15PAU506A

FINANCIAL MANAGEMENT

PROGRAMME OUTCOME

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

LEARNING OUTCOME

- To enable the students to acquire knowledge of financial functions.
- To enlighten the students knowledge in cost of capital, capital structure, capital budgeting and in working capital management.

Unit I

Finance Functions : Meaning – Definition and Scope of Finance Functions – Objectives of Financial Management – Profit Maximization and Wealth Maximization. Sources of Finance – Short term – Bank Sources – Long term – Shares – Debentures, Preferred Stock – Debt.

Unit II

Financing Decision : Cost of Capital – Cost of Specific Sources of Capital – Equity – Preferred Stock – Debt – Retained Earnings – Weighted Average Cost of Capital. Leverage – Operating Leverage – Financial Leverage.

Unit III

Capital Structure : Meaning – Definition – Factors Influencing Capital Structure – Optimal Capital Structure – Dividend and Dividend Policy – Meaning – Classification – Sources Available for Dividends – Determinants of Dividend Policy.

Unit IV

Working Capital Management : Concepts – importance – Determinants of Working Capital. Cash Management – Motives for Holding Cash – Objectives and Stratefies of Cash Management. Receivables Management – Objectives – Cost of Credit Extension, Benefits – Credit Policies – Credit Terms – Collection Policies – Inventory Management – Techniques.

Unit V

Capital Budgeting : Meaning – Objectives – Methods of Evaluation of Capital Budgeting – Traditional Methods – Pay Back Period Mehod – Rate of Return – Discounted Cash flow Methods – Net Present Value Method – Internal Rate of Return – Profitability Index Method.

Text Books

1. S.N.Maheswari, 2014, Financial Management, Sultan Chand & Sons. New Delhi

References

- 1. P.V.Kulkarni, 2011, Financial Management, Himalaya Publishing House, Mumbai
- 2. Khan and Jain, 2007, Financial Management, Rata Mc Graw Hill, Publishers Pvt. Ltd. New Delhi.
- 3. I.M.Pandey, 2009, Financial Management, Vikas Publications, New Delhi.

KARPAGAM UNIVERSITY

Karpagam Academy of Higher Education

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III BCOM (PA)- FINANCIAL MANAGEMENT 15PAU506A LECTURE PLAN

S. no	Lecture Duration	Topic to be covered	Support Materials		
	(Hr)				
1.	1	Financial Management : meaning and features	T : Pg 3		
2.	1	Scope and objectives of Financial Management	R1: Pg 5-10		
3	1	Profit Maximization and wealth maximization	R1: Pg 5-10		
4.	1	Sources of Finance and its classification	T: Pg 82		
5.	1	Security Financing, Short term and Long term	T: Pg . 91		
6.	1	Preferred stock and debt	T: P.120		
7.	1	Comparison between financing through equity shares and	T: P. 94		
		debentures.			
8.	1	Short term loans and credit	T: Pg 98		
9.	1	Loans, Cash Credit and Overdrafts	T: Pg 99		
	1	Bank loan and other short term loans	T: Pg 99		
10.					
11.	1	Loan against debentures and shares	T.Pg 94		
12.	1	Contribution to government revenues	R3 : A/10		
13.	1	Recapitulation and important question discussion			
14.	1	Recapitulation and important question discussion			

Unit I

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S.	Lecture	Topic to be covered	Support Materials		
no	Duration				
	(Hr)				
1.	1	Cost of Capital, Meaning and definition	W2		
2.	1	Importance of Cost of Capital	T : Pg 368-369		
3.	1	Cost of redeemable Debt capital	T: Pg.377-378		
4.		Cost of Irredeemable Debt	T: Pg.377-378		
5.	1	Cost of redeemable Preference Share Capital	T : Pg. 378-380		
6.		Cost of irredeemable Preference share Capital	T: Pg.377-378		
7.	1	Cost of Equity Capital – Problems	T: Pg 380-385		
8.		Dividend Yield plus Growth	T: Pg.377-378		
9.	1	Cost of Retained earnings -problems	T: Pg 385-388		
10.		Cost of Retained earnings - problems	T: Pg 385-388		

11.	1	Weighted Average Cost of Capital-problems	T: Pg 388-396
12.	1	Weighted Average Cost of Capital - Problems	T: Pg 388-396
13.	1	Leverages-operating leverage	R1Pg 10.1-10.44
14.	1	Financial leverage	R3: C/186-C/190
15.	1	Problems in Financial Leverage	R3: C/186-C/190
16.	1	Combined leverage - Problems	R3: C/186-C/190 R3:
			C/186-C/190
17.	1	Recapitulation and important question discussion	

S.	Lecture	Topic to be covered	Support Materials
no	Duration		
	(Hr)		
1.	1	Capital Structure, Meaning and definition	R2:Pg 51-55
2.	1	Theories of Capital structure-Net Income Approach	T:Pg 51-54
3.	1	Net Operating Income Approach	T:Pg 54-63
4.	1	Modiglani Miller Approach	T:Pg 54-63
5.	1	Traditional Approach	T:Pg 54-63
6.	1	Determinants of Capital Structure	T: Pg 70-74
7.	1	Calculation of optimum Capital Structure	T: Pg 70-74
8.	1	Dividend policy meaning and importance	R2.Pg 12.1
9.	1	Types of dividend policy and forms of dividend	T:Pg12.5
10.	1	MM Hypothesis Problems	T: Pg 12.5-12.7
11.	1	Walter Model of dividend payment	R2 Pg 12.37-12.40
12.	1	Gordon Model of dividend Payment	R2 Pg 12.37-12.40
13.	1	Factors determining dividend policy	R2 Pg 12.8-12.10
14.	1	Recapitulation and important question discussion	
15.	1	Recapitulation and important question discussion	

Unit III

S.	Lecture	Topic to be covered	Support Materials		
no	Duration				
	(Hr)				
1.	1	Working Capital Management, meaning, concepts	R1:Pg13.1-13.2		
2.	1	Determinants of Working Capital	T: Pg 293-295		
3.	1	Cash Management, meaning and objectives	T:Pg 299-309		
4.	1	Level of maintaining Optimum Cash	T:Pg 299-309		
5.	1	Motives of holding cash, cash budget, problems	T:Pg 299-309		
6.	1	Preparation of Cash Budget	T:Pg 299-309		
7.	1	Receivable management, meaning and objectives	T:Pg 331-353		
8.	1	Calculation of DTR and CTR	T:Pg 331-353		
9.	1	Cost of credit extension and it benefits	T:Pg 331-353		
10.	1	Credit policy and credit terms	T: Pg331-353		
11.	1	Collection policies,	T: Pg 311-314		
12.	1	inventory Management and its significance	T: Pg 311-314		
13.	1	Calculation of Inventory Turnover Ratio	T: Pg 311-314		
14.	1	Techniques of Maintaining Inventory	T: Pg 311-314		
15.	1	Recapitulation and important question discussion			

Unit IV

Unit V

S.	Lecture	Topic to be covered	Support Materials
no	Duration		
	(Hr)		
1.	1	Capital Budgeting, meaning and objectives	W2
2.	1	Methods of evaluation of capital budgeting	R1:Pg 5.1-5.2
3.	1	Traditional methods, Problems	T: Pg213-217
4.	1	Pay Back period method	T:Pg 213-217
5.	1	Problems in Pay Back Period Method	T:Pg 213-217
6.	1	Rate of return method	T:Pg 424-436
7.	1	Discounted cash flow method	T: Pg 424-436
8.	1	Problems in Discounted Cash Flow Method	T: Pg 424-436
9.	1	Net present value, IRR and profitability index method	T:Pg 218-223
10.	1	Problems in NPV and IRR	T:Pg 218-223
11.	1	Recapitulation and important questions discussion	
12.	1	Discussion of Previous year ESE question	
13.	1	Discussion of Previous year ESE question	
14.	1	Discussion of Previous year ESE question	

TEXT BOOK

T- Dr. S.N. Maheswari, 2015 Financial Management, Sultan Chand and Sons publications

REFERENCE BOOK

R1 Dr. R. Ramachandran, Dr. S. Srinivasan, Financial Management, 2014, Sriram Publications

WEBSITE

W2 www.investopedia.com/terms/c/cost of capital.asp

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<u>UNIT-I</u>

SYLLABUS

Introduction: Meaning, Definition, Scope of Financial Management – Financial Decisions – Financial Planning – Objectives and Principles of Sound Financial Planning – Long-term and Short-term – Role and Functions of a Finance Manager.

FINANCIAL MANAGEMENT - MEANING

- ✤ Financial Management is concerned with management of finance or finance function
- Financial management is a managerial activity which is associated with planning and controlling of companies' financial resources because financial resources are scarce and limited which needs proper planning and control in order to achieve the best result out of the complex situations of risk and uncertainty prevailing in the business world.

FINANCIAL MANAGEMENT – DEFINITION

- Prof. Ezra Solomon, "Financial Management is concerned with the efficient use of an important economic resources, namely economic funds"
- Hoagland, "Financial Management deals with how the corporation obtains the funds and how it uses them"
- Joesph and Massie, "Financial Management is the operational activity of a business, that is responsible for obtaining and effectively utilizing the funds necessary for efficient operations"

SCOPE OF FINANCIAL MANAGEMENT

Determining Financial Needs

The most important function of the financial manager is to ensure the available of adequate financing. Financial needs have to be assessed for different purposes. Money may be required for initial promotional expenses, fixed capital and working capital needs. Promotional expenditure includes expenditure incurred in the process of the company formation. Fixed assets needs depends upon the nature of the business enterprise-whether it is a manufacturing, non-manufacturing or merchandizing enterprise. Current assets needs depend upon the size of working capital required by an enterprise

Determining Sources of Funds

The financial manager has to decide the sources of funds. He may issue different types of securities. He may borrow funds from a number of financial institutions and the public. When a firm is new and small and little known in financial circles, the financial manager faces a great challenge in raising funds. Even when he has a choice in selecting the sources of funds, that choice should be exercised with great care and caution

Financial Analysis

The financial manager has to interpret different financial statements. He has to use a large number of ratios to analyze the financial status and activities of his firm. He is required to measure its liquidity, determine its profitability, and assess overall performance in financial terms. This is often a challenging task, because he must understand the importance of each one of the aspects of the firm, and he should be crystal clear in his mind about the purposes for which liquidity, profitability and performance are to be measured

Capital Structure

The financial manager has to establish capital structure and ensure the maximum rate of return on investment. The ratio between equity and other liabilities carrying fixed charges has to be defined. In the process, he has to consider the operating and financial leverages of his firm. The operating leverage exists because of operating expenses, while the financial leverage exists because of the amount of debt involved in the firm's capital structure. The financial manager should have adequate knowledge of the different empirical studies on the optimum capital structure and find out whether and to what extent he can apply their findings to the advantage of the firm

Cost-volume profit Analysis

This is popularly known as the 'CV Relationship'. For this purpose, fixed costs, variable costs and semi-variable costs have to be analyzed. Fixed costs are more or less constant for varying sales volumes. Variable costs vary according to the sales volume. Semi-variable costs are either fixed or variable in the short run. The financial manager has to ensure that the income of the firm will cover its variable costs. Moreover, a firm will have to generate an adequate income to cover its fixed costs as well. The financial manager has to find out the break-even point that is, the point at which the total costs is matched by total sales or total revenue. He has to try to shift the activity of the firm as far as possible from the breakeven point to ensure the company's survival against seasonal functions.

Profit Planning and Control

Profit planning is an important responsibility of the financial manager. Profit is the surplus which accrues to a firm after its total expenses are deducted from its total revenue. It is necessary to determine profits properly for the measure of the economic viability of a business. The revenue may be from sales or it may be operating revenue, or income from other sources. The

expenditure may include manufacturing costs, trading costs, selling costs, general administrative costs and finance costs. Profit planning and control is a dual function which enables a management to determine the cost it has incurred, and revenues it has earned during a particular period and provides shareholders and potential investors with information about the earning strength of the corporation. Profit planning and Control directly influence the declaration of dividend, creation of surpluses, taxation, etc., Break-even analysis and cost volume profit are some of the tools used in profit planning and control

Fixed Assets Management

Fixed assets are land, building, machinery and equipment, furniture and intangibles as patents, copyrights, goodwill, etc., The acquisition of fixed costs involves capital expenditure decisions and long-term commitments of funds. These fixed assets are justified to the extent of their utility and / or their productive capacity. Long-term commitment of funds, the decisions governing their purchase, replacement etc., should be taken with great care and caution. Often, these fixed assets are financed by issuing stock, debentures, long-term borrowings and deposits from the public. When it is not worthwhile to purchase fixed assets, the financial manager may lease them and use the assets on a rental basis

Project Planning and Evaluation

A substantial portion of the initial capital is the long-term assets of a firm. The error of Judgement in project planning and evaluation should be minimized. Decisions are taken on the basis of feasibility and project reports containing economic, commercial, technical, financial and organizational aspects. The essentiality of a project is ensured by a technical analysis. The economic and commercial analysis studies the demand position for the product. The economy of price, the choice of technology and the availability of the factors favoring a particular industrial site are all considerations which merit attention in a technical analysis. The financial analysis is perhaps the most important and includes a forecast of the

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cash inflows and the total outlay which will keep down the cost of capital and maximize the rate of return on investment.

Capital Budgeting

Capital budgeting decisions are most crucial for these have long-term implications. These relate to a judicious allocation of capital. Current funds have to be invested in long-term activities in anticipation of an expected flow of future benefits spread over a long period of time. Capital budgeting forecasts returns on proposed long-term investments and compares the profitability of different investments and their cost of capital. It results in capital expenditure investments. The various proposals are ranked on the basis of such criteria as urgency, liquidity, profitability and risk sensitivity. The financial analyzer should be thoroughly familiar with such financial techniques as payback, internal rate of return, discounted cash flow and net present value among others because risk increases when investment is stretched over a long period of time

Working Capital Management

Working capital refers to that part of firm's capital which is required for financing short term or current assets such as cash, receivables and inventories. It is essential to maintain proper level of these assets. Financial Manager is required to determine the quantum of such assets

Dividend Policies

Dividend policies constitute a crucial area of financial management. While owners are interested in getting the highest divided from a corporation, the Board of Directors may be interested in maintaining its financial health by retaining the surplus to be used when

contingencies, if any arise. A firm may try to improve its internal financing so that it may avail itself the benefits of future expansion.

However, the interests of a firm and its stockholders are complementary, for the financial management is interested in maximizing the value of the firm and the real interest of the stockholders always lies in the maximization of this value of the firm; and this is the ultimate goal of financial management. The dividend policy of a firm depends on a number of financial considerations, the most critical among them being profitability. Thus, there are different dividend policy patterns which a firm may choose to adopt, depending upon their suitability for the firm and its stockholders' group.

Acquisition and Mergers

Firms may expand externally through co-operative arrangements, by acquiring other concerns or by entering into mergers. Acquisitions consist of either the purchase or lease of a smaller firm by a bigger organization. Merger may be accomplished with a minimum cash outlay, through these involve major problems of valuation and control. The process of valuing a firm and its securities is difficult, complex and prone to errors. The financial manager should, therefore, go through the valuation process very carefully.

FINANCIAL DECISION OR IMPORTANT DECISION IN FM

Financial decisions refer to decision concerning financial matters of a business firm. There are many kinds of financial management decisions that the firm makes in pursuit of maximizing shareholder's wealth, viz., kinds of assets to be acquired, pattern of capitalization, distribution of firm's income etc.,

Investment Decision

- Investment decision relates to the determination of total amount of assets to be held in the firm, the composition of these assets and the business risk complexions of the firm as perceived by its investors. It is the most important financial decision. Since funds involve cost and are available in a limited quantity, its proper utilization is very necessary to achieve the goal of wealth maximization
- The investment decisions can be classified under two broad groups: (i) Long-term investment decision and (ii) Short-term investment decision. The long-term investment decision is referred to as the capital budgeting and the short-term investment decision as working capital management.
- Capital budgeting is the process of making investment decision in capital expenditure. These are expenditures, the benefits of which are expected to be received over a long period of time exceeding one year. The finance manager has to assess the profitability of various projects before committing the funds. The investment proposal should be evaluated in terms of expected profitability, costs involved and the risks associated with the projects. The investment decision is important not only for the setting up of new units but also for expansion of present units, in case, investments made earlier do not fetch result as anticipated earlier
- Short-term investment decision, on the other hand, relates to the allocation of funds as among cash and equivalents, receivables and inventories. Such a decision is influenced by trade off between liquidity and profitability. The reason is that, the more liquid the asset, the less it is likely to yield and the more profitable an asset, the more illiquid it is. A sound short-term investment decision or working capital management policy is one which ensures high profitability, proper liquidity and sound structural health of the organization

Financing Decision

- Once the firm has taken the investment decision and committed itself to new investment, it must decide the best means of financing these commitments. Since, firms regularly make new investments, the needs for financing and financial decisions are on going. Hence, a firm will be continuously planning for new financial needs. The financing decisions is not only concerned with how best to finance new assets, but also concerned with the best overall mix of financing for the firm
- A finance manager has to select such source of funds which will make optimal capital structure. The important thing to be decided here is the proportion of various sources in the overall capital mix of the firm. The debt-equity ratio should be fixed in such a way that it helps in maximizing the profitability of the concern. The raising of more debts will involve fixed interest liability and dependence upon outsiders. It may help in increasing the return on equity but will also enhance the risk. The raising of funds through equity will bring permanent funds to the business but the shareholders will expect higher rates of earnings. The financial manager has to strike a balance between various sources so that the overall profitability of the concern improves. If the capital structure is able to minimize the risk and raise the profitability then the market prices of the shares will go up maximizing the wealth of the shareholders

Dividend Decision

The third major financial decision relates to the disbursement of profits back to investors who supplied capital to the firm. The term dividend refers to that part of profits of a company which is distributed by it among its shareholders. It is the reward of shareholders for investments made by them in the share capital of the company. The dividend decision is concerned with the quantum of profits to be distributed among shareholders. A decision has to be taken whether all the profits are to be distributed, to retain all the profits in business or to keep a part of profit in the business and distribute others among shareholders. The higher rate of dividend may raise the market price of shares and thus, maximize the wealth of

shareholders. The firm should also consider the question of dividend stability, stock dividend (bonus shares) and cash dividend

FINANCIAL PLANNING

Planning is the primary function of management. Planning is done for each functional area of management. As financial management is one of the functional areas of management, planning is done even by financial management. Financial planning is done starting from the stage of promotion of the enterprise to its expansion, modernization, diversification and dayto-day running

DEFINITION ON FINANCIAL PLANNING

In the words of J.H. Bonneville, "The financial plan of a corporation has two-fold aspects. It refers not only to the capital structure of the corporation but also to the financial policies which the corporation has adopted or intends to adopt". According to this definition, financial planning means determination of capital structure of the corporation and formulation of the financial policies to be adopted by the corporation

According to Cohen and Robbins, financial planning should:

- > Determine the financial resources required to meet the company's operating programme
- Forecast the extend to which these requirements will be met by internal generation of funds and the extent to which they will be met from external sources
- > Develop the best plans to obtain the required external funds
- Establish and maintain system of financial controls governing the allocation and use of funds
- > Formulate programmes to provide the most effective profit-volume cost relationships
- > Analyse the financial result of operations
- Report the facts to the top management and make recommendations on future operations of the firm

OBJECTIVES OF FINANCIAL PLANNING

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- ✤ To ensure adequate supply of funds to the enterprise to achieve the enterprise goals
- ✤ To minimize the cost of fund raising by procuring the funds under the most favorable terms
- To maintain proper balance of costs with the risks involved in raising funds to protect the interests of the investors
- To see that the financial structure of the firm is simple, and not complicated by issuing a variety of securities
- To see that the funds raised are used wisely (i.e. put to optimum use)
- ✤ To ensure a fair return to the shareholders on their investment
- To see that the financial plan is flexible, (i.e. adjustable) as per the changing conditions and requirements
- ✤ To facilitate the smooth running of the business by ensuring liquidity of funds at all times

PRINCIPLES OF SOUND FINANCING PLANNING

Clear-cut Objectives

The financial plan should be based on clear-cut objectives, i.e. the overall objective of the concern, viz., improvement of the profitability of the business

Less Dependence on Outside Sources

Of course, in the beginning, resource to outside funds may be a necessity. But dependence on outside funds should be reduced in course of time. So, long-term financial planning should be such as to reduce dependence on outside sources. This is possible by ploughing back of profits

Simplicity

The financial plan should be simple so that it can be easily understood even by a layman. Further, the financial plan should contain a simple financial structure that can be implemented and managed easily. That is, the number of securities, (i.e. the sources of funds) envisaged in the financial plan should be the minimum possible

Long-term View

The financial plan should be formulated, keeping in view the long-term requirements, and not just the immediate or short-term requirements of the concern. This is because, generally, a financial plan, originally formulated, would continue to operate for a long time after the formation of the concern

Flexibility

The financial plan should have flexibility. That is, the financial plan should be such that it can be revised or changed according to the changing needs of the business with the minimum possible delay

Planning Foresight

The financial plan should be framed, keeping in view the present as well as the future requirements of funds for the business. To assess the future requirements of funds for the business, accurate forecasts are required to be made regarding the future scope of operations of the concern, technological developments, etc., The making of accurate forecasts as to the future scope of operations requires much foresight on the part of the financial planners. In short, the financial plan must be visualized with much foresight. A financial plan visualized without foresight may fall to meet the present as well as the future requirements of funds and

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bring disaster to the concern. In the words of Hoagland, "Foresight should be used in planning the scope of operations in order that the needs of capital may be estimated as accurately as possible"

Intensive or Optimum Use

A business should neither starve for funds nor should have unnecessary idle funds. That means, the financial plan should provide for the optimum use of funds. In the words of Hoagland, "Wasteful use of capital is as bad as inadequate capital". So, the financial plan should provide for sufficient funds for meeting the genuine needs of the business. To ensure the optimum use of funds, while framing the financial plan, the financial planners should keep in view the proper utilization of the funds in the context of the overall objective of maximization of wealth. Again, they (i.e. financial planners) should see that a proper balance is maintained between long-term funds and short-term funds, since the surplus of one will not be able to offset the shortage of the other.

Contingencies

The financial plan should make adequate provision for funds for meeting the contingencies likely to arise in the future. It may be noted that this principle does not mean that large amount of funds should be kept idle as reserve for unforeseen contingencies. It simply means the while formulating the financial plan, the financial planners should make proper forecasts of the contingencies likely to arise in the future and make adequate provision for funds for meeting the future contingencies

Liquidity

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- There should be adequate liquidity in the financial plan. Liquidity means the ability of the concern to make cash available, whenever required, for making payments
- Adequate liquidity in the financial plan will act as a shock absorber in the event of business operations deviating from the normal course
- Further, it gives the financial plan certain degree of flexibility. Above all, it will help in avoiding embarrassment to management and loss of reputation of the concern in the eyes of the public

Economy

The financial plan should ensure economy. That is, it should ensure that the cost of raising the funds is the minimum. That is possible by having a proper debt-equity mix in the capital structure

Investors' Preference or Temperament

The preference of the investors are different. Investors, who are bold and venturesome, prefer equity shares. Investors, who are not very bold, have a liking for preference shares. Investors, who are cautious, go for debentures. As such, the financial plan should keep in mind the temperament or the preferences of the investors. That is, the financial plan should be formulated in consonance (i.e. in accordance) with the preference of the investors.

LONG-TERM AND SHORT-TERM FINANCIAL PLAN

From the point of view of the period of coverage, financial plans may be divided into two types: They are (1) Long-term financial plan and (2) Short-term financial plan

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Long-term financial Plan

- Long-term financial plan is concerned with the formulation of long-term financial goals of the enterprise and the determination of the ways and means of achieving those goals. Longterm financial plans attempt to anticipate, analyse and make decisions about basic financial problems and issues which are beyond the present horizon of the enterprise
- The length of the period varies from concern to concern depending upon the nature of the business, the risks and uncertainties, Government control etc.,
- ◆ Large companies, generally, choose long-term financial plan
- The preparation of long-term financial plan is a very difficult task. But it is quite essential in the competitive business world
- Long-term financial plans are, generally, prepared on the basis of long-term financial forecasts, and the long-term financial forecasts are prepared by relating the items of profit and loss account and balance sheet to sales

Short-term Financial Plan

- Short-range or short-term financial plan is concerned with the planning or determination of short-term financial activities to accomplish long-term financial objectives. As a short-term financial plan is intended to achieve long-term financial objectives, it (i.e. short-term financial plan) has to be consistent with long-range financial plan. Short-term financial plan is more action-oriented, more detailed, specific and quantitative.
- The preparation of short-term financial plan is relatively easier. Small companies, generally, choose short-term financial plan.

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ROLE OF FINANCIAL MANAGER

Estimating Financial Requirements

The first task of a financial manager is to estimate short-term and long-term financial requirements of his business. For this purpose, he will prepare a financial plan for present as well as for future. The amount required for purchasing fixed assets as well as funds for working capital will have to be ascertained

Deciding the Capital Structure

The capital structure refers to the kind and proportion of different securities for raising funds. After deciding about the quantum of funds required, it should be decided which type of securities should be raised. It may be wise to finance fixed assets through long-term debts. Even here if gestation period is longer, then share capital may be most suitable. A decision about kind of securities to be employed and the proportion in which these should be used is an important decision which influences the short-term and long-term financial planning of an enterprise

Selecting Source of Finance

After preparing a capital structure, an appropriate source of finance is selected. Various sources, from which finance may be raised, include share capital, debentures, financial institutions, commercial banks, public deposits, etc., If finances are needed for short periods then banks, public deposits and financial institutions may be appropriate. On the one hand, if long-term finances are required then share capital and debentures may be useful.

