BALAJI INSTITUTE OF I.T AND MANAGEMENT KADAPA

FINANCIAL MANAGEMENT (21E00201)

ICET CODE: BIMK

1st & 2nd Internal Exam Syllabus

ALSO DOWLOAD AT http://www.bimkadapa.in/materials.html

Name of the Faculty: R.TEJASRI

Units covered : **1 to 5 Units**

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JAWAHARLAL NEHRU TECHNOLOGICAL UNIVERSITY ANANTAPUR
(Established by Govt. of A.P., ACT No.30 of 2008)
ANANTHAPURAMU – 515 002 (A.P) INDIA

MASTER OF BUSINESS ADMINISTRATION
MBA; MBA (General Management); MBA (Business Management)
COMMON COURSE STRUCTURE & SYLLABI

Course Code	FINANCIAL MANAGEMENT	L	T	P	C
21E00201		4	0	0	4
	Semester	II			

Course Objectives:

- To explain the importance of finance function and goals of financial managers.
- To impart the decision making skills in acquiring, allocating and utilising the funds of a company.
- To educate on corporate restructures and corporate governance.

*** Standard Discounting Table and Annuity tables shall be allowed in the examination**

Course Outcomes (CO): Student will be able to

- Learn the roles and goals of finance manager in a corporate structure business.
- Acquire decision making skills regarding financing, investing, and corporate restructuring in the present competitive business environment.
- Analyse the impact of capital structure on wealth maximization of owners and value of the company.
- Manage current assets and current liabilities of the company in an effective and efficient way.

UNIT - I	Lecture Hrs:08

The Finance function: Nature and Scope. Importance of Finance function – The role in the contemporary scenario – Goals of Finance function; Profit Vs Wealth maximization (Only theory).

UNIT - II	Lecture Hrs:12

The Investment Decision**:** Investment decision process – Project generation, Project evaluation, Project selection and Project implementation. Capital Budgeting methods– Traditional and DCF methods. The NPV Vs IRR Debate. (Simple Problems)

UNIT - III	Lecture Hrs:12

The Financing Decision: Sources of Finance – A brief survey of financial instruments. The Capital Structure Decision in practice: EBIT-EPS analysis. Cost of Capital: The concept, Measurement of cost of capital – Component Costs and Weighted Average Cost. The Dividend Decision: Major forms of Dividends . (simple problems on only weighted average cost of capital)

UNIT - IV	Lecture Hrs:12

Introduction to Working Capital: Concepts and Characteristics of Working Capital, Factors determining the Working Capital, Working Capital cycle-Management of Current Assets – Cash, Receivables and Inventory, Financing Current Assets (Only Theory)

UNIT - V	Lecture Hrs:12

Corporate Restructures: Corporate Mergers and Acquisitions and Take-overs-Types of Mergers, Motives for mergers, Principles of Corporate Governance.(Only Theory)

Textbooks:

- Financial management –V.K.Bhalla ,S.Chand
- Financial Management, I.M. Pandey, Vikas Publishers.
- Financial Management--Text and Problems, MY Khan and PK Jain, Tata McGraw- Hill

Reference Books:

1. Principles of Corporate Finance, Richard A Brealey etal., Tata McGraw Hill.
2. Financial Management , Tulsian P.C. & Tulsian Bharat, S.Chand
3. Fundamentals of Financial Management, Chandra Bose D, PHI

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4. Financial Managemen , William R.Lasheir ,Cengage.
5. Financial Management – Text and cases, Bringham& Ehrhardt, Cengage.
6. Case Studies in Finance, Bruner.R.F, Tata McGraw Hill, New Delhi.
7. Financial management ,Dr.M.K.Rastogi ,Laxmi Publications

Online Learning Resources:

https://onlinecourses.swayam2.ac.in/cec20_mg05/preview
https://onlinecourses.swayam2.ac.in/cec20_mg10/preview
https://onlinecourses.nptel.ac.in/noc20_mg31/preview
https://online-degree.swayam.gov.in/dyp20_d01_s2_mg11/preview

UNIT - 1
FINANCIAL MANAGEMENT

INTRODUCTION AND MEANING OF FINANCIAL MANAGEMENT:

Financial management is that managerial activity which is concerned with the planning and controlling of the firm's financial resources. Though it was a branch of economics till 1890, as a separate activity or discipline it is of recent origin. Still it has no unique body of knowledge of its own and draws heavily on economics for its theoretical concepts even today.

