital remains constant; There are no corporate taxes; The market capitalizes the value of the firm as a whole; Value of the firm (V) can be calculated with the help of the following formula

$V = EBIT/K_o$  Where, V = Value of the firm EBIT = Earnings before interest and tax  $K_o$  = Overall cost of capital

## **3. TRADITIONAL APPROACH**

It is the mix of Net Income approach and Net Operating Income approach. Hence, it is also called as intermediate approach. According to the traditional approach, mix of debt and equity capital can increase the value of the firm by reducing overall cost of capital up to certain level of debt. Traditional approach states that the  $K_o$  decreases only within the responsible limit of financial leverage and when reaching the minimum level, it starts increasing with financial leverage.

Assumptions Capital structure theories are based on certain assumption to analysis in a single and convenient manner:

- There are only two sources of funds used by a firm; debt and shares.
- The firm pays 100% of its earning as dividend.
- The total assets are given and do not change.
- The total finance remains constant.
- The operating profits (EBIT) are not expected to grow.
- The business risk remains constant.
- The firm has a perpetual life.
- The investors behave rationally.

#### **4. MODIGLIANI AND MILLER APPROACH**

Modigliani and Miller approach states that the financing decision of a firm does not affect the market value of a firm in a perfect capital market. In other words MM approach maintains that the average cost of capital does not change with change in the debt weighted equity mix or capital structures of the firm.

Modigliani and Miller approach is based on the following important assumptions:

- There is a perfect capital market.
- There are no retained earnings.
- There are no corporate taxes.
- The investors act rationally.
- The dividend payout ratio is 100%.•

The business consists of the same level of business risk.

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Value of the firm can be calculated with the help of the following formula:  $V = \frac{EBIT}{K(1-t)}$ .

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QUESTION	OPTION 1	OPTION 2	OPTION 3	OPTION 4	ANSWER
----- is to study of price behavior	fundamental analysis	technical analysis	random walk analysis	value analysis	technical analysis
Technical analysis reflects the idea that stock prices	move upward over time.	move inversely over time.	move in trends.	move randomly.	move in trends.
The stock price may intersect the	moving average price	exponential moving average	stock price average	methods	moving average price
When the oscillator reaches the extreme lower end, it is suggested to buy the -----	scrips	symmetrical	ascending	descending	scrips
Technical analysts gives importance to total -----	equity	bonds	shares	return	return
The technician believes that there is no _____ value to any stock	face value	standard value	real value	market value	real value
The primary trend which is used for analysis is	short term trend	long term trend	very short term trend	medium term trend	long term trend
The secondary trend which is used for analysis is -----	short term trend	long term trend	very short term trend	Minor term trend	short term trend

Minor trends are also called -----	random wriggles	primary trend	secondary trend	bullish trend	random wriggles
----- charts are drawn to predict the future price of stocks	bar	line	candle	Point and figure	line
Bullish market said when large volume of trade follows the _____ price	rise price	fall price	stability	constant	rise price
Share sold in small lots are called -----	odd lots	buyer	seller	broker	odd lots
An Decrease in the index shows more -----	selling	buying	sell and buy	investigate	selling
----- charts are prepared in vertical lines and made to show the closing price of each day and the closing price movements.	bar	line	candle	Point and figure	bar
In the weak form of market stock prices reflect -----	the past prices and traded volumes	the demand for the scrip	the country's economic conditions	the past price of the scrip	the past prices and traded volumes
A run in the stock price is -----	an interrupted sequence of either fall or rise in stock prices	an alternative sequence of stock price movement	an interrupted sequence of either fall or rise in stock prices	a residual analysis	an interrupted sequence of either fall or rise in stock prices

Moving average method used for -----	survey	chart	records	others	chart
Moving average are known as -----	running average	precordial average	mode average	samples	running average
The prices of securities are determined by the -----	government policy	company movements	demand and supply	price of stock	demand and supply
Which factors affect the supply and demand of a security?	rational	irrational	rational and irrational	profits	rational and irrational
Shifts in demand and supply can be detected with the help of -----	chart	Email	Letters	records	chart
The technical analysis attempts to forecast changes in the prices of securities by studying the -----	company data	industry data	economic data	market data	market data
The word moving means that the body of the data moves ahead to include the recent -----	assumptions	observation	survey	graphic records	observation
The technical analysis only helps us improve the knowledge of the probabilities of -----	price behavior	future price behavior	past price behavior	current price behavior	price behavior
The technical analyst uses the price chart as a basic tool to study the -----	share price movement	market price movement	company price movements	industry price movements	share price movement