Selecting Pattern of Investment

When funds have been procured then a decision about investment pattern is to be taken. The selection of an investment pattern is related to the use of funds. The decision-making techniques such as capital budgeting and opportunity cost analysis may be applied in making decision about capital budgeting. While spending on various assets, the principles of safety profitability and liquidity should not be ignored

Proper Cash Management

Cash management is also an important task of finance manager. He has to assess various cash needs at different times and then make arrangements for arranging cash

Implementing Financial Controls

- An efficient system of financial management necessitates the use of various control devices.
 Financial control devices generally used are:
 - Return on Investment
 - Budgeting Control
 - Break Even Analysis
 - Cost Control
 - Ratio Analysis
 - Cost and Internal Audit
- The use of various control techniques by the finance manager will help him in evaluating the performance in various areas and take corrective measures whenever needed

Proper Use of Surpluses

The utilization of profits or surpluses is also an important factor in financial management. A judicious use of surpluses is essential for expansion and diversification plans and also in protecting the interests of shareholders.

FUNCTIONS OF FINANCIAL MANAGER

Financial Forecasting and Planning

A financial manager has to estimate the financial needs of a business. How much money will be required for acquiring various assets? The amount will be needed for purchasing fixed assets and meeting working capital needs. He has to plan the funds needed in the future. How these funds will be acquired and applied is an important function of a finance manager.

Acquisition of Funds

After making financial planning, the next step will be to acquire funds. There are a number of sources available for supplying funds. These sources may be shares, debentures, financial institutions, commercial banks, etc., The selection of an appropriate source is a deliberate task. The choice of a wrong source for funds may create difficulties at a later stage. The pros and cons of various sources should be analyzed before making a final decision

Investment of Funds

The funds should be used in the best possible way. The cost of acquiring them and the returns should be compared. The channels which generate higher returns should be preferred. The technique of capital budgeting may be helpful in selecting a project. The objective of maximizing profits will be achieved only when funds are efficiently used and they do not

remain idle at any time. A financial manager has to keep in mind the principles of safety, liquidity and soundness while investing funds

Helping in Valuation Decisions

A number of mergers and consolidations take place in the present competitive industrial world. A finance manager is supposed to assist management in making valuation etc., For this purpose, he should understand various methods of valuing shares and other assets so that correct values are arrived at.

Maintain Proper Liquidity

Every concern is required to maintain some liquidity for meeting day-to-day needs. Cash is the best source for maintaining liquidity. It is required to purchase raw materials, pay workers, meet other expenses, etc., A finance manager is required to determine the need for liquid assets and then arrange liquid assets in such a way that there is no scarcity of funds.

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<u>UNIT-II</u>

SYLLABUS

Cost of Capital and Capital Budgeting: Meaning, Definition, Importance of Cost of Capital, Classification of Cost of Capital- Cost of Debt, Preference, Equity and Retained Earnings – Weighted Average Cost of Capital. Capital Budgeting – Significance – Methods of Evaluating Capital Expenditure Proposals – Payback Methods – Accounting Rate of Return – Discounted Cash Flow Method.

COST OF CAPITAL

- Cost of Capital of a firm is the minimum rate of return expected by its investors
- The Cost of Capital is the rate of return a firm must earn on its investments so that the market value of the firm remain unchanged. Thus, it is a yardstick or basis of approval or rejection of an standard of assessment of performance of a project
- The capital used by a firm may 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 its investors. In case a firm is not able to achieve even the cutoff rate, the market value of its shares will fall. In fact, cost of capital is the minimum rate of return expected by its investors which will maintain the market value of shares at its present level. Hence, to achieve the objective of wealth maximization, a firm must earn a rate of return more than its cost of capital. Further, optimal capital structure maximizes the value of a firm and hence the wealth of its owners and minimizes the firm's cost of capital. The cost of capital of a firm or the minimum rate of return expected by the investors has a direct relation with the risk involved in the firm. Generally, higher the risk involved in a firm, higher is the cost capital.

COST OF CAPITAL - DEFINITION

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- The cost of capital is the minimum rate of return which a firm requires as a condition for undertaking an investment – Milton H. Spencer
- Cost of Capital is the minimum rate of earnings or the cutoff rate for capital expenditures Solomon Ezra

IMPORTANCE OF COST OF CAPITAL

Designing the Optimal Capital Structure

This concept is very helpful in designing a sound, optimal and economical capital structure of the firm. Each source of capital involves different cost and different risk. By comparing various specific costs of different sources, the financial manager can select the best and the most economical source of finance

Helpful in Evaluation of Expansion Projects

It helps in the evaluation of financial soundness of a given expansion project. An expansion project will be accepted by the management only when the marginal return on investment exceeds the cost of its financing

Rational Allocation of National Resources

 The concept of cost of capital is important for national economy as well since its provides the basis of promotion allocation of financial resources

Evaluation of Financial Performance of Top Management

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The cost of capital framework can be used to evaluate the financial performance of top executives. Such an evaluation can be done by comparing the actual profitability of the projects undertaken with the projected overall cost of capital, and an appraisal of the actual costs incurred in the required funds

Financing and Dividend Decisions

This concept is useful in other areas of financial decision making, such a dividend decisions, decision on capitalization of profits and rights issue, working capital management and capital expenditure control etc.,

COMPUTATION OF COST OF CAPITAL or CLASSIFICATION OF COST OF CAPITAL

- Computation of overall cost of capital of a firm consists of the following steps
- Computation of the cost of specific source such as debentures, preference share capital and equity capital
- > Computation of the weighted average cost of capital or the overall cost of capital

COMPUTATION OF COST OF SPECIFIC SOURCES

COST OF DEBT

a) Cost of Irredeemable Debt

Irredeemable debt is debt which is not redeemable during the life time of the company
 Before Tax Cost of Debt = Interest / Net Proceeds (NP)

- a) When debt is issued at par: NP = Face Value Issue Expense
- b) When debt is issued at a Premium: NP = Face Value + Premium Issue Expenses
- c) When debt is issued at a discount: NP = Face Value Discount Issue Expenses

After Tax Cost of Debt

In the computation of income tax, interest is allowed as a deduction. Hence, a firm saves tax on interest paid. As a result, after tax cost is lower than the before tax cost of debt
 After Tax Cost of Debt = Interest – Tax Savings / Net Proceeds

Net Proceeds = Net Amount Realized

b) Cost of Redeemable Debt

• Redeemable debt refers to debt which is to be redeemed after the stipulated period.

Before Tax Cost of Redeemable Debt = Annual Cost Before Tax / Average Value of Debt

Annual Cost Before Tax

Interest Per Annum

Add: Issue Expenses, amortized p.a.

Add: Discount on issue, amortized p.a.

Add: Premium on Redemption, amortized p.a.

Less: Premium on Issue, amortized p.a.

Annual Cost Before Tax

To calculate annual cost, the issue expenses, discount on issue, premium on redemption and premium on issue are amortized over (spread over) the tenure of the debt.

Average Value of Debt

Average Value of Debt is the average of net proceeds (NP) and redemption value (RV) of debt

AV = NP + RV / 2

After Tax Cost of Redeemable Debt

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After Tax Cost of Debt	= Annual Cost After T	Γax / Average Value of Debt			
Annual Cost After Tax	= Annual Cost Before	Tax – Tax Savings			
Average Value of Debt	= NP + RV / 2				

COST OF PREFERENCE SHARE CAPITAL

A fixed rate of dividend is payable on preference shares. The dividend is payable at the discretion of directors. Yet, preference dividend is regularly paid by companies when they earn profit.

Cost of Irredeemable Preference Capital

The cost of preference capital which is perpetual is calculated by the following formula:
 Cost of Preference Capital = Annual Divided / Net Proceeds

Where,

Annual Dividend = Annual preference dividend payable

Net Proceeds = Net amount realized from the issue of preference shares

a) When preference shares are issued at par:

Net Proceeds = Face Value – Issue Expenses

b) When preference shares are issued at a Premium

Net Proceeds = Face Value + Premium – Issue Expenses

c) When preference shares are issued at a Discount

Net Proceeds = Face Value – Discount – Issue Expenses

 Preference dividend is not allowed as a deduction in the computation of income tax. Hence, before tax cost and after tax cost are the same

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Cost of Redeemable Preference Share Capital

Preference shares which are to be redeemed after the expiry of the stipulated period are known as redeemable preference shares

Cost of Redeemable Preference Shares = Annual Cost / Average Value of RPS

Annual Cost

Preference Dividend p.a

Add: Issue Expenses, amortized p.a.

Add: Discount on Issue, amortized p.a.

Add: Premium on Redemption, amortized p.a.

Less: Premium on Issue, amortized p.a.

Annual Cost

Average Value of RPS

Average value is the average of net proceeds (NP) on the issue and the redemption value (RV)

Average Value = NP + RV / 2

- Net Proceeds = Net amount realized from the issue of preference shares
- a) When preference shares are issued at par:

Net Proceeds = Face Value – Issue Expenses

b) When preference shares are issued at a Premium

Net Proceeds = Face Value + Premium – Issue Expenses

c) When preference shares are issued at a Discount

Net Proceeds = Face Value – Discount – Issue Expenses

COST OF EQUITY CAPITAL

- It is not legally binding on a company to pay dividend on equity shares even if it earns profits. Further, the rate of equity dividend is not fixed while the rate of preference dividend and interest on debt are fixed. Hence, it is sometimes argued that the equity capital is cost free. This view is not correct. The share holders invest in equity shares with the expectation of receiving dividends. The market price of equity shares also depends on the return expected by shareholders.
- Therefore, the cost of equity capital is the minimum rate of return that must be earned to maintain the market price of the share unchanged.

Dividend Price Method (or) Dividend Yield Method

According to this method, cost of equity capital is the discount rate at which the present value of expected future dividends per share is equal to the net proceeds (or current market price) per share

Cost of Equity Capital = D/NP (or) D/MP

Where,

- D = Expected Dividend Per Share
- NP = Net Proceeds Per Share (in case of new issue)
- MP = Market Price Per Share (in case of existing shares)

Net Proceeds

- When a company issues new shares it incurs floatation cost such as fees to investment bankers, brokerage, underwriting commission and commission to agents. So, the net proceeds per share is considered to calculate the cost equity capital
- ✤ In the case of existing equity shares, market price is considered
- The dividend /price method recognizes the importance of dividends. But it ignores retained earnings which have an impact on the market price. The D/P method also ignores growth in

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dividends, capital gains and future earnings. The method is suitable only when the company has stable earnings and a stable dividend policy over a reasonable length of time.

Dividend Price + Growth Method

- Under this method, cost of equity capital is determined on the basis of dividend yield and the growth rate in dividends
- Cost of Equity Capital = D/NP + g (or) D/MP + g

Where,

- D = Expected Dividend Per Share
- NP = Net Proceeds Per Share (in case of new issue)
- MP = Market Price Per Share (in case of existing shares)
- G = Growth rate in dividends
- The D/P + g method recognizes the importance of dividends as well the growth in dividends.
 But, the method assumes that dividends grow at a constant rate. In reality, it is not true

Earnings Price Method

- Earnings price method is also called earnings model. It considers earnings as more appropriate than dividends in computing the cost of equity capital. The cost of equity is the rate at which total present value of expected future EPS is equal to the market price per share.
- ✤ Cost of Equity Capital = EPS/NP (or) EPS/MP

Where,

EPS = EarningsPer Share

- NP = Net Proceeds Per Share (in case of new issue)
- MP = Market Price Per Share (in case of existing shares)
- The E/P Method takes into account the retained earnings. But it is criticized on the ground that the E/P ratio does not reflect the expectations of shareholders.

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- Earnings Model is suitable when
- > The EPS is expected to remain constant
- > The pay out is 100 per cent (all the profits are distributed as dividends)
- > The firm does not employ any debt

COST OF RETAINED EARNINGS

- All the profits earned by a company are not distributed as dividends to shareholders. Generally, companies retain a portion of the earnings for use in business. This is called as retained earnings.
- The company does not have to pay any dividend on the retained earnings. Hence, it is sometimes argued that retained earnings do not have any cost. This view is not correct. If the amount retained by the company had been distributed to the shareholders, they would have invested the amount elsewhere and earned some return. As the earnings have been retained by the company the shareholders have foregone the return. Therefore, retained earnings do have a cost. The cost of retained earnings is the return foregone by the shareholders. It is thus, the opportunity cost of dividend foregone by the shareholders.
- It is to be noted that the shareholders cannot invest the entire dividend income. They have to pay income tax on dividends. Further, they have to pay brokerage for the purchase of securities. Therefore, adjustments are made for tax and brokerage in the computation of cost of retained earnings.

Cost of Retained Earnings may be ascertained as follows:

- a) Cost of Equity Capital (Ke)
- b) Less: Tax on Cost of Equity
- c) Less: Brokerage (% on a-b)
- Cost of Retained Earnings (Kr)

Weighted Average Cost of Capital

Weighted Average Cost of Capital is very important in financial decision making. WACC is the weighted average of the costs of different sources of finance. It is also known as composite cost of capital or overall cost of capital

Steps for the calculation of WACC

- After tax cost is relevant in financial decision making. Therefore, the after tax cost of each of the source (x) of finance is ascertained
- The proportion of each of the source in the total capital (w) is determined. The proportions are used as weights for finding out WACC
- The cost of each source (x) is multiplied by the appropriate weight (x) X (w)
- ✤ The total of the weighted cost of each source is the weighted average cost of capital

Book Value Weights Vs Market Value Weights

- In order to calculate the WACC, the proportion of each source of finance in the total capital is used as weights. To determine the weights, book value or market value may be used. Theoretically, market value weights are superior as they reflect the expectations of investors. But in practice, book value weights are widely used. The reasons are:
- Book values are readily available
- > It is difficult to use market values because of their fluctuations
- > Firms use only book values in designing their capital structure
- > Equity share capital gets more importance if market values are used.

CAPITAL BUDGETING

Capital budgeting is concerned with designing and carrying through a systematic investment program. This is planning of such expenditures whose benefits accrue for more than one year. Under it proposed capital expenditure and their financing are considered and plans are formulated for the best investment of available resources.

Definition

- Capital Budgeting is long-term planning for making and financing proposed outlays Charles T. Horngren
- Capital Budgeting involves the planning of expenditures for assets the returns from which will be realized in future time periods – Milton H. Spencer

 Capital Budgeting consists in planning the development of available capital for the purpose of maximizing the long-term profitability (return on investment) of the firm

SIGNIFICANCE OF CAPITAL BUDGETING

- Capital Budgeting is helpful for taking proper decision on Capital Expenditure
- It facilitates proper adjustment of production facilities with the sales budget
- It provides the basis for long-term financial planning
- It avoids over-investment and under-investment in fixed assets
- It indicates proper timings for purchase of fixed assets
- It provides a sound policy for depreciation and replacement of fixed assets
- ✤ It serves as a means of controlling capital expenditure
- It furnishes essential information for cash budgeting. Without a capital budget, the cash budget will become a futile (useless) exercise
- ✤ A well-established capital budget would enable the management to decide in advance the finances required and ensure their availability at the right time

REDEEMABLE DEBT

Issued at Par and Redeemable at Par

A firm issue debentures of Rs. 100000 and realizes Rs. 98000 after allowing 2% commission to brokers. The debentures carry an interest rate of 10%. The debentures are due for maturity at the end of the 10^{th} year. Calculate the effective cost of debt before tax.

Before tax Cost of Debt = Annual Cost Before Tax / Average Value of Debt X 100

Annual Cost Before Tax

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Interest at 10% on 100000	10000
Add: Commission p.a. 2% on 100000= 2000 / 10	200
Annual Cost Before Tax	10200

Average Value of Debt

Issue Price			100000
			100000
Less: Commission			2000
Net Proceeds (NP)			98000

Redemption Value = 100000

Average Value = NP + RV / 2 = 98000 + 100000 / 2 = 99000

Before Tax Cost of Debt $= 10200 / 99000 \times 100 = 10.30\%$

Issued at a Premium and Redeemable at Par

Venus Ltd. issued 10000 9% debentures of Rs. 100 each at a premium of 5%. The maturity period is 5 years and the tax rate is 50%. Compute the cost of debentures to the company if the debentures are redeemable at par.

Annual Cost Before Tax

Interest p.a. 9% on 1000000	90000
-	
KARPAGAM ACADEMY OF HIGHER EDUCATIONCLASS: III B.com., (PA)COURSE NAME: FINANCIAL MANAGEMENTCOURSE CODE: 15PAU506AUNIT: IIBATCH-2015-2018Less: Premium Received on Issue (5% on 100000= 50000/5)10000Annual Cost Before Tax80000Less: Tax Savings at 50%40000Annual Cost After Tax40000

Average Value of Debt

Net Proceeds (1000000 + 50000)	=	1050000
Redemption Value	=	1000000
Average Value	=	1050000 + 1000000 / 2 = 1025000
Before Tax Cost of Debt	=	80000 / 1025000 X 100 = 7.80%
After Tax Cost of Debt	=	40000 / 1025000 X 100 = 3.90%

Issued at Discount and Redeemable at Par

Sunrise Ltd. issues Rs. 5000000 12% redeemable debentures at a discount of 10%. The flotation costs are 4% and the debentures are redeemable after five years. Calculate before and after tax cost of debt assuming a tax rate of 40%.

Annual Cost Before Tax

Interest 12% p.a. on 5000000	600000
Add: Discount p.a. (10% on Rs. 5000000) = 500000 / 5	100000
Add: Flotation Cost p.a. (4% on 4500000) = 180000 / 5	36000
Annual Cost Before Tax	736000

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Less. Tax Savings 4070	294400
Annual Cost After Tax	441600

Average Value of Debt

Face Value of Debentures	500000
Less: Discount at 10%	500000
Issue Price	4500000
Less: Floatation Cost 4% on 4500000	180000
Net Proceeds	4320000

Redemption Value	= 5000000	
Average Value	= 4320000 + 5000000 / 2 =	4660000
Before Tax Cost of Debt	= 736000 / 4660000 X 100 =	: 15.79%
After Tax Cost of Debt	= 441600/ 4660000 X 100 =	9.48%

Issued at Par and Redeemable at Premium

A Company issues 10% debentures at par for a total value of Rs. 1000000. The debentures are redeemable after 10 years at a premium of 10%. If the tax rate is 40%, compute the cost of debentures to the company (a) before tax and (b) after tax.

Annual Cost Before Tax

Interest p.a. 10% on 1000000	100000
Add: Premium on Redemption 10% on 1000000 = 100000 / 10	10000
Annual Cost Before Tax	110000

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Less: Tax Savings 40%				44000	
Annual Cost	After T	ax		66000	
Average Value of Debt					
Face Value of Debentures	=	1000000			
Redemption Value of Debentures	=	1100000			
Average Value	=	1000000	+ 1100000 / 2	= 1050000	
Before Tax Cost of Debt	=	110000 /	1050000 X 100	= 10.47%	
After Tax Cost of Debt	=	66000 / 1	050000 X 100	= 6.28%	

Issued at a Discount and Redeemable at a Premium

A Company issues Rs. 1000000, 13% debentures at a discount of 5%. The debentures are redeemable after 5 years at a premium of 5%. Calculate before tax and after tax cost of debt, if the tax rate is 50%

Annual Cost Before Tax

Interest p.a. 13% on 1000000	130000
Add: Discount p.a.(5% on 1000000) = 50000/5	10000
Add: Premium on Redemption p.a. (50000 /5)	10000
Annual Cost Before Tax	150000
Less: Tax Savings 50%	75000
Annual Cost After Tax	75000

Average Value of Debt

Face Value of Debentures	1000000
Less: Discount at 5%	50000
Net Proceeds	950000

Redemption Value	= 1050000	
Average Value	= 950000 + 1050000/ 2 = 1000000	
Before Tax Cost of Debt	= 150000 / 1000000 X 100 = 15.00%	
After Tax Cost of Debt	= 75000/ 1000000sX 100 = 7.5%	

Issued at Discount and Redeemable at Premium

A five year Rs. 100 debentures can be sold for a net price of Rs. 97.50. The coupon rate of interest is 14% p.a. and the debenture will be redeemed at 5% premium. The tax rate is 50%. Compute the after tax cost of debenture

Annual Cost Before Tax

Interest p.a.	12.50
Add: Discount p.a	0.50
Add: Premium on Redemption p.a.	1
Annual Cost Before Tax	15.50
Less: Tax Savings 50%	7.75
Annual Cost After Tax	7.75

Average Value of Debt

Net Proceeds

97.50

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Redemption Value	=	105		
Average Value	=	97.50 + 105/ 2 = 101.25		
Before Tax Cost of Debt	=	15.50/ 101.25 X 100	= 15.30%	
After Tax Cost of Debt	=	7.75 / 101.25 X 100	= 7.65%	

A Company issues 10000 bonds of Rs. 100 each at 14% p.a. Marketing costs are Rs. 20000. The bonds are to be redeemed after 10 years and the company is taxed at the rate of 40%.

Compute the cost of debt if the bonds are issued (a) at Par (b) at a discount of 5% and (c) at a premium of 5%

a) Bonds issued at par

Before tax cost of debt = Annual Cost Before Tax / Average Value of Debt

After Tax Cost of Debt = Annual Cost After Tax / Average Value of Debt

Annual Cost Before Tax

Interest at 14% on 1000000	140000
Add: Marketing Costs p.a. (20000 / 10 Years)	2000
Annual Cost Before Tax	10200
Less: Tax 40%	56800
Annual Cost After Tax	85200

Average Value of Debt

KARPAGAM ACADEMY OF HIGHER EDUCATIONCLASS: III B.com., (PA)COURSE NAME: FINANCIAL MANAGEMENTCOURSE CODE: 15PAU506AUNIT: IIBATCH-2015-2018Face Value of Bonds Rs. 100 X 100001000000Less: Marketing Costs20000Net Proceeds980000Redemption Value1000000

Average Value	= Net Proceeds + Redempti	on Value / 2
	= 980000 + 1000000 / 2	
	= 990000	
Before Tax Cost of Debt	= 142000 / 990000 X 100	= 14.40%
After Tax Cost of Debt	= 85200 / 990000 X 100	= 8.60%

b) Bond Issued at a Discount of 5%

Annual Cost Before Tax

Interest at 14% on 1000000	140000
Add: Marketing Costs p.a. (20000 / 10 Years)	2000
Add: Discount p.a. 50000 / 10 Years	5000
Annual Cost Before Tax	147000
Less: Tax at 40%	58800
Annual Cost After Tax	88200

Average Value of Debt

Face Value of Bonds Rs. 100 X 10000	1000000

KARPAGAM ACADEMY OF HIGHER EDUCATION CLASS: III B.com., (PA) COURSE NAME: FINANCIAL MANAGEMENT COURSE CODE: 15PAU506A UNIT: II BATCH-2015-2018 Less: Marketing Costs 20000 Less: Discount 5% 50000 Net Proceeds 930000 Redemption Value 1000000

Average Value	= Net Proceeds + Redemption Value / 2
	= 930000 + 1000000 / 2
	= 965000
Before Tax Cost of Debt	= 147000 / 965000 X 100 = 15.20%
After Tax Cost of Debt	= 88200 / 965000 X 100 = 9.10%

c) Bonds Issued at a Premium of 5%

Interest at 14% on 1000000	140000
Add: Marketing Costs p.a. (20000 / 10 Years)	2000
	142000
Premium received on issue $5\% = 50000 / 10$ Years	5000
Annual Cost Before Tax	137000
Less: Tax 40%	54800
Annual Cost After Tax	82200

Average Value of Debt

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Average Value= Net Proceeds + Redemption Value	1e / 2
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= 1030000 + 1000000 / 2

= 1015000

Before Tax Cost of Debt	= 137000 / 1015000X 100	= 13.49%
After Tax Cost of Debt	= 82200 / 1015000 X 100	= 8.09%

COST OF REDEEMABLE PREFERENCE CAPITAL

A company issues 20000 10% shares of Rs. 10 each. The issue expenses were Rs. 2 per share. Calculate the cost of preference share capital if the shares are issued at (a) Par (b) at a premium of 10% and (c) at a discount 5%

Cost of Redeemable Preference Share Capital = Annual Dividend / Net Proceeds

Annual Dividend

KARPAGAM ACADEMY OF HIGHER EDUCATION CLASS: III B.com., (PA) COURSE NAME: FINANCIAL MANAGEMENT COURSE CODE: 15PAU506A UNIT: II BATCH-2015-2018 Face Value of Preference Share Capital 100 X 20000 2000000 Annual Dividend at 10% 200000 a) Shares issued at Par Image: Course of the course of

Face Value of Preference Share Capital 100 X 20000	2000000
Less: Issue Expenses Rs. 2 X 20000	40000
Net Proceeds	1960000

Cost of Preference Capital = 200000 / 1960000 X 100 = 10.20%

b) Shares Issued at a Premium of 10%

Face Value of Preference Share Capital 100 X 20000	2000000
Add: Premium 10%	200000
	2200000
Less: Issue Expenses	40000
Net Proceeds (NP)	2160000

Cost of Preference Capital = 200000 / 2160000 X 100 = 9.26%

c) Shares Issued at a Discount of 5%

Face Value of Preference Share Capital 100 X 20000	
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Less: Discount on Issue 5%	100000
Less: Issue Expenses	40000
Net Proceeds (NP)	1860000

Cost of Preference Capital = 200000 / 1860000 X 100 = 10.75%

COST OF REDEEMABLE PREFERENCE SHARE CAPITAL

Issued at Par, Redeemable at a Premium

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A Ltd, issues 10000 9% preference shares of Rs. 100 each. The shares are redeemable after 10 years at a premium of 5%. Flotation Costs are 2%. Calculate the effective of redeemable preference share capital.