Financial management is about analysing financial situation making financial decision setting financial objectives. Formulating financial plan to attain this objectives and providing effective system of financial control to ensure plan to progress towards the set of objective.

DEFINITIONS OF FINANCIAL MANAGEMENT:

1. According to Weston and Brighan, "Financial Management is an area of financial decision making, harmonising individual motives and enterprise goals".

2. According to Howard and Upon, " Financial Management is the application of the planning and controlling functions to the finance function".

1. NATURE AND SCOPE OF FINANCIAL MANAGEMENT:
NATURE OF FINANCIAL MANAGEMENT

The nature of financial management includes the following −

- **Estimates capital requirements**

Financial management helps in anticipation of funds by estimating working capital and fixed capital requirements for carrying business activities.

- **Decides capital structure**

Proper balance between debt and equity should be attained, which minimizes the cost of capital.

Financial management decides proper portion of different securities (common equity, preferred equity and debt).

- **Select source of fun**

Source of fund is one crucial decision in every organisation. Every organisation should properly analyse various source of funds (shares, bonds, debentures etc.) and must select appropriate funds which involves minimal risk.

- **Selects investment pattern**

Before investing the amount, the investment proposal should be analysed and properly evaluates its risk and returns.

- **Raises shareholders value**

It aims to increase the amount of return to its shareholders by decreasing its cost of operations and increase in profits.

Finance manager should focus on raising the funds from different sources and invest them in profitable avenues.

- **Management of cash**

Finance manager observes all cash movements (inflow and outflow) and ensures they should face any deficiency or surplus of cash.

- **Apply financial controls −**

Implying financial controls helps in keeping the company actual cost of operation within limits and earning the expected profits.

SCOPE OF FINANCIAL MANAGEMENT

Financial Management means the entire excise of managerial efforts devoted to the management of finance, both its sources and uses of financial resources of an enterprise.

Financial management has undergone significant changes over years as regards its scope and coverage. As such the role of finance manager has also undergone fundamental changes over the years. In order to have a better understanding of these changes, it will be appropriate to study both traditional approach and modern approach to the finance function.

I.TRADITIONAL APPROACH:

The traditional approach, which was popular in the early part of this century, limited role of financial management to raising and administering of funds required by the enterprise to meet their financial needs. It broadly covered the following three aspects,

i) Arrangement of funds from financial institutions.

ii) Arrangement of funds through issue of financial instruments.

iii) Looking after the legal and accounting relationship between a corporation and its sources of funds.

Thus the traditional concept of financial management included the whole exercise of raising funds externally. The finance manager had a limited role to perform.

He was expected to keep accurate financial records, prepare reports on the financial performance and manage cash in a way that the corporation is in a position to pay bills in time. The term "Corporate Finance" was used in place of the present term "Financial Management".

The traditional approach evolved during 1920 continued to dominate academic thinking during forties and through the early fifties.

However, in the later fifties it started to be severely criticised and later abandoned on account of the following reasons:

1. Outsiders looking in Approach:

This approach treated the subject of finance from the view point of suppliers of funds i.e., outsiders, bankers and investors etc.

It followed an outsider-looking in approach and not the insider looking-out approach, since it completely ignored the viewpoint of those who had to take internal financing decisions.

2. Ignored Routine Problems:

The approach gave undue emphasis to infrequent happenings in the life of an enterprise. The subject of financial management was confined to the financial problems arising during course of, incorporation, mergers, consolidations and reorganization of corporate enterprise. As a result this approach did not give any importance to day-to-day financial problems of business undertakings.