The _____ theory is one of the oldest technical methods of security valuation	Dow theory	Markowitz theory	Japanese candle stick charts	Random walk theory	Dow theory
When the market is moving upwards continuously, of short duration is referred as	bull run	bear phase	correction	movements	bull run
The Dow theory makes certain assumptions. The second hypothesis is	correction are manipulated	secondary reactions are manipulated	the average discount everything	primary trend can be manipulated	correction are manipulated
When there is a bull in the trading market followed by -----	low purchase	high purchase	medium purchase	average purchase	high purchase
The market indices do not rise or fall in -----	straight line	upward	downward	upward and downward	straight line
When the short-term average moves below the long-term average, it is indicative of -----	fall price	decrease price	very low price	very high price	fall price
Rate of change measures the rate of change between	current price and price	future price and the price	past price behavior	forecast price and price	current price and price
Oscillators indicate the -----	price momentum	positive momentum	negative momentum	market momentum	market momentum
Short -selling is a technical indication which is also known as -----	medium interest	short interest	high interest	short and high interest	short interest



Odd-lot trading helps to -----	small investor	medium investor	big investors	financial investor	small investor
In short-selling when the ratio is less than 1, the market is considered	good	satisfy	highly satisfy	weak	weak
Investors sells their shares when market value is -----	high price	low price	medium price	average price	high price
Investors buys their shares when market value is -----	high price	average price	medium price	low price	low price
Technical analysis works on the basis of -----	assumption	accurate value	outline value	future value	assumption
Technical analysis believes -----	stock price	price trend	past trend	market price	past trend
Technical analysis _____are used to compare various price movement	charts and tools	communication	industry analysis	company analysis	charts and tools
Market data includes all of the following except ----- -	number of shares traded.	earnings.	level of market indices.	stock price.	earnings.
The two primary tools of a technical analyst are ----- ---	level of the market index and volume.	economic indicators and level of the market index.	price and volume.	price and technical indicators.	price and volume.

When market shows an increasing trend it is known as----- ----	bull and bear	bear market	lam duck	bull market	bull market
APT stands	arbitrage pricing theory	asset product term	asset price terms	assumption pricing theory	arbitrage pricing theory
DOW theory formulated hypothesis that the stock market does not perform on a	assumption basis	consist basis	random basis	parallel basis	random basis
The secondary trend also known as ----- in technical analysis	evaluation trend	correction trend	biased trend	relates trend	correction trend
The technical analysis only helps us improve the knowledge of the probabilities of	price behavior	future price behavior	past price behavior	current price behavior	price behavior
The technical analyst uses the price chart as a basic tool to study the -----	share price movement	market price movement	company price movements	industry price movements	share price movement
The _____ theory is one of the oldest technical methods of security valuation	Dow theory	Markowitz theory	Japanese	Random walk theory	Dow theory
			Candle		
Return on investment Ratio measures the ----- of a business	solvency	Debt service	profitability	equity	profitability

----- stage of Industry life cycle growth rate is more than the industries average growth rate.	Pioneering	Rapid growth	Maturity and stabilization	Declining	Rapid growth
Charts helps technical analysis -----	difficult	complicated	different	effectively	effectively
When there is a bull in the trading market followed by -----	low purchase	high purchase	medium purchase	average purchase	high purchase
The investor have to closely monitor the events that take place in ----- stage of the industry	Pioneering	Rapid growth	Maturity and stabilization	Declining	Maturity and stabilization
When the short-term average moves below the long-term average, it is indicative of -----	fall price	decrease price	very low price	very high price	fall price
Rate of change measures the rate of change between -----	current price and price	future price and the price	past price behavior	forecast price and price	current price and price
Oscillators indicate the -----	price momentum	positive momentum	negative momentum	market momentum	market momentum
Short -selling is a technical indication which is also known as	medium interest	short interest	high interest	short and high interest	short interest
Odd-lot trading helps to -----	small investor	medium investor	big investors	financial investor	small investor



FINANCIAL MANAGEMENT  
UNIT -4  
SYLLABUS

**Dividend Decisions:** Theories for Relevance and Irrelevance of Dividend Decision for Corporate valuation; cash stock Dividends policies in Practices

**MEANING OF DIVIDEND**

Dividend refers to the business concerns net profits distributed among the shareholders. It may also be termed as the part of the profit of a business concern, which is distributed among its shareholders. According to the Institute of Chartered Accountant of India, dividend is defined as “a distribution to shareholders out of profits or reserves available for this purpose”.

**TYPES OF DIVIDEND/FORM OF DIVIDEND**

**(I)Cash dividend:** A cash dividend is a usual method of paying dividends. Payment of dividend in cash results in the reduction out flow of funds and reduces the net worth of the company. The share holders get an opportunity to invest the cash in any manner, they desire. Hence, the ordinary share holders prefer to receive dividends in cash. In case of companies having cash dividends, the firm must have adequate liquid resources, so that its liquidity position is not adversely affected on account of cash dividend.