Cost of Redeemable Preference Shares (RPS) = Annual Cost / Average Value of Preference Capital

Annual Cost

Face Value 100 X 10000	1000000
Preference Dividend 9% on 1000000	90000
Add: Flotation Cost 2% on 1000000 = 20000 / 10	2000
Add: Premium on Redemption 5% of 1000000 = 50000 / 10	5000
-	
Annual Cost	97000

Average Value

Issue Price	1000000
Less: Flotation Cost	20000
Net Proceeds	980000
Face Value	1000000
Add: Premium on Redemption	50000
Redemption Value (RV)	1050000

Average Value= Net Proceeds + Redemption Value / 2

= 980000 + 1050000 / 2

= 1015000

Cost of Redeemable Preference Capital $= 97000 / 1015000 \times 100 = 9.56\%$

Issued at a Premium, Redeemable at Par

Jayant Ltd. issued 5000 10% preference shares of Rs. 100 each at a premium of 10%. The shares are redeemable after 10 years. Flotation costs are 4%. Calculate the effective cost of redeemable preference capital.

Cost of Redeemable Preference Capital = Annual Cost / Average Value of Preference Capital

Annual Cost

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CLASS: III B.com., (PA)COURSE NAME: FINANCIAL MANAGEMENTCOURSE CODE: 15PAU506AUNIT: IIBATCH-2015-2018

Preference Dividend 10% on 500000	50000
Add: Floatation Cost 4% on 550000 = 22000 / 10 Years	2200
	52200
Less: Premium p.a. 50000 / 10 Years	50000
Annual Cost	47200

Average Value

Face Value Rs. 100 X 5000	500000
Add: Premium on Issue 10%	50000
Issue Price	550000
Less: Floatation Costs	22000
Net Proceeds (NP)	528000
Redemption Value	500000

Average Value = N

= Net Proceeds + Redemption Value / 2

= 528000 + 500000 / 2

= 514000

Cost of Redeemable Preference Capital $= 47200 / 514000 \times 100 = 9.18\%$

Issued at a Discount, Redeemable at Par

B Ltd., issues 10000 10% preference shares of Rs. 100 each at a discount of 5%. The shares are redeemable after ten years and the issue expenses are 4%. Calculate the effective cost of redeemable preference share capital.

Cost of Redeemable Preference Capital (RPS) = Annual Cost / Average Value of Preference Capital

Annual Cost

Preference Dividend 10% on 1000000	100000
Add: Discount p.a. 50000 / 10 Years	5000
Add: Issue Expenses p.a. 38000 / 10 Years	3800
Annual Cost	108800

Average Value

Face Value Rs. 100 X 10000	1000000
Less: Discount on issue 5%	50000
Issue Amount	950000
Less: Issue Expenses 4%	38000
Net Proceed (NP)	912000
Redemption Value (RV)	1000000

Average Value

= Net Proceeds + Redemption Value / 2

= 912000 + 1000000 / 2

= 956000

Cost of RPS

= 108800 / 956000 X 100 = 11.38%

Alpha Ltd., issued 10% redeemable preference shares (RPS) of Rs. 100 each, redeemable after 10 years. The floatation costs were 5% of the nominal value. Compute the effective cost to the company if the issue is made at (a) Par (b) a premium of 5% (c) at a discount of 5%

Cost of Redeemable Preference Capital (RPS) = Annual Cost / Average Value of RPS

a) Shares Issued at Par

Face Value				100
Annual Cost				
Preference Dividend p.a. at 10%		\mathbf{N}		10.00
Add: Floatation Cost p.a.= Rs. 5 /	10 Years			0.50
Annua	l Cost			10.50

Average Value

Issue Price	100
Less: Floatation Cost 5%	5
Net Proceeds (NP)	95
Redemption Value	100

Average Value	= Net Proceeds + Redemption Value / 2		
	= 95 + 100 / 2		
	= 97.50		
Cost of RPS	= 10.50 / 97.50 X 100	= 10.77%	

b) Shares Issued at a Premium of 5%

Annual Cost		
Preference Dividend p.a. at 10%		10.00
Add: Floatation Cost p.a. = Rs. $5/10$ Years		0.50
-		
		10.50
Less: Premium p.a. 5 / 10 Years		0.50
L L		
Annual Cost		10.00

Average Value

Issue Price 100 + 5% Premium	105
Less: Floatation Costs	5
Net Proceeds (NP)	100
Redemption Value (RV)	100

Average Value	= Net Proceeds + Red	emption Value / 2
	= 100 + 100 / 2	
	= 100	
Cost of RPS	= 10 / 100 X 100	= 10%

c) Shares issued at a discount of 5%

Annual Cost

KARPAGAM ACADEMY OF HIGHER EDUCATION CLASS: III B.com., (PA) COURSE NAME: FINANCIAL MANAGEMENT COURSE CODE: 15PAU506A UNIT: II BATCH-2015-2018 Preference Dividend p.a. at 10% 10.00 10.00 Add: Discount on issue p.a. Rs. 5/ 10 Years 0.50 Add: Floatation Cost p.a. Rs. 5/ 10 Years 0.50 Annual Cost 11.00

Average Value		
Issue Price Rs. 100 – 5% Discount		95
Less: Floatation Cost		5
Net Proceeds (NP)		90
Redemption Value (RV)	100	

Average Value	= Net Proceeds + Ree	demption Value / 2
	= 90 + 100 / 2	
	= 95	
Cost of RPS	= 11 / 95 X 100	= 11.57%
COST OF EQUITY SHAL	RE CAPITAL	

Dividend Yield Method (or) Dividend Price Method

A company issues one crore equity shares of Rs. 100 each at a premium of 10%. The company has been consistently paying a dividend of 18 per cent for the past five years. It is expected to maintain the dividend in future also.

a) Compute the cost of equity capital

b) What will be the cost of equity capital if the market price of the share is Rs. 200?

Cost of Equity = Dividend / Net Proceeds

Expected Dividend Per Shares = 18% on Rs. 100 = 18

Net Proceeds = Net Proceeds Per Share = Rs. 100 + Premium 10 = 110

Cost of Equity Capial = 18 / 110 = 16.36%

b) If the market price is Rs. 200

Price

D = Expected Dividend = 18

Market Price = 200

Cost of Equity Capital = $18/200 \times 100 = 9\%$

Anand Ltd. offers for public subscription equity shares of Rs. 10 each at a premium of 10%. The company pays an underwriting commission of 5% on the issue price. The equity shareholders expect a dividend of 15%.

a) Calculate the cost of equity capital

b) Calculate the cost of equity capital, if the market price of the shares is Rs. 20

Cost of Equity Capital

Cost of Equity = D1/NP

Expected Dividend Per Share $= 15/100 \times 10$	1.50
Net Proceeds	
Issue Price = Face Value + Premium 10% (10+1)	11.00
Less: Underwriting Commission 5%	0.55

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Net I	Proceeds Per Share		10.45
Cost of Equity Capital	= 1.50/10.45 X 100	= 14.35%	
b) If the Market Price is	Rs. 20		
b) If the Market Price is Cost of Equity Capital	Rs. 20 = D1/MP		
b) If the Market Price is Cost of Equity Capital Expected Dividend Per Sh	Rs. 20 = D1/MP		1.50
b) If the Market Price is Cost of Equity Capital Expected Dividend Per Sh Market Price Per Share	Rs. 20 = D1/MP		1.50

Ajit is a Shareholder in India Polyester Ltd., The earnings of the company have varied considerably. Ajit feels that the long run average dividend would be Rs. 3 per share. He expects that the same pattern would continue in future. Ajit expects a minimum rate of earning of 15%.

Cost of Equity	= D/MP
Market Price Per Share	= D1 / K _e
Expected Dividend	= Rs. 3
Cost of Equity Capital	= 15%
Market Price	= 3 / 0.15 = Rs.20

DIVIDEND YIELD + GROWTH METHOD

The market price of an equity shares of G Ltd., is Rs. 80. The dividend expected a year hence is Rs.1.60 per share. The shareholders anticipate a growth of 7% in dividends. Calculate the cost of equity capital.

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Cost of Equity $= D1/MP + g$	g	
Expected Dividend per share	= Rs. 1.60	
Market price per share	= Rs. 80	
Growth Rate in dividend	= 7%	
Cost of Equity Capital	= 1.60 / 80 X 7%	
	= 0.2 + 0.7 =	9%

The Current market price of a company's share is Rs. 100. The company plans to issue new shares to raise one crore rupees. The net proceeds per share will be the market price less the floatation cost which is 5% of the share price.

If the company plans to pay dividend of Rs.4.75 and the growth in dividend is expected to be 8%, calculate the cost of new issue of equity shares.

Cost of Equity capital	= D1 / NP + g
Expected Dividend	= 4.75
Net Proceeds	
Issue Price	= 100
Less: Floatation Costs 5%	= 5
Net Proceeds	= 95
Growth Rate in Dividend	= 8%
Cost of Equity Capital	= 4.75 / 95 + 8%
	= 0.05 + 0.08 = 13%

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A Company's share is quoted in the market at Rs. 40 and the expected dividend for the next year is Rs. 2 per share. Thereafter, the investors expect a growth rate of 5% p.a.

a) Calculate the cost of equity capital

b) Calculate the market price per share if the expected growth rate is 6% p.a.

c) Calculate the market price per share if the dividend of Rs. 2 is maintained, the cost of equity is 9% and the expected growth in dividends is 6% p.a.

a) Cost of Equity Capital

 $K_e = D/MP + g$

Expected Dividend Rs. 2; Market Price = Rs. 40; Growth Rate = 5%

Cost of Equity Capital = 2/40 + 5%

= 0.05 + 0.05 = 10%

b) Market Price, if growth rate is 6%

$$K_{e} = D/MP + g$$

$$10\% = 2/MP + 6\%$$

$$10\% - 6\% = 2/MP$$

$$4\% = 2/MP$$

$$MP = 2 / 0.04$$

$$MP = Rs. 50$$

c) Market Price, if growth rate is 6% and $K_e \, is \, 9\%$

 $K_e = D/MP + g$

9% = 2/MP + 6%

9%-6% = 2/MP

3% = 2/MP

MP =2/0.03

MP = Rs.66.67

The Shares of a company are selling at Rs.50 per share and it had paid a dividend of Rs. 5 per share last year. The investors expect a growth rate of 5% per year.

a) Compute the company's cost of equity capital

b) If the anticipated growth in dividends is 7% p.a., calculate the indicated market price per share

a) Cost of Equity Capital

Ke = D/MP + g

Expected Dividend : Last Year's Dividend		5.00
Add: Growth at 5%		0.25
Current Year Dividend		5.25

Market Price = Rs. 50; Growth Rate = 5%

Cost of Equity Capital = 5.25 / 50 + 5 %

= 0.105 + 0.05 = 15.50%

b) Market Price, if growth rate is 7%

Cost of Equity Capital Ke = D / MP + g

Expected Dividend : Last Year's Dividend	5.00
Add: Growth at 5%	0.35
Current Year Dividend	5.35

15.5% = 5.35 / MP + 7%

15.5% - 7% = 5.35 / MP

8.5% = 5.35/ MP

MP = 5.35 / 0.085 = Rs. 62.94

The Shares of a Steel Company are quoted at Rs. 42 per share. The firm had paid a dividend of Rs. 4 per share last year. The expected growth in dividends is 5% p.a.

i) Determine the cost of equity capital of the company

ii) Determine the market price of the equity share, if the anticipated growth rate of the firm. (a) rise to 8% and (b) falls to 3%

Cost of Equity Capital

Ke = D/MP + g

Expected Dividend : Last Year's Dividend		4.00
Add: Growth at 5%		0.20
Current Year Dividend		4.20

Market Price = Rs. 42; Growth Rate = 5%

Cost of Equity Capital = 4.20 / 42 + 5%

= 0.10 + 0.05 = 15%

ii) a) Market Price, if the growth rate is 8%

Ke = D/MP + g

Expected Dividend : Last Year's Dividend	4.00
Add: Growth at 8%	0.32
Current Year Dividend	4.32

Ke

= D/MP + g

15% = 4.32/MP + 8%

15%-8% = 4.32/MP

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7%	= 4.32/MP			
MP	= 4.32/0.07			
MP	= Rs. 61.71			
b) Market P	rice, if the growth rate i	s 3%		
Ke $= D/$	MP + g			
Expected D	ividend : Last Year's Di	vidend		4.00
Add: Growt	h at 3%			0.12
	Current Year	Dividend		4.12
Ke	= D/MP + g			
15%	= 4.12/MP + 3%			
15%-3%	= 4.12/MP			
12%	= 4.12/MP			
	- 4 12/0 12			
MP	- 4.12/0.12			

A Ltd., is a mining company. Its iron ore reserves are being depleted and cost of recovering iron ore is increasing each year. As a result, the company's earnings and dividends are declining at the rate of 8% p.a. The previous year's dividend (D) was Rs. 10 and the required rate of return is 15%. What would be the market price of the equity share of A Ltd?

i) Cost of Equity Capital = D / MP + g

Cost of Equity Capital = 15%; Growth Rate = -8%

Expected Dividend : Last Year's Dividend	10.00
Less: Declined at 8%	0.80

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	Current Year D	Dividend		9.20
Ke	= D/MP + g			
15%	= 9.20/MP + (-8%)			
15%+8%	= 9.20/MP			
23%	= 9.20/MP			
MP	= 9.20/0.23			
MP	= Rs. 40			

EARNINGS PRICE METHOD

Blue Star Ltd. is a dynamic growth firm. It pays no dividends and anticipates a long-run future earnings of Rs. 7 per share. The current market price of the company's shares is Rs. 55.45. Floatation cost for the issue of equity shares would be about 10% of the share price. What is the cost of new equity capital to Blue Star?

Cost of Equity Capital	= EPS / NP
Earnings Per Share	= Rs. 7
Net Proceeds	= Issue Price – Floatation Costs
	= 55.45 - 10%
	= 55.45 - 5.55
	= 49.90
Cost of Equity Capital	= 7 / 49.90
	= 14.02%

The entire capital of J Ltd. consists of five lakh shares of Rs. 100 each. The profit after tax of the current year is Rs. 50 lakhs. The company wants to raise Rs. 2 crore by issuing new shares. The floatation costs are expected to be 10% of the face value of the shares. Calculate the cost of

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equity capital assuming th five years.	at the earnings of the comp	pany are expected to be stable over the next
Cost of Equity Capital	= EPS / NP	
Earnings Per Share	= Profit After Tax / No.	of Shares
	= 5000000 / 500000	
	= Rs. 10	
Net Proceeds	= Issue Price – Floatatio	on Costs
	= 100 - 10 = 90	
	-10/00 $-110/$	

Vijay Ltd. wants to raise Rs. 50 lakhs by the issue of new equity shares. The relevant information is given below:

No. of Existing Equity Shares	10 lakhs
Profit after tax	Rs. 60 lakhs
Market value of existing shares	Rs. 400 lakhs

a) Compute the cost of existing equity capital

b) Compute the cost of new capital if the shares are issued at a price of Rs. 32 per share and the issue expenses are Rs. 2 per share

a) Cost of Equity Capital = EPS / MP

EPS = Profit after tax /No. of Equity Shares

= 6000000 / 100000 =Rs. 6

MP = Market Value / No. of Shares

= 40000000 / 1000000 =Rs. 40

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Cost of Equity Capital	= 6 / 40	
	= 15%	
b) Cost of New Equity Capital	= EPS /NP	
Net Proceeds per share	= Issue Price – E	xpenses
	= Rs. 32 $-$ Rs.2	= 30
Cost of New Capital	= 6/30 = 20%	

COST OF RETAINED EARNINGS

A Company's Cost of Equity Capital is 15%. The average tax rate of shareholder's is 40% and the brokerage cost for purchase of securities is 2%. Calculate the cost of retained earnings.

		%
Cost of Equity Capital	1	5.00
Less: Tax at 40% on 15		6.00
		9.00
Less: Brokerage at 2% on 8	•	0.18
Cost of Retained Earnings		8.82

The following particulars relate to Prakash Ltd.,

	RS.
Equity Share Capital 100000 shares of Rs. 10 each	1000000
Profit After Tax	900000
Current Market Price of Equity Shares	75

a) Calculate the Cost of Equity

b) What is the cost of retained earnings if the average personal tax rate of shareholders is 30% and the brokerage cost for making new investments is 2%

Cost of Equity Capital = EPS/MP

EPS = Profit after tax / No. of Equity Shares

= 900000/1000000

= Rs. 9.

Market Price = Rs.75

Cost of Equity Capital= 9/75 = 12%

b) Cost of Retained Earnings

	%
Cost of Equity Capital	12.00
Less: Tax at 30% on 12	3.60
	8.40
Less: Brokerage at 2% on 8.40	0.17
Cost of Retained Earnings	8.23

Ajanta Ltd., is earning a profit of Rs. 100000 p.a. The shareholder's required rate of return is 10%. It is expected that if the earnings are distributed to the shareholders, after paying taxes on dividends, they will invest the proceeds in the shares of similar firms and earn a 10% return. It is also estimated that the brokerage cost will be 2% of the investments. What rate of return should be earned by the firm if the earnings are retained? Assume that the shareholders are in 30% tax bracket.

	Rs.
Profit available for distribution	100000
Less: Income tax payable by shareholders @30%	30000

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	70000
Less: Brokerage on new investments @ 2%	1400
Net amount available for investment	68600

Expected return on investment 10% on 68600 = 6860

Rate of return to be earned by the firm on retained earnings = 6860/100000 = 6.86%

WEIGHTED AVERAGE COST OF CAPITAL

The capital structure and after tax cost of different sources of funds are given below:

Sources of Funds	Amount (Rs.)	Proportion to Total	After Tax Cost %
Equity Share Capital	720000	.30	15
Retained Earnings	600000	.25	14
Preference Share Capital	480000	.20	10
Debentures	600000	.25	8

You are required to compute the weighted average cost of capital.

Sources of Funds	Proportion to Total (w)	After Tax Cost % (x)	Weighted Cost % (w) X (x)
Equity Share Capital	.30	15	4.5
Retained Earnings	.25	14	3.5
Preference Share Capital	.20	10	2.0
Debentures	.25	8	2.0
Weighted Average	12.00		

A firm finances all its investments by 60% equity and 40% debt. The estimated return on equity is 18% after taxes. Cost of debt is 8% after taxes. The firm is considering an investment proposal costing Rs. 400000 with an expected return that will continue for ever. What amount (in rupees) must the proposal yield per year so that the market price of the share does not change?

Sources of Funds	Proportion to Total (w)	After Tax Cost % (x)	Weighted Cost % (w) X (x)
Equity Share Capital	.60	18	10.80
Debentures	.40	8	3.2
Weighted Avera	14.00		

The investment must earn 14%

Earnings Required in Rs. 14% on 400000 = Rs. 56000

From the following particulars, calculate the overall cost of capital using book value weights

Sources of Funds	Book Value (Rs.)	After Tax Cost (%)
Equity Share Capital	400000	14
Retained Earnings	200000	13
Preference Share Capital	100000	10
Debentures	300000	6

Sources of	Proportion to	After Tax Cost	Weighted Cost
Funds Amount (Rs.)	Total (w)	% (x)	% (w) X (x)

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ESC	400000	.40	14	5.6
RE	200000	.20	13	2.6
PS	100000	.10	10	1.0
Debt	300000	.30	6	1.8
Total	1000000	WA	CC	11.0

From the following particulars relating to the capital structure of Blue Ltd., calculate the overall cost of capital, using (a) book value weights and (b) Market value weights

Sources of Funds	Book Value (Rs.)	Market Value (Rs.)
Equity Share Capital	45000	90000
Retained Earnings	15000	-
Preference Share Capital	10000	10000
Debentures	30000	30000

The after-tax cost of different sources of finance is:

Equity Share Capital	: 14%	Retained Earnings	: 13%
Preference Share Capital	: 10%	Debentures	: 8%

a) Book Value

Sources of Funds	Amount (Rs.)	Proportion to Total (w)	After Tax Cost % (x)	Weighted Cost % (w) X (x)
ESC	45000	.45	14	6.30
RE	15000	.15	13	1.95
PS	10000	.10	10	1.00
Debt	30000	.30	8	2.40

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	1		r
Total	100000	WACC	11.65
		•	

b) Market Value

Sources of Funds	Amount (Rs.)	Proportion to Total (w)	After Tax Cost % (x)	Weighted Cost % (w) X (x)
ESC	90000	.692	14	9.69
PS	10000	.077	10	0.77
Debt	30000	.231	8	1.85
Total	130000	WA	ICC	12.31

Capital Budgeting

Pay Back Method

1. Firm is considering two projects X and y following particulars are available

	Project X	Project Y
Cost	1, 00,000	1,00,000
Annual cash in flow	25,000	20,000
Economic life	10 years	10 year

Which project will you suggest under?

- a) Pay back period
- b) Post pay back profit
- c) Post profitability index

Solution

a) Pay back period = Initial Investment\ Annual Cash Inflows

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Project A =1000002500=4 years
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Project B=100000\2000= 5 years

Project A has shorter pay back period and hence it is suggested

Post pay back profit= annual cash inflow* life of the asset-payback period

Project A =25000(10yeras-4 years)

=25000*6

= 150000

Project B =20000(10yeras-5 years)

= 2000*5 years

=100000

b) Post pay back profit is higher in Project A than project B. Hence project A is suggested

Post pay back profit index =Post Pay Back Profit\Initial Investment*100

Project A =150000\100000*100 = 150%

Project B=100000\100000*100 = 100%

Discounted Pay Back Period

2. The following particulars relating to a project

Cost of project -50500

Annual cash inflows:

Year	Amount	P.V factor at 10%
1 year	5000	0.909
2 year	20000	0.826
3 year	30000	0.751
4 year	30000	0.683

5 year 10000

0.621

Calculated discounted pay back period

Year	Annual cash inflows	P.V factor 10%	P.V of cash inflows	Cumulative discounted cash
				inflows
1	5000	0.909	4545	4545
2	20000	0.826	16520	21065
3	30000	0.751	22530	43595
4	30000	0.683	20490	64085
5	10000	0.621	6210	70295

Discounted pay back period = 3 years+50500-43595\20490*12

= 4 months

= 3 years and 4 months

Accounting Rate of Return

- 1. ARR= average annual profit\original investment *100
- 2. ARR= average annual profit\average investment *100

3. Investment data for a new product are as follows

Capital outlay 200000

Depreciation 20% on written down value basis

Forecasted annul income before charging depreciation but after all other charges are as follows

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Year	Amour	nt		
1	100	0000		
2	100	0000		
3	800	000		
4	800	000		
5	400	000		
Total	400	000		

Calculate accounting rate of return

Year	Earnings	Depreciation @	Earnings after
	before	20 %	Depreciation
	Depreciation		
1	100000	40000	60000
2	100000	32000	68000
3	80000	25600	54400
4	80000	20480	59520
5	4000	16384	23616
Total profits 5 ye	265536		

Average profits =265536\5

=53107

Accounting rate of return

=Rate of return on original investment = average annual profit\original investment *100

=53107\200000*100

=26.55%

Rate of return on average investment

= Average Annual Profit\Average Investment *100

=Investment in the beginning+ Investment at the end\2

= 200000\2

=10000

=53107/100000*100

=53.11%

Discounted Cash Flow Method

Discounted cash flow methods for evaluating capital investment proposals are three types

- a) Net present value method
- b) Excess present value method
- c) Internal rate of return

4. Rock fort steel ltd whose cost of capital is 10% is considering investing in a project. The following particulars are available

Initial Investm	nent	90000	
Cash inflows	year 1		1000
	Year 2		20000
	Year 3		30000
	Year 4		40000
	Year 5		50000
	Total		150000
a) Compu	ute N.P.V		
b) Profita	bility index		

c) Internal rate of return

Year	Cash inflows	P.V factor	P.V of cash
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		10%	inflows	
1	10000	0.909	9090	
2	20000	0.826	16520	
3	30000	0.751	22530	
4	40000	0.683	27320	
5	50000	0.621	31050	
Total pres	ent value of cash inflow	/S	106510	
Less initia	l investment		90000	
Net present value		16510		

b). profitability index = Total present value of cash inflows \Total present value of cash outflows *100

=106510/90000*100

=118.34%

c).Internal rate of return

P.V. Factor= Initial investment\average cash inflow*100

=15000\5 years

=30000

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Unit III

Leverages& Capital structure: Meaning, Definition, Importance of leverage-EBIT – EPS and DPS Analysis –financial business and operating risk – Operating leverage – Financial Leverage-Combined leverage. Capital structure theories – Net income approach -Net operating income approach MM approach and Traditional approach – determinants of Capital structure.

Meaning of leverage

The capital structure decision is a significant managerial decision. It influences the debt equity mix of the company, which ultimately affects the share holders return and return and risk

If the proportion of borrowed funds is more than owners fund in the total capital structure, the return as well as the risk of the share holders will be high. On the other hand, if the proportion of owners funds is more than the borrowed funds in the total capital structure, the return as well as the risk of the share holders will be much less. The leverage analysis is used by firms to quantity risk return relationship of different alternative capital structures.