3. Ignored Non-Corporate Enterprise:

The approach focused only the financial problems of corporate enterprise. Non-corporate industrial organizations remained outside its scope.

4. Ignored Working Capital Financing:

The approach laid emphasis on the problems of long term financing. The problems relating to financing short term or working capital were ignored.

II. MODERN APPROACH:

i. During the next two decades various pricing models, valuation models and investment portfolio theories also developed.

ii. Efficient allocation of capital became an important area of study under financial management.

iii. Eighties witnessed an era of high inflation, which caused the interest rates to rise dramatically. Thus, raising loan on suitable terms became an important aspect of financial management.

iv. In the new volatile environment investment and financing decisions became more risky than ever before.

v. These environmental changes enlarged the scope of finance. The concept of managing a firm as a system emerged. External factors now no longer could be evaluated in isolation.

vi. Decision to arrange funds were to be seen in consonance with their efficient and effective use. This total approach to study of finance is being termed as financial management.

vii. Thus, according to modern approach/concept, financial management is concerned with both acquisitions of funds as well as their allocation. The new approach views the term financial management in a broader sense.

i) Investment Decision:

The investment decision is a selection of assets in which funds will be invested by a firm. These are broadly divided into two parts; they are
(a) Long-term Assets and
(b) Short-term Assets.

a) Long-term Assets:

These are the asset which yield over a period of time in future such as capital budgeting. The capital budgeting is a crucial financial decision and it is a process begin with identifications of potential investment opportunities.

b) Short-term Assets:

The capital budgeting decisions relates to the choice of assets out of the alternatives or reallocation of capital when an old assets fails to justify. It is a decision which analyse the risk and uncertainty

The short-term assets are resources of a firm in the form of cash or converted in cash without the diminution in value. Example: The working capital management.

It is day to day activity of finance which deals with current assets and current liabilities. The two basic ingredients of working capital are i) An overview of working capital management as a whole ii) Efficient management of the individual current assets such as cash, Bills receivables and inventory.

ii) Financial Decision:

The financial decision is process perform by financial manager to decide, when, where from and how to acquire funds to meet the investment needs. The main aspect is to determine the appropriate proportion of debt and equity mix known as capital structure.

iii) Dividend Decision:

The financial manager must decide whether the firm should distribute all profit or return to them or distribute a portion. The proportion of profit distributed as dividend is known as dividend payout ratio and retained portion of profit is called retention ratio.

2. IMPORTANCE OF FINANCE MANAGEMENT

Financial management is essential to achieve the objectives of business organization. It ensures the operational efficiency of the organization .The finance management is important due to the following reasons.

1. Financial Management help the financial planning.

2. Financial Management help to acquire fund from different source at the minimum cost.

3. Financial Management help to utilize its acquired fund effectively

4. Financial Management help to take critical financial decisions easily

5. Financial Management provide financial stability at any time

6. Financial Management help to meet contingencies of business organization.

7. Financial Management help to improve profitability

8. Financial Management help to invest fund considering the profitability

9. Financial Management help to improve shareholder's worth

10. Financial Management help to improve overall value of the organization

11. Financial Management provide information through financial reporting

12. Financial Management makes employees aware about saving fund

3. THE ROLE OF FINANCE FUNCTION IN THE CONTEMPORARY SCENARIO.

➢ Today's highly dynamic business environment is driven by opening and expanding global markets; multiple corporate governance requirements; pressure on improving efficiency, cost cutting, demand for higher return on investment; greater stress on timely valuable information; rapid changes in technology and increased use of technology, sharp focus on aligning the companies towards the customer needs and increasing focus on core unpredictable activities.

➢ It indicates that the business environment is diverse multi-faced and unpredictable. Not only the business environment at the same time, we have seen major accounting scandals around the world-Enron, parmalat, WorldCom, Qwest Communications, Tyco international, Health South Corporation, Adelphia, Peregrine Systems, AIG and Satyam Computer services.

➢ These scandals have occurred due to the misdeeds like overstating revenues, understating expenses, overstating value of assets, underreporting the liabilities, misuse of funds, some cases with billions and dollars due to the collapsed share prices, shook public confidence in the global security markets.