**(II)Scrip (or) Bond dividend:** A scrip dividend promises to pay the share holders at a future specific date. In case a company does not have sufficient funds to pay dividends in cash, it may issue notes or bonds for amounts due to the share holders. The objective of scrip dividends is to postpone the immediate payment of cash. A scrip dividend bears interest and is accepted as collateral security.

**(III) Property Dividend:** Property dividends are paid in the form of some assets other than cash. They are distributed under exceptional circumstances and are not popular in India.

**(IV) Stock Dividend:** Stocks dividend means the issue and the bonus shares to the existing share holders. If a company does not have liquid resources, it is better to declare stock dividends. Stock dividend amounts to capitalization of earnings and distribution of profits among the existing share holders without affecting the cash position of the firm.

**BONUS SHARE:** A company can pay bonus to its share holders either in cash or in the form of shares. Many a times a company need not in a position to pay bonus in cash, in spite of sufficient profits, because of unsatisfactory cash position or because of its adverse effects on the working capital of the company. Association provide any conditions, then it can pay bonus to its share holders in the form of cash. The dictionary meaning of bonus shares is a premium or gift, usually a stock, by a corporation to share holders. A Bonus share is neither dividend nor a Gift

### **FACTORS THAT GOVERN DIVIDEND POLICY**

#### **1. Profitable Position of the Firm**

Dividend decision depends on the profitable position of the business concern. When the firm earns more profit, they can distribute more dividends to the shareholders.

#### **2. Uncertainty of Future Income**

Future income is a very important factor, which affects the dividend policy. When the shareholder needs regular income, the firm should maintain regular dividend policy.

**3. Contractual constraints :** Often, the firm's ability to pay cash dividends is constrained by restrictive provisions in a loan agreement. Generally, these constraints prohibit the payment

of cash dividends until a certain level of earnings have been achieved, or they may limit dividends to a certain amount or a percentage of earnings. Constraints on dividends help to protect creditors from losses due to the firm's insolvency. The violation of a contractual constraint is generally grounds for a demand of immediate payment by the funds supplier.

#### **4. Internal constraints**

The firm's ability to pay cash dividends is generally constrained by the amount of excess cash available rather than the level of retained earnings against which to charge them. Although it is possible for a firm to borrow funds to pay dividends, lenders are generally reluctant to make such loans because they produce no tangible or operating benefits that will help the firm repay the loan. Although the firm may have high earnings, its ability to pay dividends may be constrained by a low level of liquid assets. (Cash and marketable securities) We will take the previous example to explain this point. In our example, the firm can pay Rs.1, 40,000 in dividends. Suppose that the firm has total liquid assets of Rs.50, 000 (Rs.20, 000 cash +marketable securities worth Rs.30, 000) and Rs.35, 000 of this is needed for operations, the maximum cash dividend the firm can pay is 15,000 (Rs.50, 000 – Rs.35, 000)

#### **5. Growth prospects**

The firm's financial requirements are directly related to the anticipated degree of asset expansion. If the firm is in a growth stage, it may need all its funds to finance capital expenditures. Firms exhibiting little or no growth may never need replace or renew assets. A growth firm is likely to have to depend heavily on internal financing through retained earnings instead of distributing current income as dividends.

### 6. Owner considerations

In establishing a dividend policy, the firm's primary concern normally would be to maximize shareholder's wealth. One such consideration is then tax status of a firm's owners. Suppose that if a firm has a large percentage of wealthy shareholders who are in a high tax bracket, it may decide to pay out a lower percentage of its earnings to allow the owners to delay the payments of taxes until they sell the stock. Of course, when the equity share is sold, the proceeds are in excess of the original purchase price, the capital gain will be taxed, possible at a more favourable rate than the one applied to ordinary income. Lower-income shareholders, however who need dividend income will prefer a higher payout of earnings. As of now, the dividend income is not taxed in the hands of the share holders in India. Instead, for paying out such dividends to its share holders, the company bears the dividend distribution tax

### 7. Market Considerations

The risk-return concept also applies to the firm's dividend policy. A firm where the dividends fluctuate from period to period will be viewed as risky, and investors will require a high rate of return, which will increase the firm's cost of capital. So, the firm's dividend policy also depends on the market's probable response to certain types of policies. Shareholders are believed to value a fixed or increasing level of dividends as opposed to a fluctuating pattern of dividends.

### 8. Legal Constrains



The Companies Act 1956 has put several restrictions regarding payments and declaration of dividends. Similarly, Income Tax Act, 1961 also lays down certain restrictions on payment of dividends.