Types of leverages

• Operating leverage

Operating leverage refers to the use of fixed cost in the operations of a firm. A firm has to pay costs irrespective of volume of output or sales. As the fixed costs remains the same, even a small change in sales brings about a proportionate change in operating profit .

Operating leverage = Contribution/EBIT

• Financial leverage

The use of long term debt and preference share capital along with the owners equity in the capital structure is called as financial leverage

Financial leverage =EBIT/EBT

EBIT- earnings before interest and tax

EBT- Earnings before tax

• Composite leverage

Composite leverage is a combination of operating leverage and financial leverage

Operating leverage affects the firms operating profit which is the result of production. The degree of operating leverage shows the effects of changes in sales on EBIT

Financial leverage affects the earnings of shareholders. It's the result of financial decision. The degree of financial leverage shows the effect of changes in EBIT on EPS.

As a result of he combination of operating and financial leverage fluctuations are caused in EPS. The composite leverage measures the combined effect on operating leverage and financial leverage.

Composite leverage= Operating leverage * Financial leverage

Preparation of leverage sums

1. Calculate the operating leverage, financial leverage and combined leverage from the following information

Sales Rs.500000

variable cost Rs.25000

Interest Rs.5000

fixed cost Rs. 15000

STATEMENT OF PROFIT

Sales 50000

Less: variable cost 25000

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Contribution	25000			
Less fixed cost	15000			
Operating profit	10000			
Less interest	5000			
Profit before tax	5000			
• Operating levera	ge = contribut = 25000/10	ion/ operating 1)000	profit	
	= 2.5 times			
• Financial leverage	$\begin{array}{ll} = \text{operativ}\\ = 10000/5 \end{array}$	ng profit/ profit 5000	before tax	
	= 2 times			
Combined levera	age = operation = $2.5*2$	ng leverage X f	inancial leverage	
	=5			
2. Calculate operatin	g and financial	leverage from	the following particulars	
Units sold 5000				

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COURSE CODE: 15PAU50	6A UNIT: III	BATCH-2015-2018	
Variable cost per unit Rs	s.20		
10% public debt Rs. 100	0000		
Selling price per unit Rs.	. 30		
EBIT Rs.30000			
STATEMENT OF PRO	OFIT		
Sales (5000*30)	150000		
Variable cost	100000		
Contribution	50000		
Fixed cost	20000		

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EBIT	30000	
Less (10% of 100000)	10000	
EBT	20000	
• Operating leverage	= contribution /EBIT =50000/30000	
	=1.667	
• Financial leverage	= EBIT/EBT =30000/20000	
	= 1.5	

Particulars	Company X	Company Y
Volume of output and sales	80000 units	100000
Variable cost per unit	4	3

Prepared by Dr.B. SEETHA DEVI, Associate Prof, Department of Commerce, KAHE

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Fixed cost	240000	250000
Interest on debt	120000	50000
Selling price per unit	10	8

On the basis of above information calculate

- Operating leverage
- Financial leverage
- Combined leverage

Statement of Profit	Company X	Company Y
Sales	800000	800000
Less variable cost	320000	300000
Contribution	480000	500000
Less fixed cost	240000	250000
EBIT	240000	250000

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Less interest	120000	50000	
EBT	120000	200000	
• Operating leverage	= contribution / EBIT		
For Company X	= 480000/240000		
	= 2 times		
For Company Y	= 500000/250000		
	= 2 times		
Financial leverage	= EBIT/EBT		
For Company X	= 240000/120000		
	= 2 times		

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For Company Y	= 250000/200000)
	-1 25 times	
	-1. 25 times	
Combined leverage	= operating leve	rage X Financial leverage
For Company X	= 2*2 = 4	
For Company Y	= 4 = 2*1.25 =2	

4. A ltd sells goods at Rs.10 P.U its variable cost are Rs. 7 P.u and fixed cost amount to Rs.170000 it finances all its assets by equity funds. It pays 40% tax on its income.

Z Ltd is identical to A Ltd except in the pattern of financing Z ltd finances its assets 50% by equity and 50 % by debt, the interest on which amounts to Rs. 20000

Determine the degree of operating, Financial and Combined leverage when sales are Rs.700000 for both the firms and interpret the results

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STATEMENT OF PROFIT

Particulars	A ltd	Z Ltd
Sales	700000	700000
Less variable cost	490000	490000
Contribution	210000	210000
Fixed cost	170000	170000
EBIT	40000	40000
Less interest		20000
EBT	40000	20000
TAX 40%	16000	8000
PROFIT AFTER TAX	24000	12000

• Operating leverage = contribution / EBIT

For A Ltd

= 210000/40000

= 5.25 times

For Z Ltd

= 210000/40000

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	= 5.25 times	
• Financial leverage	=EBIT/EBT	
For A Ltd	=40000/40000	
	= 1 times	
For Z Ltd	= 40000/20000	
	= 2 times	
Combined leverage	= operating leverage * financial leverage	
For A Ltd	=5.25*1 = 5.25	
	5.05*2 10.50	
For Z Ltd	= 5.25*2 =10.50	
5. The following data are availa	able for R and S I to	
Selling price Rs.120 per u	Rs.120 per unit	
Variable cost Rs.70 per un	nit	

- What is the operating leverage when R and S Ltd. Produces and sells 6000 units
- What is the percentage change that will occur in the EBIT, if the output increases by 5%.
- Calculate revised operating leverage.

STATEMENT OF PROFIT

Particulars	6000 units	6300 units
Sales	720000	756000
Less variable cost	420000	441000
Contribution	300000	315000
Fixed cost	200000	200000
FBIT	100000	115000
	10000	115000

• Operating leverage @6000units = contribution/EBIT

= 300000/100000

= 3 times

Percentage change in EBIT if the output increases by 5 %
 EBIT at 6300 units =115000

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EBIT at 6000	=100000			
	15000			

- Percentage change in EBIT= 15000/100000=15%
- Operating leverage at 6300 units= 315000/115000= 2.74

CAPITAL STRUCTURE

MEANING OF CAPITAL STRUCTURE

Capital structure of a company cannot be the composition of long-term sources of long-term sources of funds, such as ordinary shares, preference shares, debentures, bonds, long-term funds. It implies the determination of form or make-up of a company's capitalization.

DEFINITIONS OF 'CAPITAL STRUCTURE'

- "Capital structure is the permanent financing of the firm, represented primarily by longterm debt, preferred stock, and common equity, but excluding all short-term credit. Common equity includes common stock, capital surplus and accumulated retained earnings."
 - Weston and Brigham
- 2. "The term capital structure is frequently used to indicate the long-term sources of funds employed in a business enterprise".
 - Robert H. Wessel
- 3. "From a strictly financial point of view, the optimum capital structure is achieved by balancing the financing so as to achieve the lowest average cost of long term funds. This, in, turn produces the maximum market value of the total securities issued against a given amount of corporate income".
 - Guthman and Dougall

- 4. "Capitalization embraces the composition or the character of the structure as well as the amount"
 - Husband and Dockeray
- 5. "Capital structure refers to the kind of securities that make up the capitalization."
 - W. Gerstenberg
- 6. "The term capital structure is frequently used to indicate the long-term sources of funds employed in a business enterprise".
 - R.H. Wessel
- "Capital structure is the combination of debt and equity securities that comprise a firm's financing of its assets".
 - John J. Hampton

DISTINCTIONS BETWEEN CAPITALIZATION AND CAPITAL STRUCTURE

Difference in scope – Capitalization refers to the total accounting value of all the capital regularly employed in the business, which includes share capital, long-term debt, reserves and surplus. On the other hand capital structure refers to the proportion of different sources of long-term funds in the capitalization of a company.

Difference in objectives – Capitalization is concerned with the determination of the total amount of capital required for the successful business operation, on the other hand capital structure is concerned with the determination of the composition of different long-term sources of funds, such as debentures, long-term debt, preference capital and ordinary share capital including retained earnings.

In order to maximize the shareholder's wealth, the financial manager should attempt to achieve an optimal capital structure which refers to an ideal combination of various sources of long-term funds so as to minimize the overall cost of capital and maximize the market value per share. The optimum capital could be achieved when the marginal cost of each source of finance is the same. It is incorrect to say that there exists an ideal mix of debt and equity capital which

will produce an optimum capital structure leading to the maximization of market price per share. There is no single optimal capital structure for all firms, or for the same firm for all times. The financial manager should attempt to develop an appropriate capital structure for his firm instead of trying for un utopian 'optimal capital structure'.

CHARACTERISTICS OF OPTIMAL STRUCTURE

Following are the characteristics of an optimal of capital structure.

- 1. Simplicity –A sound capital structure is simple in the initial stage are which limits to the of the number of issues and types of securities. If the capital structure is complicated from the very beginning by issuing different types of securities, the investors hesitate to invest is such a company. The company may also face difficulties in raising additional capital in future. That it is advisable to issue equity and preference shares in developing an optimum capital structure. Debentures and bonds should be reserved for futures financial requirements.
- 2. Minimum Cost A sound capital structure attempts to establish the security-mix in such a way as to raise the requisite funds at the lowest possible cost. As the cost of various sources of capital is not equal in all circumstances it is ascertained on the basis of weighted average cost of capital. The management aims at keeping the expenses of issue and fixed annual payments at a minimum in order to maximize the return to equity shareholders.
- **3.** Maximum Return A balanced capital structure is devised in such a way so as to maximize the profits of the corporation through a proper policy of trading on equity so as to minimize the cost of capital.
- 4. Minimum Risk An ideal capital structure possesses the quality of minimum risk. Risks, such as increase in taxes, rates of interest, costs, etc., and decrease in prices and value of shares as well as natural calamities adversely affect the company's earning. Therefore, the capital structure devised in such a way as to enable it to afford the burden of these risks easily.

- 5. Maximum Control A sound capital structure retains the ultimate control of a company with the equality shareholders who have the right to elect directors. Due consideration is given to the question of control in management while deciding the issue of securities. The existing shareholders may not be able to retain control. If a large number of equity share are issued, the company issues preference shares or debentures instead of equity shares to the public because preference shares carry limited voting rights and debentures do not have any voting rights. The capital structure of a company is changed in such a way which would favorably affect the voting structure of the existing shareholders and increase their control on the company's affairs.
- 6. Flexible A flexible capital structure enables the company to make the necessary changes in it according to the changing conditions and make it possible to procure more capital whenever required or redeem the surplus capital.
- Liquid In order to achieve proper liquidity for the solvency of a corporation, all such debts are avoided which threaten the solvency of the company. A proper balance between fixed assets and current assets is maintained according to the nature and size of business.
- 8. Conservative In division of the capital structure a company follows the policy of conservation. It helps in maintaining the debt capacity of the company even in unfavourable circumstances.
- **9. Balanced Capital** A balance is necessary for the optimum capital structure of a company. As both, under capitalization and over-capitalization are injurious to the financial interests of a company, there is a proper co-ordination between the quantum of capital and the financial needs of the corporation. A fair capitalization enables a company to make full utilization of the available capital at minimum cost.
- 10. Balance Leverage A sound capital structure attempts to secure a balanced leverage by issuing both types of securities i.e., ownership securities and creditor ship securities. Shares are issued when the rate of capitalization is high, while debentures are issued when rate of interest is low.

IMPORTANCE OF SOUND CAPITAL STRUCTURE

- Minimized Cost The primary objective of a company is to maximize the shareholder's wealth through minimization of cost. A well-advised capital structure enables a company to raise the requisite funds from various sources at the lowest possible cost in terms of market rate of interest, earning rate expected by prospective investors, expense of issue etc. this maximize the return to the equity shareholders as well as the market value of shares held by them.
- Maximized Return The primary objective of every corporation is to promote the shareholders interest. A balanced capital structure enables company to provide maximum return to the equity shareholders of the company by raising the requesting capital funds at the minimum cost.
- 3. Minimize Risks A sound capital structure serves as an insurance against various business risks, such as interest in costs, interest rates, taxes and reduction in prices. These risks are minimized by making suitable adjustments in the components of capital structure. A balanced capital structure enables the company to meet the business risks by employing its retained earning for the smooth business operations.
- 4. Controlled Though the management of a company is apparently in the hands of the directors, indirectly, a company is controlled by equity shareholders carry limited voting rights and debentures holders do not have any voting right, a well-devised capital structure ensures the retention of control over the affairs of the company with in the hands of the existing equity shareholders by maintaining a proper balance between voting right and non-moving right capital.
- 5. Liquid An object of a balanced capital structure is to maintain proper liquidity which is necessary for the solvency of the company. A sound capital structure enables a company to maintain a proper balance between fixed and liquid assets and avoid the various financial and managerial difficulties.
- 6. Optimum Utilization Optimum utilization of the available financial resources is an important objective of a balanced financial structure. An ideal financial structure enables the company to make full utilization of available capital by establishing a proper co-ordination between the quantum of capital and the financial requirements of the business.

A balanced capital structure helps a company to estimate both the states of overcapitalization and under-capitalization which are harmful to financial interests of the company.

- **7. Simple** A balanced capital structure is aimed at limiting the number of issues and types of securities, thus, making the capital structure as simple as possible.
- 8. Flexible Flexibility or capital structure enables the company to raise additional capital at the time of need, or redeem the surplus capital. it not only helps is fuller utilization of the available capital but also eliminates the two undesirable states of over-capitalization and under capitalization.

FACTORS DETERMINING CAPITAL STRUCTURE

The factors determining capital structure of a company may be internal or external.

A. INTERNAL FACTORS

- 1. Nature of Business Companies have stable earnings can afford to raise funds through sources involving fixed charges, while other companies have to rely heavily in equity share capital. Public utilities, extractive, financing and merchandising enterprises are more stable in their earnings and enjoy greater degree of freedom form competition than industrial concerns.
- 2. Regularity of Income Capital structure is affected by the regularity of income. If a company expects regular income in future, debenture and bonds should be issued. Preference shares may be issued if a company does not expect regular income but it is hopeful that its average earnings for a few years may be equal to or in excess of the amount of dividend to be paid on such preference shares.
- **3.** Certainty of Income If a company is not certain about any regular income in future, it should never issue any type of securities other than equity shares.
- **4. Desire to control the Business** If the control of the company is to be retained within few hands, a large proportion of funds is raised by issuance of non-voting right securities, such as debentures and preference shares. A majority of voting right securities, i.e. equity

shares are held by the promoters or their relatives to control the affairs of the business. Thus, majority of funds are raised from public retaining the control of the company with the promoters or the existing shareholders.

- 5. Development and Expansion Plans Capital structure of a company is affected by its development and expansion progremmes in future. The amount of authorized capital is kept higher so that the requisite amount may be raised at the time of need. In the beginning the company collects capital by issuing shares. Therefore, capital structure is devised in accordance with the future development and expansion programmes. The requisite capital is raised through preference shares and debentures.
- 6. Purpose of Finance An important factor determining the type of capital to be raised is the purpose for which it is required. If funds are needed for some product give activity directly adding to the profitability of the company, capital may be raised by issuing securities bearing fixed charges like preference shares and debentures. On the other hand, if funds are needed for such purposes as betterment, maintenance, etc. which do not directly add to the earnings of the company retained earnings, equity share capital will be the better source of financing.
- 7. Characteristic of Management Varying in skill, judgement, experience, temperament and motivation management evaluates the same risks differently and its willingness to employ debt capital also differ. Thus capital structure is influenced by the age, experience, ambition, confidence, conservativeness and attitude of the management.
- 8. Trading on Equity Trading on equity means the regular use of borrowed capital as well as equity capital in the conduct of a companies business. If a company employ borrowed capital including preference share capital to increase the rate of return on equity shares, it is said to be trading on equity. If the fixed rate of interest on borrowed capital or dividend on preference shares is lower than the general rate of earnings of the company, the equity shareholders will have an advantage in the form of additional dividend. Trading on equity implies the presence of a favourable financial leverage in the company's capital structure. A company would prefer to issue debentures or

preference shares having a rate of interest or dividend lower than the general rate of its earnings.

- **9.** Debt capacity and Risk After a certain extent the use of borrowed capital become risky for the company because it leads to increase in the fixed liability of interest payment adversely affecting the company's income and reducing its liquidity. Excessive use of borrowed funds endangers the solvency of the company in the long run. High debt equity ratio is particularly risky for the companies with uncertain, irregular and inadequate earnings. The determination of debt equity ratio of such companies should be in accordance with their debt capacity.
- 10. Cost of Capital Cost of capital is an important determinant of capital structure of a company. It influences the profitability and general rate of earnings. A company must raise capital funds by borrowing when rate of interest is low, and by issuing equity shares when rate of earnings and share prices are high.
- **11. Capital Gearing Ratio** The ratio of equity share capital to the total capital is called 'Capital Gearing'. When the ratio of equity shares is low in the total capital structure, is called 'High Gearing'. On the contrary when the ratio of equity shares in the total capital structure of a company is high, it is called 'Low Gearing'. Stability in equity price and goodwill of a company depends on adequate capital gearing. A high capital gearing ratio encourages speculation in shares of such a company and market price of shares continuous to fluctuate. Therefore, it is necessary for the promoters to determine the ratio of fixed cost securities (preference shares and debentures) and fluctuating cost securities (equity shares) very carefully.
- 12. Flexibility The capital structure must have flexibility as to increase or decrease the funds as per requirements of the enterprise. Excessive dependence on fixed cost securities make the capital structure rigid due to fixed payment of interest or dividend. These sources should be kept in reserve for emergency and expansion purpose.
- **13. Simplicity** The capital structure must have simplicity, so that financial crises may be avoided.

B. External Factors

- 1. Tastes and Preference of Investors An ideal capital structure is one which suits the needs of different types of customers. Its success largely depends upon the psychological conditions of different types of investors. While some investors prefer security of investment and stability of income others prefer higher income and capital appreciation. Hence, shares and debentures should be issued in accordance with the tastes and preferences of all types of customers. To suit the financial status of various sections of the society, a company should issues different types of securities with different denominations.
- 2. Conditions of Capital Market Conditions of capital market have a direct bearing on the capital structure. In times of depression the possibilities of profit are the least and rate of dividend on equity shares comes down. Hence the investors would prefer to invest in debentures and not in equity shares. Therefore debentures should be issued in times of depression. On the contrary, any type of security can be issued to raise the requisite funds during boom period when people have sufficient funds. Therefore, equity shares should be issued during boom period.
- 3. Cost of Capital As the cost of capital issue affects the capital structure of a company. The capital structure should be designed to minimize the commission payable to brokers, middlemen and underwriters or the discount payable on issue of debentures and bonds. A company should raise funds by issuing different types of securities in such a way as would minimize the cost of capital issue.
- 4. Present Statutes and Rules Capital structure a influenced by the statures and rules prevailing in the country. In India, Banking Companies act restricts a banking company from issuing any type of securities other than equity shares. Control of capital issues Act has fixed 4 : 1 ratio for debt and equity and 3:1 ratio for equity and preference share capital.

5. Possible Changes in Law – Besides complying the legal restrictions, a company's capital structure is also influenced by the possible changes in the law of the country. For example, if a company's income is taxed at a higher rate then the directors should issue debentures because the amount of interest payable to debentures holder is deducted while computing the company's total income. Whereas it is a statutory deduction, dividends are not an accepted deduction.

Net Income Approach

Any company is said to have leveraged if it finances its assets through debt capital and equity capital. On the other hand, a company which finances its assets entirely through equity capital is called an unleveled company.

The value of equity of any company can be found out by discounting its net income V (value of equity) = E (net income) / K (cost of equity)

Similarly the value of a company's debt can be found out by discounting the value of interest on debt.

V (value of debt) = I (interest on debt) / K (cost of debt)

The value of the company will be the sum value of value of equity and value of debt.

Net operating income approach

Net Operating Income or NOI is equal to yearly gross income less operating expenses. Gross income includes all income earned by the company. Operating expenses are costs incurred during the operation and maintenance of the company. Net operating income or NOI is used in two very important ratios. It is an essential ingredient in the Capitalization Rate (Cap Rate) calculation. We would estimate the value of company like this

Estimated Value = Net Operating Income /Capitalization Rate

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Traditional approach

The traditional view has emerged as a compromise to the extreme positions taken by the net income approach. According to this approach a judicious mix of debt capital and equity capital can increase the value of the firm by reducing the weighted average cost of capital up to a certain level of debt.

Thus, the traditional approach proposes that the cost of debt capital remains more or less constant up to a certain level of leverage but thereafter rises very sharply at an increasing rate the cost of equity capital remains more or less constant or rises only gradually up to a certain degree of leverage and rises very sharply thereafter

The average cost of capital, as a result of the above behaviour of cost of debt and cost of equity decreases up to a certain point, remains more or less unchanged for moderate increases in leverage thereafter and rises beyond a certain point

This traditional approach is not very clearly or sharply defined as the net income or net operating income approaches.

The main proposition of the traditional approach is that the cost of capital is dependent on the capital structure and there is an optimal capital structure which minimizes the cost of capital. At this optimal capital structure point the real marginal cost of debt and cost of equity will be the same. Before this optimal point, the real marginal cost of debt is less than the real marginal cost of equity and beyond the optimal point the real marginal cost of debt is more than the real marginal cost of equity

The traditional approach implies that investors' value leveraged companies more than the unlevered companies. This implies that they are prepared to pay a premium for the shares of such levered companies.

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The contention of the traditional approach that any addition of debt in sound companies does not really increase the risk ness of the business and the shares of the company is not defendable.

Therefore there is no sufficient justification for the assumption that the investors' perception about risk of leverage will vary at different levels of leverage.

However the existence of an optimum capital structure can be justified and supported on two counts: tax deductibility of interest payments on debt capital and other market imperfections

Modigliani and Miller's Proposition

Modigliani-Miller theorem (of Franco Modigliani, Merton Miller) forms the basis for modern thinking on capital structure. The basic theorem states that, in the absence of taxes, bankruptcy costs, and asymmetric information, and in an efficient market, the value of a firm is unaffected by how that firm is financed. It does not matter if the firm's capital is raised by issuing stock or selling debt. It does not matter what the firm's dividend policy is. The theorem is made up of two propositions which can also be extended to a situation with taxes.

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WORKING CAPITAL

Working Capital Management : Concepts – importance – Determinants of Working Capital. Cash Management – Motives for Holding Cash – Objectives and Stratefies of Cash Management. Receivables Management – Objectives – Cost of Credit Extension, Benefits – Credit Policies – Credit Terms – Collection Policies – Inventory Management – Techniques.

WORKING CAPITAL

The term working capital is the difference between current assets to current liabilities. The need for working capital in a corporate needs no explanation. The working capital is needed for stock of raw materials, work-in-progress, finished goods, book debts and cash balances. Thus, a part of investment in current assets is generally financed by credit availed from suppliers of services and goods. The investment in current assets should be twice of current liabilities.

It is a complete sequence and there is no need of current assets. But it is not possible; the firm is forced to have current assets. The cash inflows and outflows do not match. Firms have necessity to keep cash or invest in shares or any other securities, so that it is possible in a position to meet the obligation whenever they are in need and when they become due.

CONCEPT:

Working capital may be regarded as the lifeblood of a business. Its effective provision can do much to ensure the success of a business, while its inefficient management can lead not only to loss to profits but also to the ultimate downfall of what otherwise might be considered as a promising concern. A study of working capital is of major importance to internal and external analysis because of its close relationship with the current day-to-day operations of a business. The inadequacy or mis-management is the leading cause of business failures. Working capital is the leading cause of that portion of the assets of a business which are used in, or related to current operations, and represented at any one time by the operating cycle of such items as against receivables, inventories of raw materials, stores, work-in-process and finished goods, merchandise, notes or bills receivables and cash. "Working capital is the difference between the inflow and outflow and outflow of funds. In other words, it is the net cash inflow. It is defined as the excess of current assets over current liabilities and provisions. In other words, it is "net

current assets or net working capital".

Working capital represents the total of all current assets. In other words, it is "gross working capital" and provisions exceed current assets, the difference is referred to as negative working capital.

Working funds are the total resources of business. Working funds are the total resources of a business concern and include internal and external equities, which are sunk in current and fixed assets. Working capital funds, however, are in those, which are sunk only in the current assets of a concern.

IMPORTANCE OF WORKING CAPITAL:

1. Bill Payment:

Sufficient working capital enables the company to pay its bills, to meet the daily expenses, to make the routine purchases as and when required. Thus the business is kept going without interruption arising from shortage of funds reflected in scarcity at materials, irregular payment of wages, etc.

2. Solvency:

It also ensures solvency of the firm. Continuing production and sales would generate funds to meet the day-to-day expenses and hence availability at liquid funds brings to the firms a touch of doubtless solvency and strength.

3. The worthiness of credit:

The creditworthiness of the company is rated high if its working capital position is found satisfactory. Credit status depends on ability to pay and the promptness with which payments are actually made. A company with adequate working capital can afford to be regular and prompt in payments and thus maintain it s credit standing in the public.

4. More credit facility:

A company with sound working capital arrangements having high rated credit standings will be able to procure credit from commercial banks on easy or competitive terms. Particularly the seasonal loans are readily granted by banks to companies which have good reputation of having adequate initial working funds.

5. Cash discount:

A company having sufficient funds will be able to take advantage of cash discount offered by suppliers of raw materials or other merchandise for prompt payment.