### **9. Liquidity Position**

Liquidity position of the firms leads to easy payments of dividend. If the firms have high liquidity, the firms can provide cash dividend otherwise, they have to pay stock dividend.

### **10. Sources of Finance**

If the firm has finance sources, it will be easy to mobilize large finance. The firm shall not go for retained earnings.

### **11. Growth Rate of the Firm**

High growth rate implies that the firm can distribute more dividends to its shareholders.

### **12. Tax Policy**

Tax policy of the government also affects the dividend policy of the firm. When the government gives tax incentives, the company pays more dividends

### **13. Capital Market Conditions**

Due to the capital market conditions, dividend policy may be affected. If the capital market is perfect, it leads to improve the higher dividend.

### **TYPES OF DIVIDEND POLICY**

Dividend policy depends upon the nature of the firm, type of shareholder and profitable position. On the basis of the dividend declaration by the firm, the dividend policy may be classified under the following types:

- Regular dividend policy

- Stable dividend policy
- Irregular dividend policy
- No dividend policy.

**Regular Dividend Policy** Dividend payable at the usual rate is called as regular dividend policy. This type of policy is suitable to the small investors, retired persons and others. Stable Dividend Policy

**Stable dividend policy:** It means payment of certain minimum amount of dividend regularly. This dividend policy consists of the following three important forms: Constant dividend per share Constant payout ratio Stable rupee dividend plus extra dividend.

**Irregular Dividend Policy** When the companies are facing constraints of earnings and unsuccessful business operation, they may follow irregular dividend policy. It is one of the temporary arrangements to meet the financial problems. These types are having adequate profit. For others no dividend is distributed.

**No Dividend Policy** Sometimes, the company may follow no dividend policy because of its unfavourable working capital position or the amount required for future growth of the concerns. In establishing a dividend policy, the firm's primary concern normally would be to maximize shareholder's wealth. One such consideration is then tax status of a firm's owners. Suppose that if a firm has a large percentage of wealthy shareholders who are in a high tax bracket, it may decide to pay out a lower percentage of its earnings to allow the owners to delay the payments of taxes until they sell the stock. Of course, when the equity share is sold, the proceeds are in excess of the original purchase price, the capital gain will be taxed, possibly at a more favourable rate than the one applied to ordinary income. Lower-income

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QUESTION	OPTION 1	OPTION 2	OPTION 3	OPTION 4	ANSWER
The risk in average individual stock can be reduced by placing the individual stock in -----	Unsystematic Risk	diversified portfolio	undiversified portfolio	high risk portfolio	diversified portfolio
The expected returns weighted average on assets in the portfolio is considered as	weighted portfolio	expected return on portfolio	coefficient of portfolio	expected assets	expected return on portfolio
_____means combination of financial assets and physical assets	portfolio	evaluation	portfolio construction	diversification	portfolio
_____ deals with the selection of optimal portfolios by rational risk averse investors	risk management	portfolio management	portfolio construction	debt instrument	portfolio management
_____involves a shift from one stock to another or from stock to bond and vice versa in portfolio composition	risk management	portfolio management	portfolio construction	portfolio revision	portfolio revision
The policy which lays emphasis on safety of principal invested in securities is	defensive policy	aggressive policy	aggressive defensive policy	growth policy	defensive policy
Growth policy in portfolio gives priority to	current income of the portfolio	capital appreciation of the portfolio	derivatives	tax savings	capital appreciation of the portfolio
The single index model is widely employed to allocate investments in the portfolio among	equity shares	debt instruments	derivatives	revision	equity shares
portfolio diversification mangement diversification is the technique of reducing_____in a portfolio	stability	evaluation	risk	return	risk

Bonds issued by the _____ are highly safe as they are supported by the tax paying capacity of the whole nation	central government	state government	public	industry	central government
A security is regarded _____ when it can be disposed off at short notice and without any monetary loss	portfolio	liquid	scrips	industry data	liquid
The first and foremost step in the portfolio management process is the _____	identification of objectives and constraints	selection of the asset mix	portfolio execution	portfolio revision	identification of objectives and constraints
Portfolio management is the process of selecting a bunch of	current assets	long term asset	securities	debt instrument	securities
Portfolio means a combination of	financial assets and physical assets	short term assets	long term assets	very short term assets	financial assets and physical assets
The financial assets are -----	shares	silver	real estate	gold	shares
The physical assets are -----	debentures	shares	other securities	gold	gold
Asset mix means the -----	proportion of stock	proportion current asset	proportion of liability	proportion of profits	proportion of stock
A proper mix means -----	assets	asset and liability	stock and bonds	liability	stock and bonds
the first and foremost factor contributing to portfolio management is	timing of investment	planning	performance appraisal	close monitoring of shares	planning

Timing of investment is an important factor in	portfolio management	economic forecast	industry analysis	company analysis	portfolio management
Diversification reduces -----	inflation risk	market risk	interest rate risk	unique risk	unique risk
Which one of the following is not an efficient portfolio?	portfolio which gives the highest return at a particular level of risk	portfolio which gives minimum risk for given levels of return	portfolio which gives a higher return at the same risk or lower risk	portfolio which gives lower return at the lower risk	portfolio which gives lower return at the lower risk
Corner portfolio is one with -----	lowest return and risk combination	nil return	excess return	unexplained variance	lowest return and risk combination
Shares having betas less than 1 can be said to be	defensive	aggressive	neutral	appropriation	aggressive
Capital Market Line is firstly initiated by	Mohsin	Linter	Markowitz	William Sharpe	William Sharpe
The most favorable portfolio is the proficient portfolio with the	lowest risk	highest risk	highest utility	least investment	highest utility
A main difference among real and nominal interest proceeds is that	real returns adjust for inflation and nominal returns do not	real returns use actual cash flows and nominal use expected cash flows	real interest adjusts for commissions and nominal returns do not	real returns show the highest possible return and nominal returns show the lowest possible	real returns adjust for inflation and nominal returns do not

				returns	
_____ includes portfolio which gives more return for the same level of risk or same return with lesser level of risk	Efficient frontier	Baumel's model	Sharpe's model	Portfolio selection	Efficient frontier
In a two-stock portfolio, the minimum attainable risk and the lower return would be _____ portfolio	investment portfolio	sharpe's portfolio	corner	efficient portfolio	corner
_____ model is based on security's return relationship with the index return	sharpe	baumel's model	portfolio selection	efficient frontier	portfolio selection
A number of portfolio models have been developed for choosing an	sharpe's model	optimal portfolio	capital asset pricing model	possible portfolio	optimal portfolio
Sharpe's portfolio model is a	single index model	double index model		past index model	single index model
Markowitz approach has roots in	Good portfolio management	proper entry and exit in the market	estimation of stock return	Analyzing the risk and return related to stocks	Analyzing the risk and return related to stocks
An aggressive policy is one which places more emphasis on the	yield of securities	principal of securities	loss of securities	types of securities	yield of securities
Defensive policy lays much emphasis on	growth of securities	yield of securities	types of securities	safety of invested securities	safety of invested securities
aggressive defensive policy lays emphasis on a balances portfolio constructed with varied	growth of securities	yield of securities	types of securities	safety of invested securities	types of securities

Income vs growth policy resolves the conflicting issues between	fixed income and fixed capital	current income or capital gains	bonds and debentures	shares and public deposits	current income or capital gains
A sound portfolio management should ensure	selection of securities	liquidity of securities	transferability of securities	marketability of securities	marketability of securities
The marketability of a security depends upon the _____ of the market for it	risk and return	price and size	investors	under price	price and size
The size of the market is further affected by the fact whether the security is ____	over-priced	average priced	medium priced	average or medium priced	over-priced
A good investment portfolio consists of securities whose prices remain reasonably	diversify	stable	not stable	over valued	stable
Liquidity is another important principle that governs the _____ for the investor	transfer securities	yield securities	invested securities	selection of securities	selection of securities
The value of shares fluctuates more than that of	debentures	bonds	gold	real estate	bonds
Institutional investors are	commercial bank	central government	state government	semi government	commercial bank
Portfolio managers should continuously evaluate the	management	liquidity	portfolio performance	industry performance	portfolio performance
A proper decision on _____ of investment would always fetch maximum gains from investment	planning	timing of investment	portfolio revision	performance appraisal	timing of investment



Portfolio management deals with the selection of optimal portfolio by	rational risk averse	irrational risk averse	rational and irrational	various assets	rational risk averse
Portfolio revision generally involves a shift from	stock to bond	assets or revenue	assets to liability	stock to risk	stock to bond
Security analysis depends on the	sources of information	price	average return	equity	sources of information
Financial hazard is most related with	the use of equity financing by corporations	the use of the debt financing by corporations	equity investments held by corporations	debt investment held by the corporations	the use of the debt financing by corporations
In order to settle on the compound growth rate of an investment over period, an investor determine the	geometric mean	calculus mean	arithmetic mean	arithmetic median	geometric mean
Investors should be agreeing to invest in riskier investments merely	if the return is short	if there are no safe alternatives except for holding cash	if the expected return is adequate for the risk level	if there are true speculators	if the expected return is adequate for the risk level
Hold two securities as an alternative of will not decrease the hazard occupied by an investor if the two securities are	perfectively positive correlated	perfectively negative correlated	no correlation	all of the answer correct	perfectively positive correlated
----- describes the relationship between the stock's return and the index returns.	alpha	beta	regression line	standard deviation	beta
In Capital Market Line every investment is	infinitely divisible	finitely divisible	a & b	all of the answer correct	infinitely divisible