6. High morale of employees:

Regular payment of wages and salaries by a company with working capital maintains and enhances morale among the personnel and efficient performance can be secured thereby.

7. Business cycles:

A company having strong finances can successfully whether the storms at business cycles. In depression there would be pressure or working funds; hence a company having sufficient cash reserves will be able to ride over the dark phase at slump and recession.

8. Boom period:

In times of boom when there is rush of orders, companies having adequate working capital can execute the routine as well as special cadres by purchasing additional raw materials and employing additional staff.

9. Higher prices of product:

Companies having sufficient working funds can wait for better marketing opportunities by holding up inventories and secure higher prices. Otherwise, hasty sales by companies with short funds would lower their bargaining power in the competition.

10. Self-confidence: Continued prosperity and progress at the undertaking can be maintained by ample working capital. Managers themselves will get self-confidence and can infuse such confidence among the other levels of administration.

TYPES OF WORKING CAPITAL:

1. Net Working Capital:

The net Working capital is the difference between current assets and current liabilities. The concept of net working capital enables a firm to determine how much amount is left for operational requirements.

2. Gross Working Capital:

Gross working capital is the amount of funds invested in the various components of current assets. This concept has the following advantages:

- a) Financial managers are profoundly concerned with current assets.
- b) Gross working capital provides the correct amount of working capital at the right time;

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- c) It enables a firm to realize the greatest return on its investment;
- d) It helps in the fixation of various areas of financial responsibility;
- e) It enables a firm to plan and control funds and to maximize the return on investment. Gross working capital has become a more acceptable concept in financial management.

3. Permanent Working Capital:

Permanent working capital is the minimum amount of current assets, which is needed to conduct a business even during the dullest season of the year. This amount varies from year to year, depending upon the growth of a company and the stage of the business cycle in which it operates. It is the amount of funds required to produce the goods and services, which are necessary to satisfy demand at a particular point. It represents the current assets, which are required on a continuing basis over the entire year. It is maintained as the medium to carry on operations at any time. Permanent working capital has the following characteristics:

- (a) It is classified on the basis of the time factor;
- (b) It constantly changes from one asset to another and continues to remain in the business process;
- (c) Its size increases with the growth of business operations.

(A) Initial Working Capital:

At the time of inception of a company and during the formative period of its operation, it should set up a sizeable cash fund to meet its obligation. In initial years revenues may not be regular and adequate, credit arrangements may not be available from banks etc. till the company established it's credit standing; credits may have to be granted on sales to attract the customers.

(B) Regular Working Capital:

The amount needed to keep the operations in continuity. It refers to excess of current assets over current liabilities so that the process of conversion of cash into stock, stock into sales, receivables and collections is maintained without break.

4. Temporary or Variable Working Capital:

It represents the additional assets which are required at different times during the operating year additional inventory, extra cash, etc. Seasonal working capital is the additional amount of current assets-particularly cash, receivables and inventory that is required during the more active

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business seasons of the year. It is temporarily invested in current assets and possesses the following characteristics:

- a) It is not always gainfully employed, through it may change from one asset to another, as permanent working capital does;
- b) It is particularly suited to business of a seasonal or cyclical nature.

(A) Seasonal Working Capital:

Obviously it refers to financial requirements that crop up during the particular season "beyond their initial and regular circulating capital". "Most businesses will require at stated intervals a larger amount of current assets to fill the demands of the seasonal busy periods".

(B) Special Working Capital:

All business enterprises have to be prepared to meet unforeseen risks that may arise in the course of operations. These should have extra funds at unstated period to meet contingencies.

The following are the circumstances:

- (i) To meet the sudden demand of products, war contract, supply of new products to new enterprises;
- (ii) Depression leads to decline in demand, prices and incomes;
- (iii) Rising prices too may spell out the need for special funds to keep up or step up the inventories and avail the opportunities of enhancing the profits.

5. Balance Sheet Working Capital:

The balance sheet working capital is one which is calculated from the items appearing in the balance sheet. Gross working capital, which is represented by current assets, and not working capital, which is represented by the excess of current assets over current liabilities, is examples of the balance sheet working capital.

6. Cash Working Capital:

Cash working capital is one, which is calculated, form the items appearing in the profit and loss account. It shows the real flow of money or value at a particular time and is considered to be the most realistic approach in working capital management. IT is the basis of the operation cycle concept, which has assumed a great importance in financial management in recent year. The

reason is that the cash working capital indicates the adequacy of the cash flow, which is an essential pre-requisite of a business.

7. Negative Working Capital:

Negative working capital emerges when current liabilities exceed current assets. Such a situation is not absolutely theoretical, and occurs when a firm is nearing a crisis of some magnitude.

FACTORS DETERMINING THE AMOUNT OF WORKING CAPITAL:

1. Nature of Industry:

The composition of an asset is a function of the size of a business and the industry to which it belongs. Small companies have smaller proportions of cash, receivables and inventory than large corporations. This difference becomes more marked in large corporations. For example, mostly employs fixed assets in its operations, which a merchandising department depends generally on inventory and receivables. Needs for working capital are thus determined by the nature of an enterprise.

2. Demand of Creditors:

Creditors are interested in the security of loans. They want their obligations to be sufficiently covered. They want the amount of security in assets, which are greater than the liability.

3. Cash Requirements:

Cash is one of the current assets, which is essential for the successful operations of the production cycle. Cash should be adequate and properly utilized. It would be wasteful to hold excessive cash. A minimum level of cash is always required to keep the operations going.

4. General Nature of Business:

The nature of a business is an important determinant of the level of the working capital. Working capital requirements depend upon the general nature or type of business. They are relatively low in public utility concerns, in which inventories and receivables are rapidly converted into cash. Manufacturing organizations, however, face problems of show turnovers of inventories and receivables, and invest large amounts in working capital.

5. Time:

The level of working capital depends upon the time required to manufacture goods. If the time is longer, the size of working capital depends upon inventory turnover and the unit cost of the goods that are sold. The greater this cost, the bigger is the amount of working capital.

6. Volume of Sales:

This is the most important factor affecting the size and components of working capital.

7. Terms of Purchases and Sales:

If the credit terms of purchases are more favorable and those of sales less liberal, less cash will be invested in inventory. With more favorable credit terms, working capital requirements can be reduced. A firm gets more time for payment to creditors or suppliers. A firm, which enjoys greater credit with banks, needs less working capital.

8. Inventory Turnover:

If the inventory turnover is high, the working capital requirements will be low. With a better inventory control, a firm is able to reduce its working capital requirements. While attempting this, it should determine the minimum level of stock, which it will have to maintain throughout the period of its operations.

9. Receivable Turnover:

It is necessary to have an effective control of receivables. A prompt collection of receivables and good facilities for settling payables result into low working capital requirements.

10. Business Cycle:

Business expands during periods of prosperity and declines during the period of depression. Consequently, more working capital is required during periods of prosperity and less during the periods of depression. During marked upswings of activity, there is usually a need for larger amounts of capital to cover the lag between collection and increased sales and to finance purchases of additional materials to support growing business activity.

11. Value of Current Assets:

A decrease in the real value of current assets as compared to their book value reduces the size of the working capital. If the real value of current assets increases, there is an increase in working capital.

12. Variations in Sales:

A seasonal business requires the maximum amount of working capital for a relatively short period of time.

13. Production Cycle:

The time taken to convert raw materials into finished products is referred to as the production cycle or operating cycle. The longer the production cycle, the greater is the requirement of working capital. An utmost care should be taken to shorten the period of the production cycle in order to minimize working capital requirements.

14. Credit Control:

Credit control includes such factors as the volume of credit sales, the terms of credit sales, the collection policy, etc. With a sound credit control policy, it is possible for a firm to improve its cash inflow.

15. Liquidity and Profitability:

If a firm desires to take a greater risk for bigger gains or losses, it reduces the size of its working capital in relation to its sales. If it is interested in improving its liquidity, it increases the level of its working capital.

16. Inflation:

As a result of inflation, size of the working capital is increase in order to make it easier for a firm to achieve a better cash inflow. To some extent, this factor may be compensated by the rise in selling price during inflation.

17. Seasonal Fluctuations:

Seasonal fluctuations in sales affect the level of variable working capital. Often, the demand for products may be of a seasonal nature. Yet inventories have got to be purchased during certain seasons only. The size of the working capital in one period may, therefore, be bigger than that in another.

18. Profit Planning and Control:

The level of working capital is decided by the management in accordance with its policy of profit planning and control. Adequate profit assists in the generation of cash. It makes it possible for the management to plough back a part of its earnings in the business and substantially build up internal financial resources.

19. Repayment Ability:

A firm's repayment ability determines level of its working capital. The usual practice of a firm is to prepare cash flow projections according to its plans of repayment and to fix the working capital levels accordingly.

20. Cash Reserves:

It would be necessary for a firm to maintain some cash reserves to enable it to meet contingent disbursements. This would provide a buffer against abrupt shortages in cash flows.

21. Operational and Financial Efficiency:

Working capital turnover is improved with a better operational and financial efficiency of firm. With a greater working capital turnover, it may be able to reduce its working capital requirements.

22. Changes in Technology:

Technological developments related to the production process have a sharp impact on the need for working capital.

23. Firm's Policies:

These affect the levels of permanent and variable working capital. Changes in credit policy, production policy, etc., are bound to affect the size of working capital.

24. Size of the Firm:

A firm's size, either in terms of its assets or sales, affects its need for working capital. Bigger firms, with many sources of funds, may need less working capital as compared to their total assets or sales.

25. Activities of the Firm:

A firm's stocking on heavy inventory or selling on easy credit terms calls for a higher level of working capital for it than for selling services or making cash sales.

26. Attitude to Risk:

The greater the amount working capital, the lower is the risk of liquidity.

CASH MANAGEMENT

Cash management deals with the following

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- Cash inflows and outflows
- Cash flows within the firm
- Cash balances held by the firm at a point of time

Cash management strategies:

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- a. Cash planning
- b. Cash forecasts and budgeting

Long term and short term forecasts may be made with the help of the following methods.

- i. Receipts and disbursements method
- ii. Adjusted net income method

Managing cash flows:

Cash management will be successful only if cash collections are accelerated and cash disbursements as far as possible delayed. The following methods of cash management will help.

Methods of accelerating cash inflows

- Make the customers to pay promptly
- Convert the payments which is in the form of Cheques or DD into cash quickly
- > Big firms operating in different areas can have collection centers in those area (Decentralized collections)
- Lock Box system firm hires post box from post office and the parties are asked to send the Cheques to that post box number.

Methods of slowing cash outflows:

- Delaying the payments till last date
- > Making payments through drafts
- Adjusting the payroll funds by making the weekly payment in to month etc.
- Cheques shall be issued from the main office then it will take time for the Cheques to be cleared through post.
- ▶ Inter bank transfers shall be made to make efficient use of cash

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RECEIVABLES MANAGEMENT

Meaning:

Receivables represent amounts owed to the firm as a result of sale of goods or services in the ordinary course of business. These claims of the firm against its customers form part of its current assets.

Factors influencing the size of receivables:

- 1. The volume of the credit sales out of total sales
- 2. The conservative or the liberal credit policy of the firm
- 3. The period of credit, rate of discount and other terms of trade
- 4. The various expansion plans of the firm
- 5. The increase in sales will increase the size of the receivables or vice versa
- 6. The various credit collection efforts of the firm
- 7. The habits of the customers also influence the size of the receivables.

Forecasting the Receivables:

The concern should be clear about its credit policies. Though it is not possible to forecast exact receivables in the future but some estimation is possible on the basis of past experience, present credit policies and policies pursued by other concerns.

The following factors will help in forecasting receivables.

1. Credit period allowed

The increase in receivables will result in more profits as well as higher costs too. The collection expenses and bad debts will also be more. If credit period is less, then the size of the receivables will also be less.

2. Effect of Cost of Goods Sold:

An increase in sales would result in decrease in cost of goods sold. The sales shall be increased to that extent till the costs are low. The increase in sales will also increase the amount of receivables. The estimate of sales will enable the estimation of receivables too.

3. Forecasting expenses.

If the costs of receivables are more than the increase in income, further credit sales should not be allowed. On the other hand, if receivables earned by the increase in sales are more than the costs of receivables, then sales should be expanded.

4. Forecasting Average Collection:

If the average collection period is more then the size of receivables will be more. Average collection period is calculated as follows

Trade debtors * No. of working days

Average collection period =

Net sales

5. Average size of receivables:

The determination of average size of receivables will also be helpful in forecasting receivables. Average size of receivables is calculated as:

Average size of Receivables = Estimated annual sales * Average collection period

INVENTORY MANGEMENT

Inventory includes Raw materials, work - in - progress, consumables, finished goods and spares. The purpose of inventory management is to keep the stocks in such a way that neither there is over stocking nor under stocking. The overstocking will mean a reduction on liquidity and starving of other production processes; under stocking will result in stoppage of work. The investments in inventory should be kept in reasonable limits.

Objects of Inventory management:

- To ensure continuous supply of materials, spares and finished goods so that production should not suffer at any time and the customers demand should also be met.
- > To avoid both over stocking and under stocking of inventory.
- To keep material cost under control so that they contribute in reducing cost of production and overall costs.
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- To eliminate duplication in ordering or replenishing stocks. This is possible by centralizing purchases.
- > To minimize losses through deterioration, pilferage, wastages and damages.
- To design proper organization for inventory management. Clear cut accountability should be fixed at various levels of he organization.
- > To ensure right quality goods at reasonable prices.
- To facilitate furnishing of data for short tern and long tern planning and control of inventory.

Tools and Techniques of Inventory management:

1. Determination of Stock levels:

An efficient inventory management requires that a firm should maintain an optimum level of inventory where inventory costs are the minimum and at the same time there is no stock out which may result in loss of sale or stoppage of production. Various stock levels are discussed as such:

a. Minimum Level:

This represents the quantity which must be maintained in hand at all times. If stocks are less than the minimum level then the work will stop due to shortage of materials. Factors that are taken into account while fixing the minimum stock level are lead time, Rate of consumption and the nature of materials.

Minimum Stock Level = Re-ordering level – (Normal consumption * Normal Re-order Period)

Reorder Level = Maximum Consumption * Maximum Re- order period

b. Maximum Level:

This is the level beyond which the quantity of materials should not exceed. It it exceeds this level it means over stocking. A firm should avoid over stocking because it will result in high material costs.

Maximum Stock Level = Re-ordering Level+ Re-ordering Quantity – (Minimum Consumption * Minimum Re-ordering period)

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c. Danger Level:

It is the level beyond which materials should not fall in any case. If danger level arises then immediate steps should be taken to replenish the stocks even if more cost is incurred in arranging the materials.

Danger Level = Average Consumption * Maximum re-order period for emergency purchases.

d. Average Stock Level:

Average Stock Level = Minimum Stock Level + $\frac{1}{2}$ of re – order quantity

2. Determination of Safety Stocks

Safety stock is a buffer to meet some unanticipated increase in usage. Two costs are involved in the determination of this sock i.e., opportunity costs of stock outs and the carrying costs. The stock outs of raw materials cause production disruption resulting into higher cost of production. Similarly, the stock outs of finished goods result into the failure of the firm in competition as the firm cannot provide proper customer service. So Safety stock should be maintained.

3. Ordering Systems of Inventory:

There are three systems prevailing and a concern shall choose any one of these. They are

- **I.** Fixed order quantity system (EOQ)
- **II.** Fixed period order system or periodic re ordering system
- **III.** Single order and scheduled part delivery system

4. Economic Order Quantity:

Economic Order Quantity is the size of the lot to be purchased which is economically viable. This is the quantity of materials which can be purchased at minimum costs.

a. Ordering Costs:

These are the costs which are associated with the purchasing or ordering of materials.

b. Carrying Costs:

These are the costs for holding the inventories. These costs will not be incurred if inventories are not carried.

Assumptions of EOQ:

- 1. The supply of goods is satisfactory
- 2. The quantity to be purchased by the concern is certain
- 3. Prices of goods are stable

$$EOQ = \sqrt{\frac{2AS}{1}}$$

- A = Annual consumption in rupees
- S = Cost of placing order
- I = Inventory carrying costs of one unit

5. A-B-C Analysis:

Under this method, the materials are divided into three categories A, B, C. Past experience has shown that almst10 per cent of the items contribute to 70 per cent of value of consumption and this category is called A category. About 20 per cent of the items contribute about 20 per cent of vale of consumption and this is known as category B materials. Category C covers about 70 per cent of items of materials which contribute only 10 per cent of value of consumption. There may be some variation in different organizations and an adjustment can be made in these percentages.

A B C analysis helps to concentrate more efforts on category. A since greatest monetary advantage will come by controlling these items. An attention should be paid in estimating requirements, purchasing, maintaining safety stocks and properly storing of A category materials. These items are kept under constant review so that a substantial material cost may be controlled. The control of C items may be relaxed and these stocks may be purchased for that year. A little ore attention should be given towards B category items and their purchase should be under taken at quarterly or half yearly intervals.

6. VED Analysis:

The demand for the spares depends upon the performance of the plant and machinery. Spare parts are classified as Vital (V), Essential (E), and Desirable (D). The vital spares are must for running the concern smoothly and these must be stored adequately. The non-availability of vital spares will cause havoc in the concern. The E types of spares are also necessary but their stocks may be kept at low figures. The stocking of D type of spares may be

avoided at times. The classification of spares under three categories must be made correctly and it should be left tot the decision of technical staff.

7. Inventory Turnover Ratios:

These ratios are used to find out whether the inventories are efficiently used or

not.

	Cost of goods sold
Inventory Turnover Ratio =	
	Average Inventory at Cost
	(O r)
	Net Sales
=	
	Average Inventory
Inventory Conversion Period =	Days in a year
_	

Inventory turnover ratio

8. Aging Schedule of Inventories:

Classification of inventories according to the period of their holding also helps in identifying slow moving inventories thereby helping in effective control and management of inventories.

9. Classification and Codification of Inventories:

The inventories of a manufacturing concern may consist of raw materials; work - in - progress, finished goods, spares, consumables etc. All these categories have their sub divisions. The classification and coding of inventories enables the introduction of mechanized accounting. It also helps in marinating secrecy of description. It helps in the prompt issue of stores.

10. Inventory Reports:

From effective inventory control, the management should be kept informed with the latest stock position of different items. This is usually done by preparing periodical inventory reports. These reports should contain all information necessary for the management. On the basis of these reports management takes corrective measures.

ADVANTAGES OF EXCESSIVE OR ADEQUATE WORKING CAPITAL

1. Continuous Production

Adequate working capital ensures regular supply of raw materials and continuous production.

2. Solvency and goodwill

Adequate working capital enables prompt payment to creditors. This helps in creating and maintaining goodwill.

3. Easy loans

A concern having sufficient working capital enjoys high liquidity and good credit standing. Hence it can secure loans from banks and others on easy and favourable terms.

4. Cash discounts

Adequate working capital enables a concern to avail cash discounts on purchases, leading to reduction in costs.

5. Regular payment of expenses

A company which has ample working capital can make regular payment of salaries, wages, and other day to day commitments. Such prompt payment raises the morale of employees and increases their efficiency. As a result, costs are minimized and profit increases.

6. Exploitation of market conditions

A concern with adequate working capital can exploit favourable market conditions. It can buy its requirement of raw materials in bulk when the market price is lower. Similarly, it can hold stock of finished goods to realize better prices.

7. Ability to face crisis

Adequate working capital enables a concern to face business crisis such as depression because during such periods there is much pressure on working capital.

8. High return on investments

Adequacy of working capital facilitates continuous production and effective utilization of fixed assets. Because of this, the concern is able to generate more profits and ensure high return on investments.

DISADVANTAGES OF EXCESSIVE WORKING CAPITAL

- 1. Excessive working capital means idle funds which earn no profit for the business. Hence, the business cannot earn a proper rate of return on its investments.
- 2. Due to low rate of return on investments, the value of shares may also fall.
- **3.** Redundant working capital may lead to unnecessary purchasing and accumulation of inventories. As a result, chances of theft waste and losses will increase.
- **4.** Excessive working capital is an indication of excessive debtors and defective credit policy. Consequently, there may be delay in collection and higher incidence of bad debts.
- **5.** Excessive working capital makes management complacent. It leads to overall inefficiency in the organization.

DISADVANTAGES OF INADEQUATE WORKING CAPITAL

- 1. A concern which has inadequate working capital cannot pay its short-term liabilities in time. As a result, it loses its reputation and faces tight credit terms.
- 2. It cannot buy its requirements in bulk and take advantage of cash discounts.
- 3. The concern will experience difficulties in meeting its day to day expenses.
- **4.** It becomes difficult to exploit favourable market conditions and undertake profitable projects due to lack of working capital.
- **5.** Due to paucity of working capital, fixed assets are not efficiently utilized. Thus, the rate of return investments falls.

Problems in Working Capital

1. From the following balance sheet compute (a) Gross working capital (b) Net working capital.

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BALANCE SHEET AS ON 31.12.2005

Liabilities	Rs.	Assets	Rs.
Share capital	6,00,000	Fixed assets:	
Reserves	1,00,000	Land and building	3,00,000
Debentures	3,00,000	Plant and machinery	4,00,000
Current Liabilities:		Current assets:	
Bank loans	1,00,000	Cash	60,000
Creditors	60,000	Investments	1,00,000
Bills payable	40,000	Debtors	1,40,000
		Inventory	2,00,000
	12,00,000		12,00,000

Solution:

(a) Gross working capital = Total Assets – Fixed Assets 12,00,000 - 7,00,000Rs. 5,00,000 = (or)Cash + Investments + Debtors + inventory = 60,000+1,00,000+1,40,000+2,00,000 = Rs.5,00,000 = (b) Net working capital Current Assets - Current Liabilities =5,00,000 - 2,00,000 Rs.3,00,000 =

2. From the following estimates, calculate the average amount of working capital required.

Per Annum

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1. Average amount locked up	o in stock:		Rs.
Stock of finished goods an	d work-in-progress		10,000
Stock of stores, material et	c.		8,000
2. Average credit given:			
Local Sales 2 weeks credit		1,	04,000
Outside the State 6 weeks	credit	3,	12,000
3. Time available for payment	nts:		
For purchases 4 weeks			78,000
For wages 2 weeks		2,	60,000
Add 10% to allow for cont	ingencies		
Solution:			
Statement showing working capital	requirements		
Current Assets:		Rs.	Rs.
Stock of finished goods and w	ork-in-progress	10,000	
Stock of stores, material etc.		8,000	
Debtors – local Sales (2 weeks	5)		
1,04,000 x 2/52	2	4,000	
Outside the State (6	weeks)		
3,12,000 x 6/52	2	<u>36,000</u>	58,000
Less: Current Liabilities:			
Creditors (4 weeks) 78,000 x 4	4/52	6,000	
Outstanding wages (2 weeks)	2,60,000 x 2/52	10,000	<u>16,000</u>
			42,000
Add: 10% for contingencies			4,200
Average working capital requi	red		46,200

3. Assuming a year of 50 weeks of 5 days each, calculate the working capital requirements from the following data.

Sales: 1,50,000 units sold at Re.1per unit on credit. Customers are allowed 60 days credit. Production: Raw material 0.50

duction:	Raw material	0.50
	Labour	0.20
	Expenses	0.25

The production cycle is 20 days and all materials are issued at the commencement of each cycle.

Credit allowed by suppliers 50 days

Cash required: one quarter of the remaining current assets

Stock Levels: Raw materials	:	40 days of supply
Finished goods	:	20 days of supply

Ignore work-in-progress.

Solution:

Sales = 1,50,000; there is no closing stock

Hence, production per year	1,50,000 units	
Working days per year	5 days x 50 weeks	250 day
Production per day	1,50,000 / 250	600 units
Raw materials per day	Re.0.50 x 600 units	Rs. 300
Labour per day	Re.0.20 x 600 units	Rs. 120
Expenses per day	Re.0.25 x 600 units	<u>Rs. 150</u>
Cost of produ	ction per day	<u>Rs. 570</u>

Statement of Working Capital Requirements

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Current Assets:		Rs.	
Stock of raw materials (40 days)	300 x 40	12,000	
Stock of finished goods (20 days)	570 x 20	11,400	
Debtors (60 days) = 570 x 60		<u>34,200</u>	
		57,600	
Cash required = $1/4^{\text{th}}$ of 57600		<u>14,400</u>	
Total Current Assets		72,000	
Current Liabilities:			
Creditors (50 days) 300 x 50		<u>15,000</u>	
Working Capital Requirement		<u>57,000</u>	
Problems in Cash Management			
1. From the following information, prep	pare cash budget fo	or June 2005.	
Particulars	Rs		
Cash in hand 1.6.2005	10,0	00	
Cash purchases for June, 2005	70,0	00	
Cash sales for June, 2005	1,00,0	00	
Interest payable in June, 2005	1,0	00	
Purchase of Office furniture in June, 2003	5 2,5	00	
Solution:			
Cash Budget for the month June, 2005			
Particulars	Rs	•	
Opening cash balance	10,0	00	
Add: Estimated receipts:			
Cash Sales	<u>1,00,0</u>	<u>00</u>	
Total cash available during the month	<u>1,10,0</u>	<u>00</u>	
Less: Estimated cash payments:			
Cash purchases	70,0	00	
Interest paid	1,0	00	

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Purchase of furniture	<u>2,500</u> 73 500				
Closing cash balance	36,500				

2. Prepare a cash budget for the months of June, July, August 2004 from the following information:

- 1) Opening cash balance in June Rs.7,000.
- 2) Cash sales for June Rs.20,000; July Rs.30,000 and August Rs.40,000.
- 3) Wages payable Rs.6,000 every month.
- 4) Interest receivable Rs.500 in the month of August.
- 5) Purchase of furniture for Rs.16,000 in July.
- 6) Cash Purchases for June Rs.10,000; July Rs.9,000 and August Rs.14,000.