Superior portfolio is not basically a collection of individually	good portfolio	good investments	negative securities	all of the answer correct	good investments
Investments would grade the uppermost with regard to protection is	government bonds	common stock	preferred stock	real estate	government bonds
Tracking error is defined as	the difference between the returns on the overall risky portfolio versus the benchmark return.	the variance of the return of the benchmark portfolio	the variance of the return difference between the portfolio and the benchmark	the variance of the return of the actively-managed portfolio	the difference between the returns on the overall risky portfolio versus the benchmark return.
If a portfolio manager consistently obtains a high Sharpe measure, the manager's forecasting ability _____.	is above average	is average	is below average	does not exist	is above average
Active portfolio management consists of _____.	market timing	security analysis	indexing	market timing and security analysis	market analysis and security analysis
Perfect timing ability is equivalent to having _____ on the market portfolio.	a call option	a futures contract	a put option	a commodities contract	a call option

FINANCIAL MANAGEMENT  
UNIT -5  
SYLLABUS

**Working Capital Decisions:** Concepts of Working capital, the risk – return trade off, sources of short-term finance, working capital estimation, cash management, receivables management, inventory management and Payable Management.

**MEANING OF WORKING CAPITAL**

Capital required for a business can be classified under two main categories

- (1) Fixed Capital
- (2) Working Capital

Every business needs funds for two purposes for its establishment and to carry out its day-to-day operations. Long-term funds are required to create production facilities through purchase of fixed assets such as plant and machinery, land, building, furniture etc. Investments in these assets represent that part of firm's capital which is blocked on a permanent or fixed basis and is called fixed capital. Funds are also needed for short-term purposes for the purchase of raw materials, payment of wages and other day-to-day expenses, etc. These funds are known as working capital.

**Definition**

*In the words of Shubin,* "Working capital is the amount of funds necessary to cover the cost of operating the enterprise".

*According to Genestenberg,* "Circulating capital means current assets of a company that are changed in the ordinary course of business from one form to another, as for example, from cash to inventories, inventories to receivables, receivables into cash".

**CONCEPTS OF WORKING CAPITAL**

There are two concepts of working capital:

(A) Balance Sheet Concept

(B) Operating Cycle or Circular Flow Concept

(A)Balance Sheet Concept: There are two interpretations of working capital under the balance sheet concept:

(i) Gross Working Capital

(ii) Net Working capital

In the broad sense, the term working capital refers to the gross working capital and represents the amount of funds invested in current assets. Thus, the gross working capital is the capital invested in total current assets of the enterprise; current assets are those assets which in the ordinary course of business can be converted into cash within a short period of normally one accounting year.

**Net Working Capital = Current Assets – Current Liabilities.**

Net Working Capital may be positive or negative. When the current assets exceed the currentLiabilities the working capital is positive and the negative working capital results when the current liabilities are more than the current assets. Current liabilities are those liabilities which are intended to be paid in the ordinary course of business within a short period of normally one accounting year out of the current assets or the income of the business.

The gross working capital concept is financial or going concern concept whereas net working capital is an accounting concept of working capital. These two concepts of working capital are not exclusive; rather both have their own merits.

**(B)Operating Cycle or Circular Flow Concept**

Working capital refers to that part of firm's capital which is required for financing short-term or current assets such as cash, marketable securities, debtors and inventories. Funds, thus, invested in current assets such as cash, marketable securities, debtors and inventories. Funds, thus, invested again in exchange for other current assets. The gross operating cycle of a firm is equal to the length of the inventories and receivables conversion periods. However, a firm may acquire some resources on credit and thus defer payments for certain period. In that case, net operating cycle period can be calculated as below:

Net Operating Cycle Period = Gross Operating Cycle Period – Payable Deferral Period

**CHARACTERISTICS OF WORKING CAPITAL**

- 1. Short –term Requirements:** Working capital is utilized to purchase current assets which can be easily converted into cash in short period of time. The length of production process decides the duration of working capital; it is the time period between sale and cash receipts.
- 2. Circular Movement:** Working capital is continuously transformed into cash but it again turns into working capital. This process is on continuous basis. When cash is utilized to purchase current assets and with the help of current assets goods are produced and sold then therefore working capital is also termed as circulating capital.

**3. Permanence:** Working capital is a short-term capital but in order to continue the production process it is always required by the firm. Hence working capital is also termed as permanence or regular working capital.

**4. Instability:** Though working capital is required permanently in a firm but the amount of working capital required frequently changes with the changes in production level, changes in purchase, sale policy, price level and demand level. The amount of working capital that changes due to changes in other factors is called variable working capital.

**5. Liquidity:** Working capital can be easily converted into cash, hence it is more liquid. Firms which maintain adequate amount of working capital finds easy to convert it into cash in time when cash is required.

**6. Less Risky:** Working capital is the investment in current assets which is for a short period of time. Hence it involves less risk. Working capital does not involve any risk related to technological changes. It involves a very less amount of physical risk only.

**7. Special Accounting System not Required:** As working capital is for short-term usually for one year. Hence, there is no need to adopt special accounting system for it.

### **SHORT-TERM FINANCE**

#### **(i) Commercial Paper (CP):**

It is a new money market instrument introduced in India in recent times. CPs are issued usually in large denominations by the leading, nationally reputed, highly rated and credit worthy, large manufacturing and finance companies in the public and private sector. The proceeds of the issue of commercial paper are used to finance current transactions and

seasonal and interim needs for funds. Reliance Industries is one of the early companies which are issued Commercial Paper.

**(ii)Bank Overdraft:**

This is a special arrangement with the banker where the customer can draw more than what he has in this savings/current account subject to a maximum limit. Interest is charged on a day-to-day basis on the actual amount overdrawn. This source is utilized to meet the temporary shortage of funds

**(iii)Trade Credit:**

This is a short-term credit facility extended by the creditors to the debtors. Normally, it is common for the traders to buy the material and other supplies from the suppliers on credit basis. After selling the stocks, the traders pay the cash and buy freshstocks again on credit. Sometimes, the suppliers may insist on the buyer to sign a bill (bill of exchange). This bill is called bills payableDebt Factoring or Credit Factoring

Debt Factoring is the arrangement with factor where the trader agrees to sell its accounts receivable or debtors at discount to the specialized dealers called factors. In the case of Credit Factoring, the trader agrees to sell his accounts payables (at premium).

**(iv)Advance from Customers:**

It is customary to collect full or part of the order amount from the customer in advance. Such advances are useful to meet the working capital needs. Short-term deposited from the customers, sister companies and outsiders .It is normal to find the supermarkets and trading organizations inviting deposits of six months to one year duration. As an incentive, such deposit holders may be given 5-10 precept discounts on the purchases. Internal funds:-

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Internal funds are generated by the firm itself by way of secret reserve, depreciation provisions, taxation provision, and retained profits and so on and these can be utilized to meet out at the time of emergencies.

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QUESTION	OPTION 1	OPTION 2	OPTION 3	OPTION 4	ANSWER
The ----- refers to all the facilities and the institutional arrangements for the borrowing and the loaning of long-term funds	money market	capital market	bullion market	securities market	capital market
Stock exchange	helps in the fixation of stock prices	ensures safe and fair dealings	induces good performance of the company	performs all the above functions	performs all the above functions
The advice adopted to make profit out of the differences in prices of a security in two different markets is called	arbitrage	listing	jobber	secondary market	arbitrage
The market where existing securities are bought and sold	secondary market	primary market	money market activity	all of the above	secondary market
According to ----- all investors hold only the market portfolio and riskless securities	CAPM	SWOT	GDP	NAV	CAPM
National stock exchange was recognised on a permanent basis in the year	1956	1992	1958	1959	1992
OTCEI is	a national stock exchange	a regional stock exchange	primary market	a government undertaking	a national stock exchange
Members of OTCEI are	corporates only	individual only	corporates as well as individual	government	corporates only
Consumer protection fund is set up	to protect the investors against price fluctuations	to protect the broket in case of non-payment of money by investors	to provide in surance to investors in case of default by the members	to protect the member and the investor	to provide in surance to investors in case of default by the members
A ----- means giving privilege to certain investors in subscription of securities	call option	put option	send option	right issue	right issue
The debentures which are repayable after a certain period are called -----	convertible debentures	preferred debentures	ordinary debentures	redeemable debentures	redeemable debentures