Solution:

Cash Budget for the period June to August 2004

Particulars	June	July	August
	Rs.	Rs.	Rs.
Opening cash balance	7,000	11,000	10,000
Add: Estimated cash receipts :			
Cash sales	20,000	30,000	40,000
Interest			500
Total cash available during the month	<u>27,000</u>	41,000	50,500
Less: Estimated cash payments :			
Cash purchases	10,000	9,000	14,000
Payment of wages	6,000	6,000	6,000
Purchase of furniture		16,000	
Total cash payments during the month	<u>16,000</u>	31,000	20,000
Closing cash balance	11,000	10,000	30,500

3. Prepare a cash budget for the months – March, April and May 2005 from the following information

Month	Credit	Credit	Wages	Misc.	Office
	Sales	Purchase		Expenses	Expenses
	Rs.	Rs.	Rs.	Rs.	Rs.
January	60,000	36,000	9,000	4,000	2,000
February	82,000	38,000	8,000	3,000	1,500
March	84,000	33,000	10,000	4,500	2,500
April	78,000	35,000	8,500	3,500	2,000
May	56,000	39,000	9,500	4,000	1,000

Additional information:

1) Opening cash balance Rs.8,000.

2) Period of credit allowed to customers one month

3) Period of credit allowed by suppliers two months.

4) Wages and miscellaneous expenses are payable in the same month.

5) Lag in payment of office expenses is one month

Solution:

Cash Budget for the period March, April & May 2005

Particulars	March	April	May
	Rs.	Rs.	Rs.
Opening cash balance	8,000	38,000	69,500
Add: Estimated cash receipts :			
Cash receivable from customers	82,000	84,000	78,000
Total cash available during the month	90,000	1,22,000	1,47,500
Less: Estimated cash payments :			
Payments to suppliers	36,000	38,000	33,000
Wages	10,000	8,500	9,500
Office expenses	1,500	2,500	2,000
Miscellaneous expenses	4,500	3,500	4,000
Total cash payments during the month	52,000	52,500	48,500

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Closing cash balance	38,000	69,500	99,000		
Problems in Receivables manager	ment				
1. A company sells goods on cash	h as well as on credit	t the followir	ng particulars are extracted		
from the book of the company.					
	Rs.				
Gross sales	4,00,000				
Cash sales	80,000				
Sales returns	28,000				
Debtors at the end	36,000				
Bills Receivables at the end	8,000				
Provision for Doubtful debts	3,000	0			
Calculate average collection period					
Solution:					
	Debtors + Bills Red	ceivables			
Average collection period =	= Credit Sale	s x N	No. of dsys in a year		
$=\frac{36,000}{4.00,000-80}$	+8,000 .000-28.000 x 365				
$=\frac{44,000}{2}$ x 3	365				
2,92,000					
= 55 days					
2 Calculate (a) Avianage age of de	btors and (b) Debtors	turnovar from	n the following particulars:		
2. Calculate (a) Average age of de	Diols and (D) Dediors	uniover from	in the ronowing particulars:		
Cradit Salas	KS.				
Deturn inwords	2,70,000				
Debtom at the basics	20,000				
Dediors at the beginning	55,000	1			

45,000

5,000

Provision for doubtful debts

Assume number of days in a year is 360

Debtors at the end



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SCOPE OF FINANCIAL MANAGEMENT

Determining Financial Needs

The most important function of the financial manager is to ensure the available of adequate financing. Financial needs have to be assessed for different purposes. Money may be required for initial promotional expenses, fixed capital and working capital needs. Promotional expenditure includes expenditure incurred in the process of the company formation. Fixed assets needs depends upon the nature of the business enterprise-whether it is a manufacturing, non-manufacturing or merchandizing enterprise. Current assets needs depend upon the size of working capital required by an enterprise

Determining Sources of Funds

The financial manager has to decide the sources of funds. He may issue different types of securities. He may borrow funds from a number of financial institutions and the public. When a firm is new and small and little known in financial circles, the financial manager faces a great challenge in raising funds. Even when he has a choice in selecting the sources of funds, that choice should be exercised with great care and caution

Financial Analysis

The financial manager has to interpret different financial statements. He has to use a large number of ratios to analyze the financial status and activities of his firm. He is required to measure its liquidity, determine its profitability, and assess overall performance in financial terms. This is often a challenging task, because he must understand the importance of each one of the aspects of the firm, and he should be crystal clear in his mind about the purposes for which liquidity, profitability and performance are to be measured

Capital Structure

The financial manager has to establish capital structure and ensure the maximum rate of return on investment. The ratio between equity and other liabilities carrying fixed charges has to be defined. In the process, he has to consider the operating and financial leverages of his firm. The operating leverage exists because of operating expenses, while the financial leverage exists because of the amount of debt involved in the firm's capital structure. The financial manager should have adequate knowledge of the different empirical studies on the optimum capital structure and find out whether and to what extent he can apply their findings to the advantage of the firm

Cost-volume profit Analysis

This is popularly known as the 'CV Relationship'. For this purpose, fixed costs, variable costs and semi-variable costs have to be analyzed. Fixed costs are more or less constant for varying sales volumes. Variable costs vary according to the sales volume. Semi-variable costs are either fixed or variable in the short run. The financial manager has to ensure that the income of the firm will cover its variable costs. Moreover, a firm will have to generate an adequate income to cover its fixed costs as well. The financial manager has to find out the break-even point that is, the point at which the total costs is matched by total sales or total revenue. He has to try to shift the activity of the firm as far as possible from the breakeven point to ensure the company's survival against seasonal functions.

Profit Planning and Control

Profit planning is an important responsibility of the financial manager. Profit is the surplus which accrues to a firm after its total expenses are deducted from its total revenue. It is necessary to determine profits properly for the measure of the economic viability of a business. The revenue may be from sales or it may be operating revenue, or income from other sources. The expenditure may include manufacturing costs, trading costs, selling costs, general administrative

costs and finance costs. Profit planning and control is a dual function which enables a management to determine the cost it has incurred, and revenues it has earned during a particular period and provides shareholders and potential investors with information about the earning strength of the corporation. Profit planning and Control directly influence the declaration of dividend, creation of surpluses, taxation, etc., Break-even analysis and cost volume profit are some of the tools used in profit planning and control

Fixed Assets Management

Fixed assets are land, building, machinery and equipment, furniture and intangibles as patents, copyrights, goodwill, etc., The acquisition of fixed costs involves capital expenditure decisions and long-term commitments of funds. These fixed assets are justified to the extent of their utility and / or their productive capacity. Long-term commitment of funds, the decisions governing their purchase, replacement etc., should be taken with great care and caution. Often, these fixed assets are financed by issuing stock, debentures, long-term borrowings and deposits from the public. When it is not worthwhile to purchase fixed assets, the financial manager may lease them and use the assets on a rental basis

Project Planning and Evaluation

A substantial portion of the initial capital is the long-term assets of a firm. The error of Judgement in project planning and evaluation should be minimized. Decisions are taken on the basis of feasibility and project reports containing economic, commercial, technical, financial and organizational aspects. The essentiality of a project is ensured by a technical analysis. The economic and commercial analysis studies the demand position for the product. The economy of price, the choice of technology and the availability of the factors favoring a particular industrial site are all considerations which merit attention in a technical analysis. The financial analysis is perhaps the most important and includes a forecast of the cash inflows and the total outlay which will keep down the cost of capital and maximize the rate of return on investment.

Capital Budgeting

Capital budgeting decisions are most crucial for these have long-term implications. These relate to a judicious allocation of capital. Current funds have to be invested in long-term activities in anticipation of an expected flow of future benefits spread over a long period of time. Capital budgeting forecasts returns on proposed long-term investments and compares the profitability of different investments and their cost of capital. It results in capital expenditure investments. The various proposals are ranked on the basis of such criteria as urgency, liquidity, profitability and risk sensitivity. The financial analyzer should be thoroughly familiar with such financial techniques as payback, internal rate of return, discounted cash flow and net present value among others because risk increases when investment is stretched over a long period of time

Working Capital Management

Working capital refers to that part of firm's capital which is required for financing short term or current assets such as cash, receivables and inventories. It is essential to maintain proper level of these assets. Financial Manager is required to determine the quantum of such assets

Dividend Policies

- Dividend policies constitute a crucial area of financial management. While owners are interested in getting the highest divided from a corporation, the Board of Directors may be interested in maintaining its financial health by retaining the surplus to be used when contingencies, if any arise. A firm may try to improve its internal financing so that it may avail itself the benefits of future expansion.
- However, the interests of a firm and its stockholders are complementary, for the financial management is interested in maximizing the value of the firm and the real interest of the stockholders always lies in the maximization of this value of the firm; and this is the ultimate

goal of financial management. The dividend policy of a firm depends on a number of financial considerations, the most critical among them being profitability. Thus, there are different dividend policy patterns which a firm may choose to adopt, depending upon their suitability for the firm and its stockholders' group.

Acquisition and Mergers

Firms may expand externally through co-operative arrangements, by acquiring other concerns or by entering into mergers. Acquisitions consist of either the purchase or lease of a smaller firm by a bigger organization. Merger may be accomplished with a minimum cash outlay, through these involve major problems of valuation and control. The process of valuing a firm and its securities is difficult, complex and prone to errors. The financial manager should, therefore, go through the valuation process very carefully.

FINANCIAL DECISION OR IMPORTANT DECISION IN FM

Financial decisions refer to decision concerning financial matters of a business firm. There are many kinds of financial management decisions that the firm makes in pursuit of maximizing shareholder's wealth, viz., kinds of assets to be acquired, pattern of capitalization, distribution of firm's income etc.,

Investment Decision

- Investment decision relates to the determination of total amount of assets to be held in the firm, the composition of these assets and the business risk complexions of the firm as perceived by its investors. It is the most important financial decision. Since funds involve cost and are available in a limited quantity, its proper utilization is very necessary to achieve the goal of wealth maximization
- The investment decisions can be classified under two broad groups: (i) Long-term investment decision and (ii) Short-term investment decision. The long-term investment decision is

referred to as the capital budgeting and the short-term investment decision as working capital management.

- Capital budgeting is the process of making investment decision in capital expenditure. These are expenditures, the benefits of which are expected to be received over a long period of time exceeding one year. The finance manager has to assess the profitability of various projects before committing the funds. The investment proposal should be evaluated in terms of expected profitability, costs involved and the risks associated with the projects. The investment decision is important not only for the setting up of new units but also for expansion of present units, in case, investments made earlier do not fetch result as anticipated earlier
- Short-term investment decision, on the other hand, relates to the allocation of funds as among cash and equivalents, receivables and inventories. Such a decision is influenced by trade off between liquidity and profitability. The reason is that, the more liquid the asset, the less it is likely to yield and the more profitable an asset, the more illiquid it is. A sound short-term investment decision or working capital management policy is one which ensures high profitability, proper liquidity and sound structural health of the organization

Financing Decision

- Once the firm has taken the investment decision and committed itself to new investment, it must decide the best means of financing these commitments. Since, firms regularly make new investments, the needs for financing and financial decisions are on going. Hence, a firm will be continuously planning for new financial needs. The financing decisions is not only concerned with how best to finance new assets, but also concerned with the best overall mix of financing for the firm
- ✤ A finance manager has to select such source of funds which will make optimal capital structure. The important thing to be decided here is the proportion of various sources in the

overall capital mix of the firm. The debt-equity ratio should be fixed in such a way that it helps in maximizing the profitability of the concern. The raising of more debts will involve fixed interest liability and dependence upon outsiders. It may help in increasing the return on equity but will also enhance the risk. The raising of funds through equity will bring permanent funds to the business but the shareholders will expect higher rates of earnings. The financial manager has to strike a balance between various sources so that the overall profitability of the concern improves. If the capital structure is able to minimize the risk and raise the profitability then the market prices of the shares will go up maximizing the wealth of the shareholders

Dividend Decision

The third major financial decision relates to the disbursement of profits back to investors who supplied capital to the firm. The term dividend refers to that part of profits of a company which is distributed by it among its shareholders. It is the reward of shareholders for investments made by them in the share capital of the company. The dividend decision is concerned with the quantum of profits to be distributed among shareholders. A decision has to be taken whether all the profits are to be distributed, to retain all the profits in business or to keep a part of profit in the business and distribute others among shareholders. The higher rate of dividend may raise the market price of shares and thus, maximize the wealth of shareholders. The firm should also consider the question of dividend stability, stock dividend (bonus shares) and cash dividend

FINANCIAL PLANNING

Planning is the primary function of management. Planning is done for each functional area of management. As financial management is one of the functional areas of management, planning is done even by financial management. Financial planning is done starting from the stage of promotion of the enterprise to its expansion, modernization, diversification and dayto-day running

DEFINITION ON FINANCIAL PLANNING

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In the words of J.H. Bonneville, "The financial plan of a corporation has two-fold aspects. It refers not only to the capital structure of the corporation but also to the financial policies which the corporation has adopted or intends to adopt". According to this definition, financial planning means determination of capital structure of the corporation and formulation of the financial policies to be adopted by the corporation

According to Cohen and Robbins, financial planning should:

- > Determine the financial resources required to meet the company's operating programme
- Forecast the extend to which these requirements will be met by internal generation of funds and the extent to which they will be met from external sources
- > Develop the best plans to obtain the required external funds
- Establish and maintain system of financial controls governing the allocation and use of funds
- > Formulate programmes to provide the most effective profit-volume cost relationships
- Analyse the financial result of operations
- Report the facts to the top management and make recommendations on future operations of the firm

OBJECTIVES OF FINANCIAL PLANNING

- ✤ To ensure adequate supply of funds to the enterprise to achieve the enterprise goals
- To minimize the cost of fund raising by procuring the funds under the most favorable terms
- To maintain proper balance of costs with the risks involved in raising funds to protect the interests of the investors
- To see that the financial structure of the firm is simple, and not complicated by issuing a variety of securities
- To see that the funds raised are used wisely (i.e. put to optimum use)
- ✤ To ensure a fair return to the shareholders on their investment
- To see that the financial plan is flexible, (i.e. adjustable) as per the changing conditions and requirements
- ✤ To facilitate the smooth running of the business by ensuring liquidity of funds at all times

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PRINCIPLES OF SOUND FINANCING PLANNING

Clear-cut Objectives

The financial plan should be based on clear-cut objectives, i.e. the overall objective of the concern, viz., improvement of the profitability of the business

Less Dependence on Outside Sources

Of course, in the beginning, resource to outside funds may be a necessity. But dependence on outside funds should be reduced in course of time. So, long-term financial planning should be such as to reduce dependence on outside sources. This is possible by ploughing back of profits

Simplicity

The financial plan should be simple so that it can be easily understood even by a layman. Further, the financial plan should contain a simple financial structure that can be implemented and managed easily. That is, the number of securities, (i.e. the sources of funds) envisaged in the financial plan should be the minimum possible

Long-term View

The financial plan should be formulated, keeping in view the long-term requirements, and not just the immediate or short-term requirements of the concern. This is because, generally, a financial plan, originally formulated, would continue to operate for a long time after the formation of the concern

Flexibility

The financial plan should have flexibility. That is, the financial plan should be such that it can be revised or changed according to the changing needs of the business with the minimum possible delay

Planning Foresight

The financial plan should be framed, keeping in view the present as well as the future requirements of funds for the business. To assess the future requirements of funds for the business, accurate forecasts are required to be made regarding the future scope of operations of the concern, technological developments, etc., The making of accurate forecasts as to the future scope of operations requires much foresight on the part of the financial planners. In short, the financial plan must be visualized with much foresight. A financial plan visualized without foresight may fall to meet the present as well as the future requirements of funds and bring disaster to the concern. In the words of Hoagland, "Foresight should be used in planning the scope of operations in order that the needs of capital may be estimated as accurately as possible"

Intensive or Optimum Use

A business should neither starve for funds nor should have unnecessary idle funds. That means, the financial plan should provide for the optimum use of funds. In the words of Hoagland, "Wasteful use of capital is as bad as inadequate capital". So, the financial plan should provide for sufficient funds for meeting the genuine needs of the business. To ensure the optimum use of funds, while framing the financial plan, the financial planners should keep in view the proper utilization of the funds in the context of the overall objective of maximization of wealth. Again, they (i.e. financial planners) should see that a proper balance is maintained between long-term funds and short-term funds, since the surplus of one will not be able to offset the shortage of the other.

Contingencies

The financial plan should make adequate provision for funds for meeting the contingencies likely to arise in the future. It may be noted that this principle does not mean that large amount of funds should be kept idle as reserve for unforeseen contingencies. It simply means the while formulating the financial plan, the financial planners should make proper forecasts of the contingencies likely to arise in the future and make adequate provision for funds for meeting the future contingencies

Liquidity

- There should be adequate liquidity in the financial plan. Liquidity means the ability of the concern to make cash available, whenever required, for making payments
- Adequate liquidity in the financial plan will act as a shock absorber in the event of business operations deviating from the normal course
- Further, it gives the financial plan certain degree of flexibility. Above all, it will help in avoiding embarrassment to management and loss of reputation of the concern in the eyes of the public

Economy

The financial plan should ensure economy. That is, it should ensure that the cost of raising the funds is the minimum. That is possible by having a proper debt-equity mix in the capital structure

Investors' Preference or Temperament

The preference of the investors are different. Investors, who are bold and venturesome, prefer equity shares. Investors, who are not very bold, have a liking for preference shares. Investors, who are cautious, go for debentures. As such, the financial plan should keep in

mind the temperament or the preferences of the investors. That is, the financial plan should be formulated in consonance (i.e. in accordance) with the preference of the investors.

LONG-TERM AND SHORT-TERM FINANCIAL PLAN

From the point of view of the period of coverage, financial plans may be divided into two types: They are (1) Long-term financial plan and (2) Short-term financial plan

Long-term financial Plan

- Long-term financial plan is concerned with the formulation of long-term financial goals of the enterprise and the determination of the ways and means of achieving those goals. Longterm financial plans attempt to anticipate, analyse and make decisions about basic financial problems and issues which are beyond the present horizon of the enterprise
- The length of the period varies from concern to concern depending upon the nature of the business, the risks and uncertainties, Government control etc.,
- ◆ Large companies, generally, choose long-term financial plan
- The preparation of long-term financial plan is a very difficult task. But it is quite essential in the competitive business world
- Long-term financial plans are, generally, prepared on the basis of long-term financial forecasts, and the long-term financial forecasts are prepared by relating the items of profit and loss account and balance sheet to sales

Short-term Financial Plan

Short-range or short-term financial plan is concerned with the planning or determination of short-term financial activities to accomplish long-term financial objectives. As a short-term financial plan is intended to achieve long-term financial objectives, it (i.e. short-term

financial plan) has to be consistent with long-range financial plan. Short-term financial plan is more action-oriented, more detailed, specific and quantitative.

The preparation of short-term financial plan is relatively easier. Small companies, generally, choose short-term financial plan.

ROLE OF FINANCIAL MANAGER

Estimating Financial Requirements

The first task of a financial manager is to estimate short-term and long-term financial requirements of his business. For this purpose, he will prepare a financial plan for present as well as for future. The amount required for purchasing fixed assets as well as funds for working capital will have to be ascertained

Deciding the Capital Structure

The capital structure refers to the kind and proportion of different securities for raising funds. After deciding about the quantum of funds required, it should be decided which type of securities should be raised. It may be wise to finance fixed assets through long-term debts. Even here if gestation period is longer, then share capital may be most suitable. A decision about kind of securities to be employed and the proportion in which these should be used is an important decision which influences the short-term and long-term financial planning of an enterprise

Selecting Source of Finance

After preparing a capital structure, an appropriate source of finance is selected. Various sources, from which finance may be raised, include share capital, debentures, financial institutions, commercial banks, public deposits, etc., If finances are needed for short periods

then banks, public deposits and financial institutions may be appropriate. On the one hand, if long-term finances are required then share capital and debentures may be useful.

Selecting Pattern of Investment

When funds have been procured then a decision about investment pattern is to be taken. The selection of an investment pattern is related to the use of funds. The decision-making techniques such as capital budgeting and opportunity cost analysis may be applied in making decision about capital budgeting. While spending on various assets, the principles of safety profitability and liquidity should not be ignored

Proper Cash Management

Cash management is also an important task of finance manager. He has to assess various cash needs at different times and then make arrangements for arranging cash

Implementing Financial Controls

- An efficient system of financial management necessitates the use of various control devices.
 Financial control devices generally used are:
 - Return on Investment
 - Budgeting Control
 - Break Even Analysis
 - Cost Control
 - Ratio Analysis
 - Cost and Internal Audit
- The use of various control techniques by the finance manager will help him in evaluating the performance in various areas and take corrective measures whenever needed

Proper Use of Surpluses

The utilization of profits or surpluses is also an important factor in financial management. A judicious use of surpluses is essential for expansion and diversification plans and also in protecting the interests of shareholders.

FUNCTIONS OF FINANCIAL MANAGER

Financial Forecasting and Planning

A financial manager has to estimate the financial needs of a business. How much money will be required for acquiring various assets? The amount will be needed for purchasing fixed assets and meeting working capital needs. He has to plan the funds needed in the future. How these funds will be acquired and applied is an important function of a finance manager.

Acquisition of Funds

After making financial planning, the next step will be to acquire funds. There are a number of sources available for supplying funds. These sources may be shares, debentures, financial institutions, commercial banks, etc., The selection of an appropriate source is a deliberate task. The choice of a wrong source for funds may create difficulties at a later stage. The pros and cons of various sources should be analyzed before making a final decision

Investment of Funds

The funds should be used in the best possible way. The cost of acquiring them and the returns should be compared. The channels which generate higher returns should be preferred. The technique of capital budgeting may be helpful in selecting a project. The objective of maximizing profits will be achieved only when funds are efficiently used and they do not remain idle at any time. A financial manager has to keep in mind the principles of safety, liquidity and soundness while investing funds

Helping in Valuation Decisions

A number of mergers and consolidations take place in the present competitive industrial world. A finance manager is supposed to assist management in making valuation etc., For this purpose, he should understand various methods of valuing shares and other assets so that correct values are arrived at.

Maintain Proper Liquidity

Every concern is required to maintain some liquidity for meeting day-to-day needs. Cash is the best source for maintaining liquidity. It is required to purchase raw materials, pay workers, meet other expenses, etc., A finance manager is required to determine the need for liquid assets and then arrange liquid assets in such a way that there is no scarcity of funds.

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Unit V

Capital Budgeting – Meaning – Objectives – Methods of evaluation of capital budgeting -Traditional Methods – Pay Back Period Method – Rate of Return – Discounted Cash Flow Methods – Net Present Value Method – Internal Rate of Return - Profitability Index Method

Capital Budgeting

The term Capital Budgeting refers to long term planning for proposed capital outlays and their financing. Thus it includes both raising of long term funds as well as their utilization. It may thus be defined as "the firms formal process for the acquisition and investment of capital". It is the decision making process by which the firms evaluate the purchase of major fixed assets.

Features of Capital Budgeting

*It has the potentiality of making large anticipated profits.

* It involves a high degree of risk

* It involves a relatively long time period between the initial outlay and the anticipated return

Importance of Capital Budgeting

1. Involvement of heavy funds:

Capital budgeting decisions require large capital outlays. It is, therefore, absolutely necessary that the firm should carefully plan its investment programme so that it may get the finances at the right time and they are put to most profitable use.

2. Long term implications

The effect of capital budgeting decisions will be felt by the firm over a long period and therefore, they have a decisive influence on the rate and direction of the growth of the firm.

3. Irreversible decisions

In most cases, capital budgeting decisions are irreversible. This is because it is very difficult to find a market for the capital assets. The only alternative will be to scrap the capital assets so purchased or sell them at a substantial loss in the event of the decision being proved wrong.

4. Most difficult to make

The capital budgeting decisions require an assessment of future evnts which are uncertain. It is really a difficult task to estimate the probable future events, the probable

benefits and costs accurately in quantitative terms because of economic, political, social and technological factors.

Kinds of Capital Investment Proposals

1. Independent Proosals

These are proposals which do not compete with one another in a way that acceptance of one precludes the possibility of acceptance of another. In case of such proposals the firm may straightaway **accept or reject** a proposal on the basis of a minimum return on investment required.

2. Contingent or dependent proposals

These are proposals whose acceptance depends on the acceptance of one or more other proposals. For example a new machine may have to be purchased on account of substantial expansion of plant.

3. Mutually exclusive proposals

These are proposals which compete with each other in a way that the acceptance of one precludes the acceptance of other or others. Eg. If a company is considering investment in one of two temperature control systems, acceptance of one system will rule out the acceptance of another.

Capital Budgeting Appraisal Methods

In view of the significance of capital budgeting decisions, it is absolutely necessary that the method adopted for appraisal of capital investment proposals is a sound one. Any appraisal method should provide for the following:

- A basis of distinguishing between acceptable and non acceptable projects
- Ranking of projects I order of their desirability
- Choosing among several alternatives
- A criterion which is applicable to any conceivable project
- Recognizing the fact that bigger benefits are preferable to smaller ones and early benefits are preferable to late ones.

Methods of Capital Budgeting

- 1. Pay Back Period Method
- 2. Discounted Cash Flow Method
 - (a) The Net Present Value Method
 - (b) Present value index Method
 - (c) Internal Rate of Return Method

3. Accounting Rate of Return Method.

1. Pay Back Period Method

The term pay back refers to the period in which the project will generate the necessary cash to recoup the initial investment.eg. if a project requires Rs. 20,000 as initial investment and it will generate an annual cash inflow of Rs.5,000 for ten years, the payback period will be 4 years.

Initial Investment

Pay Back Period = -----

Annual Cash Inflow

20,000/5000 = 4 Yrs

Uneven Cash inflows

Eg. The project requires an initial investment of Rs.20,000 and the annual cash inflows for 5 years are R. 6000, Rs.8000, Rs.5,000, Rs. 4,000 and Rs.4,000 respectively the pay back period will be

Year	Cash inflows	cumulative cash inflows
1	Rs. 6,000	Rs. 6,000
2	8,000	14,000
3	5,000	19,000
4	4,000	23,000
5	4,000	27,000

The above table shows that in three years Rs.19,000 has been recovered. Rs.1,000 is left cut of initial investment. In the fourth year the csh inflow is Rs.4,000. It means the pay back period is between three to four years ascertained as follows

Pay Back Period = 3 years + 1000/4000 = 3.25 Years

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Accept or reject criterion

The pay back period can be used as criterion to accept or reject an investment proposal. A project whose actual pay back period is more than what has been pre determined by the management will be straightaway rejected.

Merits

- 1. The method is very useful in evaluating those projects which involve high uncertainity. Political instability, rapid technological development of cheap substitutes etc. are some of the reasons which discourage one to take up projects having long gestation period.
- 2. The method makes it clear that no profit arises till the pay back period is over. This helps new companies in deciding hen they should start paying dividend.
- 3. The method is simple to understand and easy to work out.
- 4. The method prefers investment in shor term projects.

Demerits

The method ignores the returns generated by a project after its pay back period projects having long gestation period will never be taken up if this method is followed though they may yield high returns for a long period.

2. Discounted Cash Flow Method (DCF)

The discounted cash flow technique is an improvement on the pay back period method. It takes into account both the interest factor as well as the return after the pay back period.

This method involves these stages

- 1. Calculation of cash flows
- 2. Discounting the cash flows so calculated by a discount factor
- 3. Aggregating of discounted cash inflows and comparing the total with the discounted cash outflows.

(a) The Net Present Value Method (NPV)

The net present value Is the difference between the total present value of future cash inflows and the total present value of future cash outflows.

Accept or reject criterion

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The Net Present Value can be used as an accept or reject criterion. In case the NPV is positive ie. Present value of cash inflows is more than present value of cash outflows the project should be accepted.

Eg. Calculate the net present value for a small sized project requiring an initial investment of Rs.20,000, and which provides a net cash inflow of Rs.6,000 each year for six years. Assume the cost of funds to be 8% pa and that there is no scrap value.

Ans: The present value of an annuity of Rs.1 for 6 years at 8% pa interest is Rs.4.623

Hence the present value of Re.6,000 comes to

6000X4.623 = 27,738Less Initial Investment = 20,000 NPV

7,738

(b) Excess Present Value Index

This is the refinement of the net present value method. Instead of working out the net present value, a present value index is found out by comparing the total of present value of ftre cash inflows and the total of the present value of future cash outflows. This can be use the following formula

Excess present value index = Present value of future cash inflows

----- X100

Present value of future cash outflows

(c) Internal Rate of Return

Internal Rate of Return is that rate at which the sum of discounted cash inflows quals the sum of discounted cash outflows. In other words, it is the rate which discounts the cash flows to zero. It can e stated in the form of a ratio as follows.

Cash Inflows

= 1

Cash outflows



afford to pay on the capital invested in a project. A project would qualify to be accettpted if IRR exceeds the cut off rate. A project giving a higher internal rate of return would be preferred.

(i) IRR when cash flows are uniform
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In the case of those projects which resits in uniform cash inflows the internal rate of return can be calculated by locating the factor in annuity table II. The factor is calculated as follows



F = Factor to be located

I = Original Investment

C = Cash Inflow per year

Eg; the annual cash flow is uniform at Rs. 2,000 for five years. Hence the Factor oor the pay back is 3 calculated as follows



2000

The factor of 3 should be located to Table II in the line of 5 years. The discount percentage would be somewhere between 18% (Rs. 3. 127 present value of annuity of Re.1) and 20% Re. 2.00 present value of annuity of Re.1). it indictes that the internal rate of return is more than 18% but less than 20%.

Relationship between pay back reciprocal and rate of return

Pay back reciprocal is exactly equal to the unadjusted rate of retun. Unadjusted rate means a r ate which has not been adjusted by taking into account the time value of money.

Pay back reciprocal also gives a reasonable approximation of the time adjusted rate of return .

There are two assumptions to the use of pay back reciprocal

- (i) The useful life of the project should be at least twice the pay back reciprocal.
- (ii) The cash inflows should be uniform over the life of the project.
- (iii) Where cash inflows are not uniform

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When cash inflows are not uniform the internal rate of return is calculated by making trial calculations in an attempt to compute the correct interest rate which equate s the present value of cash inflows with the present value of cash outflows.

Comparison of the IRR and NPV method

*The Net Present Value method takes the interest rate as a known factor while IRR method takes it as an unknown factor.

*The NPV method seeks to find out the amount that can be invested in a given project so that its anticipated earnings will exactly suffice to repay this amount with interest at the market rate. On the other hand, IRR method seeks to find the maximum rate of interest at which the funds invested in the project could be repaid out of the cash inflows arising out of that project.

* Both the NPV and IRR methods proceed on this presumption that cash inflows can be reinvested at the discounting rate in the new projects. However, reinvestment of funds at the cut off rate is more possible than as the internal rate of return. Hence, NPV method is more reliable than the IRR method for ranking two of more capital investment projects.

3. Accounting Rate of Return (ARR) Method

According to this method, the capital investmentproposals are judged on the basis of their relative profitability. For this purpose, capital e,ployed and related income are determined accouding to commonly accepted accounting principles and practices over the entire economic life of the project and then the average yield is calculated. Such a rule is termed as Accounting Rate of Return. It may be calculated by using the following formula

Annual Average Net Earnings

X 100

Original Investment

Accept/Reject criterion

Normally business enterprises fix a minimum rate of return. Any project expected to give a return below this rate will be straightaway rejected.

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Eg. The directors of Alpha Ltd are contemplating the purchase of a new macine to replace a machine which has been in operation in the factory for the last 5 years. Ignoring interest but considering tax at 50% of net earnings, suggest which of the two alternatives should be preferred. The following are the details:

Particulars	old Machine	New Machine
Purchase price	Rs. 40,000	Rs. 60,000
Estimated life of machine	10 yrs	10 yrs
Machine running hours per annum	2,000	2,000
Units per hour	24	36
Wages per running hour	3	5.25
Power per annum	2,000	4,500
Consumable stores per annum	6,000	7,500
All other charges per annum	8,000	9,000
Material cost per unit	0.5	0.5
Selling price per unit	1.25	1.25

You may assume that the above information regarding sales and cost of sales will hold good throughout the economic life of each of the machines. Depreciation has to be charged according to straight line method.

Solution

Profitability Statement				
		Old Machine	New Machine	
Cost of the Machine		Rs. 40,000	60,000	
Life of Machine	Yrs	10	10	
Otuput	units	48,000	72,000	
Sales value	Rs.	60,000	90,000	

Less: cost of sales:

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Direct material		24,000		36,000	
Wages		6,000		10,500	
Power		2,000		4,500	
Consumable stores		6,000		7,500	
Other charges		8,000		9,000	
Depreciation		4,000		6,000	
			50,000		73,500
Profit before tax					
			10,000		16,500
Tax at 50%			5,000		8,250
	Profit after tax		5,000		8,250
Accounting rate of return			·		
Old machine			New Mach	ine	
Average Net Earninngs					
	X 100				
Original Investment					
5,000			8,250		
X 100	0 = 12.3%		2	X 100 = 13	3.75%
			<u> </u>		

Thus, replacement of the old machine by a new machine is profitable.

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Unit 1

Possible Questions

Part – A

- 1. What do you mean by Financial Decision?
- 2. Explain on Financial Planning.
- 3. What is Financial Management?
- 4. Write short notes on Long-term and Short-term Financial Planning.
- 5. What do you mean by liquidity?
- 6. What is Financial Decision?
- 7. What is Dividend Decisions?
- 8. What is procurement of funds?
- 9. Write short note on wealth maximization.
- 10. Mention the three forms of financial decisions.

Part – B

- 1. Write a detailed note on Scope of Financial Management.
- 2. What is Financial Planning? Explain its Principles.
- 3. What is the Scope of Finance Function in a business enterprise?
- 4. Explain in detail on Role and Functions of a Financial Manager.
- 5. What are the objectives of Sound Financial Planning?
- 6. Explain in detail Short term Financial Plan and Long term Financial Plan.
- 7. Write a detailed note on financial plan.

Unit 2

Possible Questions

Part - A

- 1. What is Cost of Capital?
- 2. What do you understand by Capital Budgeting?
- 3. What is Pay-back Period?
- 4. Explain on Irredeemable Debt.
- 5. What is Weighted Average Cost of Capital?
- 6. Explicate on Discounted cash flow method.
- 7. Explain on Redeemable Debt.
- 8. Explain the importance of Cost of Capital?
- 9. Explicate on Weighted Average Cost of Capital.
- 10. Write a note on Retained Earnings.
- 11. What are the techniques of evaluation?
- 12. Distinguish between historical cost and future cost.
- 13. Explain briefly the cost of irredeemable debt.
- 14. Determine the net present value method.

Part – B

 Mr. Ram plans to commence a business with an initial investment of Rs. 25000. The projected future cash inflows are also submitted to you. As a Business consultant what recommendation will you offer to Mr. Ram, whether to accept the business proposal or not to accept the business proposal?

Year	Cash Inflows	Present Value
	(Rs.)	of Re. 1 at 10%
1	9000	0.909
2	8000	0.826
3	7000	0.751
4	6000	0.683
5	5000	0.621

Taking the cut-off rate as 10%.

- The shares of a Steel Company are quoted at Rs.42 per share. The firm had paid a dividend of Rs. 4 per share last year. The expected growth in dividends is 5% per annum.
 - (i) Determine the cost of equity capital of the company
 - (ii) Determine the market price of the equity shares, if the anticipated growth rate of the firm (a) rises to 8% and (b) falls to 3%
- 3. The following particulars relating to a project.

Cost of the project Rs. 50500

Annual Cash Inflows	Rs.
1 Year	5000
2 Year	20000
3 Year	30000
4 Year	30000
5 Year	10000

Year	PV Factor at 10%
1 Year	0.909
2 Year	0.826
3 Year	0.751
4 Year	0.683
5 Year	0.621

Calculate Discounted Pay Back Period.

- A company issues 10% debentures at par for a total value of Rs.10, 00,000. The debentures are redeemable after 10 years at a premium of 10% if the tax rate is 40%, Compute the cost of debentures to the company
 - a) Before tax
 - b) After tax
- A company issues one crore equity shares of Rs.100 each at a premium of 10%. The company has been consistently paying a dividend of 18% for past five years. It is expected to maintain the dividend in future also.
 - a) Compute the cost of equity capital

- b) What will be the cost of equity capital if the market price of the share is Rs.200
- 6. Investment data for a new product are as follows:

Capital out lay Rs.200000

Depreciation 20%p.a. on written down value basis Furcated annual income before charging depreciation but after all other charges are as follows

Year	Amount
1	100000
2	100000
3	80000
4	80000
5	40000
Total	400000

Compute accounting rate of return.

7. A choice is to be made between two competing proposals which require an equal investment of Rs. 50,000 and are expected to generate net cash flows as under:

	Project I	Project II
	Rs.	Rs.
End of the year 1	25,000	10,000
End of the year 2	15,000	12,000
End of the year 3	10,000	18,000
End of the year 4	NIL	25,000
End of the year 5	12,000	8,000
End of the year 6	6,000	4,000

The cost of capital of the company is 10per cent. The following are the present value factors at 10% per annum.

Year	1	2	3	4	5
P.V. factor @ 10%	0.909	0.826	0.751	0.683	0.564
Evaluate project proposal					

- (a) Pay-Back Period
- (b) Discounted Cash flow method

Which project proposal should be chosen and why?

Unit 3

Possible Questions

Part - A

- 1. What is Financial Leverage?
- 2. Explain on Operating Risk.
- 3. Define Capital Structure.
- 4. What is Composite Leverage?
- 5. Explain on Financial Structure and Capital Structure
- 6. What is an Optimum Capital Structure?
- 7. Write a formula for calculating Earnings per Share
- 8. Explain the importance of operating leverage.
- 9. Calculate EBIT when sales are Rs.1, 00, 000, fixed cost is Rs.10, 000 and variable cost is Rs.45, 000.
- 10. Describe in short the patterns of Capital Structure.
- 11. Explain EBIT EPS Analysis.
- 12. Give the formula for all the leverages.

Part – B

- Calculate Operating and Financial Leverages from the following particulars: Units Sold 5000; Selling Price Per unit Rs. 30; Variable Cost Per unit Rs.20 EBIT Rs. 30000; 10% Public Debt.
- 2. Discuss in detail, the factors which determine the capital structure of a firm.
- 3. Mr. Gokul, an investor of risk averse nature wishes to invest in Equity Shares. In this regard, he seeks your valuable advice to ascertain risk associated with Moon Ltd., and Star Ltd. As an investment consultant which company will you suggest to an Mr. Gokul and mention the reason for the same.

Particulars	Moon Ltd.,	Star Ltd.
Sales (in units)	20000	20000
Price per unit	Rs. 50	Rs.50
Variable cost per unit	Rs.20	Rs.25
Fixed Operating Cost	Rs.400000	Rs.300000
Fixed Financing Cost	Rs.100000	Rs.50000

4. The capital structure of Hindustan corporation Ltd. Consist of equity share capital of Rs.10, 00,000 (shares of Rs.100 par value) and Rs.10, 00,000 of 10% debentures. Sales has increased from 1, 00,000 units to 1,20,000 units, the selling price is Rs.10 p.u. Variable cost amounts to Rs.6 p.u. and fixed expanses amount to Rs.2,00,000. The income tax rate is assumed to be 50%.

You are required to calculate the following

- a) The percentage increase in EPS
- b) Degree of operating leverage at 1, 00,000 units and 1,20,000 units
- 5. Discuss the Net Income Approach and Net Operating Income Approaches to Capital Structure.
- 6. The following data are available for R and S ltd.

Selling price Rs.120 per unit

Variable cost Rs.70 per unit

Fixed cost Rs200000

ډ

- i. What is operating leverage when R and S ltd produces and sells 6000 units
- What is the percentage change that will occur in EBIT if the output increases by 5%
- iii. Calculate revised operating leverage

Unit 4

Possible Questions

Part - A

- 1. Elucidate on Working Capital.
- 2. What is Receivable Management?
- 3. What is meant by Inventory Management?
- 4. Write short notes on Permanent Working Capital.
- 5. What is Cash Budget?
- 6. Explain any two advantages of excessive Working Capital.
- 7. What is inadequate Working Capital?
- 8. Describe the importance of working capital?
- 9. What are the limitations of excessive working capital?
- 10. What is meant by cash Management?
- 11. What is working capital management?
- 12. What are the motives of holding cash?

Part – B

- 1. Explain the factors which determine the working capital needs of a firm.
- 2. What are the various factors influencing the size of receivables?
- 3. From the following information, calculate (i) Maximum Stock Level (ii) Minimum Stock Level and (iii) Re-order Level Minimum Consumption 240 units per day Normal Consumption 300 units per day Maximum Consumption 420 units per day Re-order quantity 3600 units Re-order period 10 to 15 days Normal order period 12 days
- 4. Discuss the advantages of working capital for a manufacturing concern.

5. From the following estimates, calculate the average amount of working capital required.

Per annum

1)	Average amount locked up in stock:	Rs.
	Stock of finished goods and work in progress	10,000
	Stock stores, material etc.	8,000
2)	Average credit given	
	Local sales 2 weeks credit	1,04,000
	Outside the state 6 weeks credit	3, 12,000
3)	Time available for payments	
	For purchases 4 weeks	78,000
	For wages 2 weeks	2,60,000

Add 10% to allow contingencies.

- 6. Discuss the advantages and limitations of excessive and inadequate working capital
- 7. Explain the concepts of working capital.
- 8. What is receivable management? What are the objectives of receivable management?
- 9. What is Cash Budget? Draft and explain the format of Cash Budget.

Unit 5

Possible Questions

Part - A

- 1. What is Stock Dividend?
- 2. Describe on Property Dividend.
- 3. What are Bonus Shares?
- 4. What is Dividend?
- 5. Elucidate on Bond Dividend.
- 6. Define Dividend Policy
- 7. Explain the importance of Dividend Policy.
- 8. Write a short note on Gordon's Model.
- 9. Explain on classifications of Dividend policy.
- 10. Write a short note on MM Hypothesis.
- 11. Describe shortly about the growth firms under Walter's model.
- 12. List out the forms of dividend.

Part - B

- 1. Discuss on Walter's views on Optimum dividend payout.
- 2. Explain in detail on the determinants of dividend policy of corporate enterprises.
- 3. Explain the various factors which influence the dividend decision of a firm.
- 4. Explain the assumptions and implications of Gordon's Dividend Model.
- 5. Explain the types of Dividend Policy.
- 6. Explain the assumptions and implications of MM Hypothesis.
- 7. What are the different forms of dividend?
- 8. (a) Following particulars relate to three companies.

A Ltd	B Ltd	C Ltd
(Growth Firm)	(Normal Firm)	(Declining Firm)
r = 15%	r = 10%	r = 5%
Ke = 10%	Ke = 10%	Ke = 10%
E = Rs. 8	E = Rs. 8	E = Rs. 8

Under Walter's model, calculate the value f equity share of each of these companies, if the dividend payout is a) 25% b) 50% c) 75%

9. Explain in detail the different theories of capital structure.

Reg. No		PART B (5 X 14-76 Marks) Answer ALL the Questions	
KARPAGAM UNIVERSITY (Under Section 3 of UGC Act 1956) COIMBATORE – 641 021	s)	 16. a. Explain the scope and functions of financial management? Or b. Discuss the role and responsibilities of a financial manager. 	
(For the candidates admitted from DE B.Com DEGREE EXAMINATION, NOVEMB Fifth Semester COMMERCE (COMPUTER APPLICATION FINANCIAL MANAGEMENT Ma	SER 2015 NS) aximum : 100 marks	 17. a. Calculate the effective cost of preference capital roots investigation of the circumstances: (i) A company raises preference share capital of Rs.1, 00,000 by issue of preference shares of Rs.10 each. Calculate the cost of preference capital when they are issued at (i) 10% premium (ii) at 10% discount. (ii) A company has 7% redeemable preference shares of Rs.1, 00,000 redeemable at the end of 10th year of their issue. The underwriting company capital the effective cost of preference capital. 	7% U #5
 Time: 3 hours PART - A (15 x 2 = 30 Marks) Answer ALL the Questions 9. What is financial management? 9. What is financial decision? 9. What is financial decision? 9. What is financial decision? 9. What project will be selected under pay back method? 1 year 25,000 30,000 Cash inflows 1 year 25,000 40,000 9. What is weighted average cost of capital? 9. What are the difference between capital structure and financial is weighted average? 9. What are the difference between capital structure and financial interest rate on marketable securities 6% p.a. You are required to calculate optimum eash balance. 10. The Daily demand for a mechanical part is about 25 units. Financial part is about 25 units. Financial part is about 25 units. 10. The Daily demand for a mechanical part is about 25 units. Financial part is about 25 units. 11. The Daily demand for a mechanical part is about 25 units. 12. The Daily demand for a mechanical part is about 25 units. 13. The Daily demand for a mechanical part is about 25 units. 14. Explain any two assumption of Gordon's dividend modeling. 15. What is dividend? 	al structure? every time an order is cost per unit is 40		- back 000 000 5 000 5,000 2ars 8,000 g their restment in 8,5.75,000

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Reg. No KARPAGAM UNIVERSITY (Under Section 3 of UGC Act 1956. COIMBATORE - 641 021 (For the candidates admitted from 2012 onwards) [12CCU502] 17. a. The shares of a Steel Company are quoted at Rs 42 per share. The firm had paid a dividend of Rs. 4 per share last year. The expected growth in dividend is 5% per annum.
a. Determine the costs of equity capital of the company.
b. Determine the market price of the equity shares, if the anticipated growth rate of the firm (a) rises to 8% and (b) fails to 3% or 1000 per share. Cost of the project Rs. 50500 B.Com. DEGREE EXAMINATION, NOVEMBER 2015 COMMERCE (COMPUTER APPLICATION) FINANCIAL MANAGEMENT Time: 3 hours PART - A (15 x 2 = 30 Marks) Answer ALL the Questions Maximum : 100 marks Annual Cash Inflows 1. What is Financial Management?
2. Write short notes on Long-term and Short-term Financial Planning.
3. What do you mean by liquidity?
4. Explain on Ircedeemable Debt.
5. What is Weighted Average Cost of Capital?
6. Explain on Discounted cash flow method.
7. What is Composite Leverage?
8. Explain on Financial Structure and Capital Structure?
9. What is an Optimum Capital Structure?
10. What is Cash Budget?
11. What is Cash Budget?
12. What do you mean by Receivables? Rs, 5000 20000 30000 30000 10000 1 Year 2 Year 3 Year 4 Year 5 Year Year PV Factor at 1 Year 2 Year 3 Year 4 Year 10% 0.909 0.826 0.751 0.683 What is cash budget?
 What do you mean by Receivables?
 What are Bonus Shares?
 What is Dividend? Calculate Disco 5 Year anted Pay Back Period 18. a. From the following information, calculate (i) Maximum Stock Level (ii) Minimum Stock Level and (iii) Re-order Level Minimum Consumption 240 units per day Normal Consumption 420 units per day Maximum Consumption 420 units per day Re-order quantity 3600 units Re-order period 10 to 15 days Normal order period 12 days Or 15. Elucidate on Bond Dividend. PART B (5 X 14= 70 Marks) Answer ALL the Questions 16. a. What is the Scope of Finance Function in a business enterprise? b. Explain in detail on Role and Functions of a Financial Manager. b. Discuss the advantages of working capital for a manufacturing concern. 19, a. Explain the various factors which influence the dividend decision of a firm. b. Explain the assumptions and implications of Gordon's Dividend Model.

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a. Ambika Company sells goods in the home market and earns a gross profit of 10% on sales. Its annual figures are as follows:

Particulars	Amount
Sales	6.00.000
Materials used	2,16,000
Wages	1,92,000
Manufacturing Expenses	2,40,000
Administrative Expenses	60,000
Depreciation	24,000
Selling Expenses	36,000
Income tax payable in two installments of which first installment falls in the next year	60,000

Additional Information

(i) Credit given by suppliers-2 months
(ii) Credit allowed to customers-1 month
(iii) Lag in payment of wages-1/2 month
(iv) Lag in payment of Administrative expenses-1 month
(v) Selling expenses are paid quarterly in advance.
(vi) Raw materials and finished goods are in stock for 1 month.
(vii) Cash balance estimated to be maintained at Rs.60,000. You are required to prepare a statement of working capital requirements. Or

b. Discuss the various aspects or dimensions of receivable management?

20. a. The earning per share of company are Rs.8 and the rate of capitalization applicable to the company is 10%. The company has before it an option of adopting a payout ratio of 25% or 50% or 75%. Using Walter's formula of dividend payout, compute the market value of the company's share if the productivity of retained earnings is (i) 15% (ii) 10% (iii) 5% Or

b. What are the factors determining the dividend policy of the company?

3

20. Com	pulsory : -		
M In this re Ltd., and an Mr. G	r. Gokul, an investor of risk averse nature wishes to invest in Equity Shares. gard, he seeks your valuable advice to ascertain risk associated with Moon Star Ltd. As an investment consultant which company will you suggest to skul and mention the reason for the same.	AM LINEVERSE (*) Den Follfan - Yet Hege SATTRE - AF 02 Fakiting Bon 2013 - Honeze)	
	Particulars Moon Ltd., Star Ltd. Sales (in units) 20000 20000 20000	A TON A TONK, MATER A TOP IS 2013	L.Com. DEGREE SY.
	Price per unit Rs. 50 Rs. 50 Variable cost per unit Rs. 20 Rs. 25	MALTER (PPI, C.) TOY	
	Fixed Operating Cost Rs.400000 Rs.300000	A MANAGENERY .	CIVLATE
	Fixed Financing Cost Rs.100000 Rs.50000		
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Maximum : 60 marks

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KARPAGAM UNIVERSITY

Karpagam Academy of Higher Education (Established Under Section 3 of UGC Act 1956) COIMBATORE – 641 021 (For the candidates admitted from 2014 onwards)

B.Com., DEGREE EXAMINATION, NOVEMBER 2016 Fifth Semester

COMMERCE (PROFESSIONAL ACCOUNTING)

FINANCIAL MANAGEMENT PART - A (20 x 1 = 20 Marks) (30 Minutes)

Time: 3 hours

(Question Nos. 1 to 20 Online Examinations) PART B (5 x 8 = 40 Marks) (2 1/2 Hours)

Answer ALL the Questions

21. a. What is Wealth Maximization? In what ways is the wealth maximization objective superior to the profit maximization?

b. How should the finance function of an enterprise be organized? What are the

functions do the finance manager perform?