SEBI is	an apex body	a security market	an intermediary in stock exchange	regulate	an apex body
----- show the linear relationship between the expected returns and betas of the securities	linear line	capital market line	security market line	regression line	Security market line
Primary market is	an issue marketability outstanding securities	a new issue market	a profitable market	security	a new issue market
----- represents relationship between the expected returns and standard deviation of the portfolio	linear line	capital market line	security market line	regression line	capital market line
At par means	shares issued at premium	shares issued at discount	shares issued at face value	actual value	shares issued at face value
Right issues are offered to	the existing shareholders	the promoters of the company	the public at large	private company	the existing shareholders
The person who is appointed to assist the stock broker is called	remitters	authorized clerk	commission brokers	tarawaniwala	authorized clerk
Mr.X buys 100 shares of Ponds India Ltd., from Mr,Y. this is a	primary market activity	secondary market activity	money market activity	SEBI	secondary market activity
an order for purchase of securities at a fixed price is known as	at best order	limit order	discretionary order	open order	limit order
NSE was set up	1956	1992	1986	1987	1992
NSE is a fully automated	screen based	brokerage	marketing	transferring	screen based
NSE trading ensures total _____of the transaction	identity	grievances	transparency	security	transparency
The identity of the NSE trading members is kept	secrecy	transparency	wide	circulating	secrecy
NSE aims at	short term settlement	long term settlement	Both a&b	medium term	short term settlement

OTCEI stands	over the counter exchange of India	over the customer exchange of India	on trade counter exchange of India		over the counter exchange of India
OTCEI was set up for	big concern	medium concern	small and medium size concern	entrepreneur	small and medium size concern
Deferred share are also known as -----	right shares	new shares	secondary shares	founders shares	founders shares
An equity share is a	fixed income bearing security	variable income bearing security	hybrid security	average	variable income bearing security
Ex-dividend on shares refers to	purchase price includes dividend	purchase price does not include dividend	purchase price includes interest and dividend	convertible price	purchase price does not include dividend
Scrip dividend is in the form of	cash	a promissory note with interest	stock	debt	a promissory note with interest
_____ Value of a share means the value of assets available per share	par	intrinsic	market value	yield	intrinsic
_____ Shares regarded as a hybrid stock between a bond and a common stock	preference	Equity Share	Debentures	yield	Equity Share
The call option price is higher when	the option period is longer and the striking price is lower	the option period is longer	the striking price is equal to striking price	there is low premium	the striking price is equal to striking price
When the writer sells the option without the stock, it is called	naked option	call option	put option	hedging	naked option
Sensex is the weighted average of the prices of	50 shares	30 shares	20 shares	10 shares	30 shares

The premium of the call option is directly related to	stock price	market price	current price	standard price	stock price
The option buyer gains in the	stock market	primary market	secondary market	bearish market	secondary market
The main function entrusted with SEBI is	capital formation	regulating the business stock exchanges and any other securities market	issue of securities	giving financial assistance to stock exchange	regulating the business stock exchanges and any other securities market
The carry forward system mainly used by the speculative brokers and large traders is known as	Badla trade	insider trading	Delisting	book building	Badla trade
SEBI was set up in the year	1966	1697	1992	1988	1992
Composite issue means	Right cum Public issue	grievance cell	buy back shares	ploughing	Right cum Public issue
only he can enter into the floor of the stock exchange and transact business in listed securities	owners	businessmen	executives	members	members
The nerve center of the monetary system of the country is	commercial bank	RBI	Corporate Banks	Financial Institution	RBI
The following are the convertible securities	preference share	Equity Share	Debentures	Public deposit	preference share
A----- is an option to buy certain securities at a fixed price on a future date	call option	put option	the jobber	trader	a call option
new companies rarely offer shares at a	Premium	Discount	Both a&b	Par	Both a&b
When the market is moving upwards continuously, of short duration. This is referred as	bull run	bear phase	correction	movements	bull run
some organization issue bonds of a	short term	long term	medium	very short	short term
----- is an investment vehicle that pools together funds from investors to purchase stocks, bonds or other securities	mutual fund	growth fund	maturity fund	initial fund	mutual fund

the _____ acquire bonds and automatically accept the indenture	shareholder	investor	bondholder speculator	broker	bondholder speculator
the activities of _____ have been divided into three points. i.e origination, underwriting and distribution	New issue market	stock exchange	secondary market	SEBI	stock exchange
It is transaction generally made by the bear speculator whereby the speculator acquire a right to sell is known as	call option	put option	the jobber	trader	put option
Investment in debentures is known as ----- securities	debtorship	creditorship	assets	liabilities	creditorship
The mutual funds that are listed in the stock exchanges are	closed end funds	stock indexed funds	open end funds	growth schemes	closed end funds
The Stock exchanges in india are regulated by the securities contract act	Feb 20 1955	Feb 20 1957	Feb 20 1958	Feb 20 1960	Feb 20 1957
The --- approach the investor continously assesses the risk and return of the securities with in the asset classes and chage them accordingly	Active approach	Passive approach	Unique approach	Market approach	Active approach
Capital issues control act was passed in	1940	1945	1947	1957	1947
The most popular method for floating shares in new issue market is_____	Prospectus	Offer for sale	Placement	Rights issue	Prospectus
Jensen's performance index gives importance to the	asset combination	professional management	market condition	predictive ability of the manager	predictive ability of the manager