22. a. A Company has equity share capital of Rs.6,00,000 divided into shares of Rs.100 each. It wishes to raise further Rs.3,00,000 for expansion cum modernization plans. The Company plans the following financial schemes (i) All common stacks.

(ii) An common stocks
 (iii) Rs.2,00,000 in common stocks and Rs1,00,000 in preference capital with the rate of dividend at 8%

(iii) Rs1,00,000 in preference capital with the rate of dividend at 7% and Rs.2,00,000 in debt @ 5% rate of interest.

The company's existing earnings before interest. Rs.2,00,000, The corporate rate of tax is 30% You are required to determine the EPS in each plan and Comment on the implication of financial leverage.

b. Briefly discuss various theories of capital structure.

23. a. Discuss the important conditions for development of venture capital. b. Explain and illustrate the equipment loan method of lease financing.

24. a. How Net Present Value [NPV] is calculated? Explain investment evaluation of NPV method. Or

Or b. Equipment A has a cost of Rs. 75,000 and net cash flow of Rs. 20,000 per year, for six years: A substitute Equipment B would cost Rs. 50,000 and generated net cash flow of Rs. 14,000 per year for six years. The required rate of return for both equipments is 11 per cent. Calculate the NPV and IRR for the equipments. Which equipment should be accepted and why?

25. a. What are the methods of preparing long-term and short-term cash forecasts?

b. The following details are available in respect of firm i. Inventory requirement per year 5700 units ii. Cost per unit Rs. 5

II. Cost per unit Rs. 5
iii. Carrying cost per item for one year is Re.1
iv. Cost of planning each order is Rs. 55
v. Alternative order size are 5700, 3000, 2000, 1200, 1000, 550 and 200.

You are requiring calculating Economic Order Quantity [EOQ].

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19. Owner capital include______ a. Share capital b. Bonds c. Loans d. Public deposits Under Walter's model, calculate the value f equity share of each of these companies, if the dividend payout is a) 25% b) 50% c) 75% Or 20. The industries with steady demand of their products can follow a dividend pay out ratio. a. Higher b. lower c. constant d. no dividend b. Explain in detail the different theories of capital structure. PART B (5 x 8 = 40 Marks) (2 ½ Hours) Answer ALL the Questions 21. a. What is the Scope of Finance Function in a business enterprise? Or b. Write a detailed note on financial plan. 22. a. A company issues 10% debentures at par for a total value of Rs.10, 00,000. The debentures are redeemable after 10 years at a premium of 10% if the tax rate is 40%, Compute the cost of debentures to the company i. Before tax ii. After tax Or b. Enumerate the classifications of Cost of Capital in detail. 23. a. Explain the factors which determine the working capital needs of a firm. Or b. Explain the concepts of working capital. 24. a. The capital structure of Hindustan corporation Ltd. Consist of equity share capital of Rs. 10, 00,000 (shares of Rs. 100 par value) and Rs. 10, 00,000 of 10% debentures. Sales has increased from 1, 00,000 units to 1,20,000 units, the selling price is Rs. 10 p.u. Variable cost amounts to Rs. 6 p.u. and fixed expanses amount to Rs.2,00,000. The income tax rate is assumed to be 50%. You are required to calculate the following i. The percentage increase in EPS ii/ Degree of operating leverage at 1, 00,000 units and 1,20,000 units Or b. Discuss the Net Income Approach and Net Operating Income Approaches to Capital Structure. 25. a. Following particulars relate to three companies. A Ltd B Ltd C Ltd · (Declining Firm) r = 5%Ke = 10% (Normal Firm) (Growth Firm) r = 15% r = 10%Ke = 10% Ke = 10% E = Rs. 8E = Rs. 8E = Rs. 8

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KARPAGAM ACADEMY OF HIGHER EDUCATION FIRST INTERNAL EXAMINATION July 2017-11-21 FINANCIAL MANAGEMENT

Part A

Choose the correct Answer:

- 1. Financial Management is
 - (a) **Both Science and Art** (b) Neither a pure science nor an Art (c) It is science (d) It is an applied science
- 2. Wealth maximisation denotes
 - (a) **Maximising wealth** (b) Maximising net worth (c) increasing the EPS (d) All the above
- 3. The traditional approach evolved during the period
 - (a) 1956 (b) 1958 (c) **1920** (d) 1940
- 4. The object of outsider looking in approach is
 - (a) **By view point of suppliers** (b) By view point of Debtors (c) By view point of shareholders (d) None of the above
- 5. Investment decisions relating to investment in
 - (a) Capital (b) current assets (c)**Both**
- 6. An efficient financial manager fixed that level of operation is called as

predetermined price within the specified period is called

- (a) High debt equity ratio (b) High risk ratio (c)**Risk return trade off** (d) All the above
- 7. The investor had the right to demand back the money earlier than the redemption date

at a

(a) put option (b) **call option** (d) Both

8. Debentures which do not carry any charge on the asset of the company is called

(a) **Naked debentures** (b) Mortgage debentures (c) convertible debentures (d) None of the above.

9. Financing through Preference shares is known as

- (a) **Fixed financing** (b) Flexible financing (c) Mortgage financing (d) None of the above
 - 10. The shares which do not carry any preferential right
 - (a) Preference shares (b) equity shares (c) debentures (d) None of the above
 - 11. Financial Management is merely concerned with

(a) arrangement of funds (b) **all aspects of acquiring and utilizing financial resources for firms activities** (c) efficient management of every business (d) all the above

12. Basic objective of financial management is

(a) Maximization of profit (b) Maximization of shareholders wealth (c) ensuring financial discipline in the organisation (d) **all the above**

13. In his traditional role, the finance manager is responsible for

(a) arrangement and efficient utilization of funds (b) **arrangement of financial resources** (c) acquiring capital assets for the organization (d) all the above

14. Equity shares are entitled to divided at a fixed rate

(a) Yes (b) No

15. Interest payable on debentures is

(a) a charge against profits (b) an appropriation of profits (c) short term finance (d)

None of these

16. Stock invest facilty is not available to

(a)An individual investor (b) a limited company (c) a mutual fund (d) none of these

17. Borrowers prefers hypothecation as compared to pledge

(a) Yes (b) No

18. The rate at which equates the present value of cash inflow and present value of cash outflow is

(a) implicit cost (b) explicit cost (c) future cost (d) historical cost

19. The rate of return of the firm requires from investment is known is

(a) **cost of capital** (b) capital budgeting (c) leverages (d) all the above

20. The weighted Average cost of each component of funds employed by the firm is

(a) Average cost (b) Marginal cost (c) future cost (d) combined cost

Part B

21 (a) Objectives of financial Management

Objectives of Financial Management

The financial management is generally concerned with procurement, allocation and control of financial resources of a concern. The objectives can be-

1. To ensure regular and adequate supply of funds to the concern.

- 2. To ensure adequate returns to the shareholders which will depend upon the earning capacity, market price of the share, expectations of the shareholders.
- 3. To ensure optimum funds utilization. Once the funds are procured, they should be utilized in maximum possible way at least cost.
- 4. To ensure safety on investment, i.e, funds should be invested in safe ventures so that adequate rate of return can be achieved.
- 5. 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.
- 21 (b) Types of Financial Decisions
 - 1. Investment decision
 - 2. Financing decision
 - 3. Dividend decision

Investment Decision

Investment Decision relates to the determination of total amount of assets to be held in the firm, the composition of these assets and the business risk complexions of the firm as perceived by its investors. It is the most important financial decision. Since funds involve cost and are available in a limited quantity, its proper utilisation is very necessary to achieve the goal of wealth maximisation.

The investment decisions can be classified under two broad groups:

- (i) Long-term investment decision and
- ii) Short-term investment decision.

The long-term investment decision is referred to as the capital budgeting and the short-term investment decision as working capital management.

Capital budgeting is the process of making investment decisions in capital expenditure. These are expenditures, the benefits of which are expected to be received over a long period of time exceeding one year. The finance manager has to assess the profitability of various projects before committing the funds.

The investment proposals should be evaluated in terms of expected profitability, costs involved and the risks associated with the projects.

The investment decision is important not only for the setting up of new units but also for the expansion of present units, replacement of permanent assets, research and development project costs, and reallocation of funds, in case, investments made earlier do not fetch result as anticipated earlier.

Short-term investment decision, on the other hand, relates to the allocation of funds as among cash and equivalents, receivables and inventories. Such a decision is influenced by tradeoff between liquidity and profitability.

The reason is that, the more liquid the asset, the less it is likely to yield and the more profitable an asset, the more illiquid it is. A sound short-term investment decision or working capital management policy is one which ensures higher profitability, proper liquidity and sound structural health of the organisation.

Financing Decision

Once the firm has taken the investment decision and committed itself to new investment, it must decide the best means of financing these commitments. Since, firms regularly make new investments; the needs for financing and financial decisions are ongoing.

Hence, a firm will be continuously planning for new financial needs. The financing decision is not only concerned with how best to finance new assets, but also concerned with the best overall mix of financing for the firm.

A finance manager has to select such sources of funds which will make optimum capital structure. The important thing to be decided here is the proportion of various sources in the overall capital mix of the firm. The debt-equity ratio should be fixed in such a way that it helps in maximising the profitability of the concern.

The raising of more debts will involve fixed interest liability and dependence upon outsiders. It may help in increasing the return on equity but will also enhance the risk.

The raising of funds through equity will bring permanent funds to the business but the shareholders will expect higher rates of earnings. The financial manager has to strike a balance between various sources so that the overall profitability of the concern improves.

Prepared by Dr. B. Seetha Devi. Associate Professor, KAHE

If the capital structure is able to minimise the risk and raise the profitability then the market prices of the shares will go up maximising the wealth of shareholders.

Dividend Decision

The third major financial decision relates to the disbursement of profits back to investors who supplied capital to the firm. The term dividend refers to that part of profits of a company which is distributed by it among its shareholders.

It is the reward of shareholders for investments made by them in the share capital of the company. The dividend decision is concerned with the quantum of profits to be distributed among shareholders.

A decision has to be taken whether all the profits are to be distributed, to retain all the profits in business or to keep a part of profits in the business and distribute others among shareholders. The higher rate of dividend may raise the market price of shares and thus, maximise the wealth of shareholders. The firm should also consider the question of dividend stability, stock dividend (bonus shares) and cash dividend.

22. (a) Kinds of Preference Shares

Most important types of preference shares of a company are as follows:

(i) Cumulative preference shares:

A preference share is said to be cumulative when the arrears of dividend are cumulative and such arrears are paid before paying any dividend to equity shareholders. Suppose a company has 10,000 8% preference shares of Rs. 100 each. The dividends for 1987 and 1988 have not been paid so far. The directors before they can pay the dividend to equity shareholders for the year 1989, must pay the pref. dividends of Rs. 2, 40,000 i.e. for the year 1987, 1988 and 1989 before making any payment of dividend to equity shareholders for the year 1989.

(ii) Non-cumulative preference shares:

In the case of non-cumulative preference shares, the dividend is only payable out of the net profits of each year. If there are no profits in any year, the arrears of dividend cannot be claimed in the subsequent years. If the dividend on the preference shares is not paid by the company during a particular year, it lapses. Preference shares are presumed to be cumulative unless expressly described as non-cumulative.

(iii) Participating preference shares:

Participating preference shares are those shares which are entitled in addition to preference dividend at a fixed rate, to participate in the balance of profits with equity shareholders after they get a fixed rate of dividend on their shares. The participating preference shares may also have the right to share in the surplus assets of the company on its winding up. Such a right may be expressly provided in the memorandum or articles of association of the company.

(iv) Non-participating preference shares:

Non- participating preference shares are entitled only to a fixed rate of dividend and do not share in the surplus profits. The preference shares are presumed to be non-participating, unless expressly provided in the memorandum or the articles or the terms of issue.

(v) Convertible preference shares:

Convertible preference shares are those shares which can be converted into equity shares within a certain period.

(vi) Non-Convertible preference shares:

These are those shares which do not carry the right of conversion into equity shares.

(vii) Redeemable preference shares:

A company limited by shares, may if so authorized by its articles issue preference shares which are redeemable as per the provisions laid down in Section 80. Shares may be redeemed either after a fixed period or earlier at the option of the company.

(viii) Guaranteed preference shares:

These shares carry the right of a fixed dividend even if the company makes no or insufficient profits.

22 (b) Difference between shares and debentures

Meaning	Shares	Debentures
Meaning	Shares are the woned funds	Borrowed funds of the
	of the company	company
	It is the Capital	It is the debt
Holder	Holder of the share is share	Holder of the debenture is
	holder	debenture holder
Form of return	They get dividend	They get interest
Payment	Payment of dividend only out	Payment of interest even
	of profit	there is nil profit
Allowable deduction	It is an appropriation of profit	It is business expense so it is
	so it is not allowed as	allowed as deduction.
	deduction	

23. Main Sources of Finance

Short Term Financing

Banks can be an invaluable source of short term working capital finance.

1. Overdraft Agreement:

By entering into an overdraft agreement with the bank, the bank will allow the business to borrow up to a certain limit without the need for further discussion. The bank might ask for security in the form of collateral and they might charge daily interest at a variable rate on the outstanding debt. However, if the business is confident of making the repayments quickly, then an overdraft agreement is a valuable source of financing, and one that many companies resort to.

2. Accounts Receivable Financing:

Many banks and non-banking financial institutions provide invoice discounting facilities. The company takes the commercial bills to the bank which makes the payment minus a small fee. Then, on the due date the bank collects the money from the customer. This is another popular method of financing especially among small traders. Businesses that offer large terms of credit can carry on their operations without having to wait for the customers to settle their bills.

3. Customer Advances:

There are many companies that insist on the customer making an advance payment before selling them goods or providing a service. This is especially true while dealing with large orders that take a long time to fulfill. This method also ensures that the company has some funds to channelize into its operations for fulfilling those orders.

4. Selling Goods on Installment:

Many companies, especially those that sell television sets, fans, radios, refrigerators, vehicles and so on, allow customers to make their payments in installments. Since many of these items have become modern day essentials, their customers might not come from well-to-do backgrounds or the cost of the product might be too prohibitive for immediate payment. In such a case, instead of waiting for a large payment at the end, they allow the customers to make regular monthly payments. This ensures that there is a constant flow of funds coming into the business that does not choke up the accounts receivable numbers.

Long-Term Financing

Relying purely on short-term funds to meet working capital needs is not always prudent, especially for industries where the manufacture of the product itself takes a long time: automobiles, aircraft, refrigerators, and computers. Such companies need their working capital to last for a long time, and hence they have to think about long term financing.

1. Long-Term Loan from a Bank:

Many companies opt for a full-fledged long term loan from a bank that allows them to meet all their working capital needs for two, three or more years.

2. Retain Profits:

Rather than making dividend payments to shareholders or investing in new ventures, many businesses retain a portion of their profits so that they may use it for working capital. This way they do not have to take loans, pay interest, incur losses on discounted bills, and they can be self-sufficient in their financing.

3. Issue Equities and Debentures:

In extreme cases when the business is really short of funds, or when the company is investing in a large-scale venture, they might decide to issue debentures or bonds to the general public or in some cases even equity stock. Of course, this will be done only by conglomerates and only in cases when there is a need for a huge quantum of funds. Companies cannot rely only on limited sources for their working capital needs. They need to tap multiple avenues. They also need to constantly evaluate what their needs are, through analysis of financial statements and financial ratios, and choose their working capital channels judiciously. This is an ongoing process, and different routes are appropriate at different points in time. The trick is to choose the right alternative as per the situation.

Reg. No ----- [15PAU506A]

KARPAGAM ACADEMY OF HIGHER EDUCATION (Established Under Section 3 of UGC Act 1956) COIMBATORE II INTERNAL EXAMINATION – AUGUST 2017 (For the candidate admitted 2015 onwards) III B.COM (PA) Fifth Semester FINANCIAL MANAGEMENT

Reg. No.____

Time : 2 Hours Date :

Maximum : 50 Marks

PART – A (20X1=20 Marks) Choose the Correct Answer

1. Business risk can be measured by

(a) operating leverage (b)financial leverage

(d) combined leverage (d) operating or financial leverage

- 2...ploughing back of profit means
- (a) earning of black money (b)reinvestment of earnings (c)unclaimed dividends (d)a part

of profit to reserve

3._____is known as trading on equity

(a) operating leverage (b)composite leverage

c)financial leverage (d)working capital leverage

4.. _____ refers to the kind and proportion of different securities for raising fund

(a) capital structure (b) cost of capital (c) capital budgeting (d) auditing

5. NOI approach advocates that the degree of debt financing is

(a) relevant (b)may be relevant (c)irrelevant (d)may be irrelevant

6. sources of finance for a business include_____

(a) equity (b) land (c) outstanding expenses (d) depreciation

7. The term capital structure includes also the_____

(a) financial structure (b)debentures (c)market value (d)EPS

8. _____refers to make up of a firms capitalization

(a)capital structure (b)financial structure (c)closing stock (d)debtors

9. The Arbitrage process is the behavioural foundation for the_____

(a) **MM Hypothesis** (b)Net Income Approach

(c)Net Operating Income Approach (d)All the above

10. The cautious investors prefer to make investment in_____

(a) Debentures (b)Shares (c) fixed assets (d) all the above

11. Financial structure includes _____

(a)short term assets (b)long term assets (c)both (d) only long term assets

12.It is risky to have both operating leverage and _____ leverage at a high level.

(a) financial (b)long term assets (c)contribution (d)sales

13. Trading on equity implies having a _____debt equity ratio.

(a) low (b) high (c)medium (d)average

14. The term trading on equity is generally used for______ financial leverage.

(a)unfavorable (b)favorable (c)normal (d)medium

15.Capital structure includes_____

(a)dividend (b)EPS (c)sales (d) shares

16.Operating leverage denotes the tendency of the operating profit to vary disproportionately with

(a)cost (b)profit (c)sales (d)all the above

17. The higher is the leverage, ______is the risk.

(a)high (b)low (c)average (d)no response

18. Grater amount of variable cost and lesser amount of fixed cost denotes

(a)low operating leverage (b)high operating leverage (c)neutral d)all the above

19. The leverages used to measure the _____

(a) owners return (b)owners credit (c)creditors return (d)creditors wealth

20. The risky firm denotes

(a) high degree of leverage (b)low degree of leverage (c)normal leverage (d)all the above.

Part B

21. Factors determining the capital structure

 Trading on Equity- The word "equity" denotes the ownership of the company. Trading on equity means taking advantage of equity share capital to borrowed funds on reasonable basis. It refers to additional profits that equity shareholders earn because of issuance of debentures and preference shares. It is based on the thought that if the rate of dividend on preference capital and the rate of interest on borrowed capital is lower than the general rate of company's earnings, equity shareholders are at advantage which means a company should go for a judicious blend of preference shares, equity shares as well as debentures. Trading on equity becomes more important when expectations of shareholders are high.

- 2. Degree of control- In a company, it is the directors who are so called elected representatives of equity shareholders. These members have got maximum voting rights in a concern as compared to the preference shareholders and debenture holders. Preference shareholders have reasonably less voting rights while debenture holders have no voting rights. If the company's management policies are such that they want to retain their voting rights in their hands, the capital structure consists of debenture holders and loans rather than equity shares.
- 3. Flexibility of financial plan- In an enterprise, the capital structure should be such that there is both contractions as well as relaxation in plans. Debentures and loans can be refunded back as the time requires. While equity capital cannot be refunded at any point which provides rigidity to plans. Therefore, in order to make the capital structure possible, the company should go for issue of debentures and other loans.
- 4. **Choice of investors-** The company's policy generally is to have different categories of investors for securities. Therefore, a capital structure should give enough choice to all kind of investors to invest. Bold and adventurous investors generally go for equity shares and loans and debentures are generally raised keeping into mind conscious investors.
- 5. Capital market condition- In the lifetime of the company, the market price of the shares has got an important influence. During the depression period, the company's capital structure generally consists of debentures and loans. While in period of boons and inflation, the company's capital should consist of share capital generally equity shares.
- 6. **Period of financing-** When company wants to raise finance for short period, it goes for loans from banks and other institutions; while for long period it goes for issue of shares and debentures.
- 7. **Cost of financing-** In a capital structure, the company has to look to the factor of cost when securities are raised. It is seen that debentures at the time of profit earning of company prove to be a cheaper source of finance as compared to equity shares where equity shareholders demand an extra share in profits.

- 8. **Stability of sales-** An established business which has a growing market and high sales turnover, the company is in position to meet fixed commitments. Interest on debentures has to be paid regardless of profit. Therefore, when sales are high, thereby the profits are high and company is in better position to meet such fixed commitments like interest on debentures and dividends on preference shares. If company is having unstable sales, then the company is not in position to meet fixed obligations. So, equity capital proves to be safe in such cases.
- 9. **Sizes of a company-** Small size business firms capital structure generally consists of loans from banks and retained profits. While on the other hand, big companies having goodwill, stability and an established profit can easily go for issuance of shares and debentures as well as loans and borrowings from financial institutions. The bigger the size, the wider is total capitalization.
- 21(b) Net Income Approach of Capital Structure

Net income Approach (NI):

Under the net income (NI) approach, the cost of debt and cost of equity are assumed to be independent of the capital structure. The weighted average cost of capital declines and the total value of the firm rise with increased use of average.

22(a) Balanced Capital Structure

1. **EBIT-EPS Approach-** The EBIT-EPS analysis is an important tool in the hands of the financial manager to get an insight into the firm's capital structure management. He can consider the possible fluctuations in the EBIT and examine their impact on EPS under different financial plans. If the probability of earning a rate of return on the firm's assets less than the cost of debt is insignificant, a large amount of debt can be used by the firm to increase the earnings per share. This may have a favorable effect on the market value per share. On the other hand, if the probability of earning a rate of return on the firm's less than the cost of debt is very high, the firm should refrain from employing debt capital. It may, thus, be concluded that the greater level of EBIT & lower the probability of downward fluctuation, the more beneficial is to employ debt in the capital structure. However, it should be realized that the EBIT-EPS is a first step in deciding about a firm's capital structure.

Cost of Capital and Valuation Approach- The cost of a source of finance is the minimum return expected by its suppliers. The expected return depends on the degree of risk assumed by investors. A high degree of risk is assumed by the shareholders than the debt-holders. In case of debt-holders, the rate of interest is fixed and the company is legally bound to pay interest whether it makes profits or not. The loan of debt-holders is returned within a prescribed period, while shareholders will have to share the residue only when the company is wound up. This leads one to conclude that debt is a cheaper source of funds than equity. The preference share capital is also cheaper than equity capital, but not as cheap as debt.
 Cash Flow Approach-

One of a feature of a sound capital structure is conservatism. Conservatism does not mean employing no debt or small amount of debt. Conservatism is created by the use of debt or preference capital in the capital structure and the firm's ability to generate cash to meet these fixed charges. The fixed charges of a company include payment of interest, preference dividends, and the principal, and they depend on both the amount of loan securities and the terms of payment. The amount of fixed charges will be high if employs a large amount of debt or preference capital with short-term maturity. The company expecting larger & stable cash inflows in the future can employ a large amount of debt in their capital structure.

One important ratio which should be examined at the time of planning the capital structure is the ratio of net cash inflows to fixed charges (debt- servicing ratio). It indicates the number of times the fixed financial obligations are covered by the net cash inflows generated by the company. The greater the coverage, the greater is the amount of debt a company can use.

23. Kinds of Leverages

1. Operating Leverage:

Operating leverage is concerned with the investment activities of the firm. It relates to the incurrence of fixed operating costs in the firm's income stream. The operating cost of a firm is classified into three types: Fixed cost, variable cost and semi-variable or semi-fixed cost. Fixed cost is a contractual cost and is a function of time. So it does not change with the change in sales and is paid regardless of the sales volume.

Variable costs vary directly with the sales revenue. If no sales are made variable costs will be nil. Semi-variable or semi-fixed costs vary partly with sales and remain partly fixed.
These change over a range of sales and then remain fixed. In the context of operating leverage, semi-variable or semi-fixed cost is broken down into fixed and variable portions and is merged accordingly with variable or fixed cost. Investment decision goes in favor of employing assets having fixed costs because fixed operating costs can be used as a lever.

2. Financial Leverage:

Financial leverage is mainly related to the mix of debt and equity in the capital structure of a firm. It exists due to the existence of fixed financial charges that do not depend on the operating profits of the firm. Various sources from which funds are used in financing of a business can be categorized into funds having fixed financial charges and funds with no fixed financial charges. Debentures, bonds, long-term loans and preference shares are included in the first category and equity shares are included in the second category.

Financing decision goes in favour of employing funds having fixed financial charges because it can be used as a lever. Financial leverage results from the existence of fixed financial charges in the firm's income stream. With the use of fixed financial charges, a firm can magnify the effect of change in EBIT on change in EPS. Hence financial leverage may be defined as the firm's ability to use fixed financial charges to magnify the effects of changes in EBIT on its EPS.

The higher the proportion of fixed charge bearing fund in the capital structure of a firm, higher is the Degree of Financial Leverage (DFL) and vice-versa. Financial leverage is computed by the DFL. DEL expresses financial leverage in quantitative terms. The percentage change in the earning per share to a given percentage changes in earnings before interest and taxes is defined as Degree of Financial Leverage (DFL).