➢ Therefore, today's business environment place extraordinary demands on corporate executives and particularly the burden of finance function is accelerated without limit.

➢ As a result, in recent years, executive roles have been forced to evolve and in some instances, change dramatically and companies restructured their traditional models to become leaner, faster and more responsive.

➢ Finance function plays a pivotal role in restructuring traditional models and it has become core of business operations, reporting and ensuring financial integration than ever before.

➢ The role of finance manager is no longer confined to accounting, number of crunching, financial reporting and risk management and finance manager once considered as an executive with proficiency in figures, is no longer confined to the game of numbers. Having undergone the changes over the period of time, they now play a major role in driving the business for their organisation by acting as strategic business partner of the chief executive officer (CEO).

➢ Put in simple words, the role and responsibilities of finance manager have become complex and demanding and require constant reinvention of the role.

4. GOALS OF FINANCIAL FUNCTION:

i. The firm's investment and financing decisions are unavoidable and continues.

ii. In order to make them rationally the firms must have a goal.

iii. It is generally agreed in theory that the financial goal of the firm should be the maximisation of owners' economic welfare.

iv. Owners' economic welfare could be maximised by the shareholders wealth as reflected in the market value of shares.

v. In this section, we show that the Shareholders Wealth Maximization (SWM) is to theorezically logical and operationally feasible normative goal for guiding the financial decision making.

I. PROFIT MAXIMISATION:

i. Profit maximization means maximising the rupee or any other currency such as dollar, pound or both income of firms.

ii. Profit is a primary motivating force for any economic activity. Firm is essentially being an economic organisation, it has to maximise the interest of its stakeholders. To this the firm has to earn profit from its operations.

iii. In fact, profits are useful intermediate beacon (encouragement/inspiration/ guiding light/symbol of hope/signal) towards which a firm's capital should be directed.

iv. McAlpine rightly remarked that profit cannot be ignored since it is both a measure of the success of business and means of its survival and growth.

v. Profit is the positive and fruitful difference between revenues and expenses of a business enterprise over a period of time.

vi. If an enterprise fails to make a profit, capital invested is eroded /wrinkled/windswept and this situation prolongs, the enterprise ultimately ceases to exist.

vii. The overall objective of business enterprise is to earn at least satisfactory returns on the funds invested, consistent with maintaining a sound financial position.

Limitations: The goal of profit maximisation has, however, been criticised in recent times because of the following reasons:

1. Vague:

i. The term "profit" is vague and it does not clarify what exactly it means. It has different interpretations for different people. Does it mean short-term or long-term; total profit or net profit; profit before tax or profit after tax; return on capital employed.

ii. Profit maximisation is taken as objective, the question arises which of the about concepts of profit should an enterprise try to maximise. Apparently, vague expression like profit can form the standard of efficiency of financial management.

2. Ignores Time Value of Money:

i. Time value of money refers a rupee receivable today is more valuable than a rupee, which is going to be receivable in future period.

ii. The profit maximisation goal does not help in distinguishing between the returns receivable in different periods.

iii. It gives equal importance to all earnings through the receivable in different periods. Hence, it ignores time value of money.

3. Ignores Quality of Benefits:

i. Quality refers to the degree of certainty with which benefits can be expected.

ii. The more certain expected benefits, the higher are the quality of the benefits and vice versa.

iii. Two firms may have same expected earnings available to shareholders, but if the earnings of one firm show variations considerably when compared to the other firm, it will be more risky.

II. SHAREHOLDERS WEALTH MAXIMISATION (SWM) :

i. On account of above discussed limitations of profit maximisations shareholders wealth maximisation is an appropriate goal for financial decision making.

ii. It is operationally feasible since it satisfies all the three requirements of a suitable operational objective of financial courses of action namely exactness, quality of benefits and the time value of money.

iii. The objective of Shareholders wealth maximization is an appropriate and operationally feasible criterion to choose among the alternative financial actions.

iv. It provides an unambiguous measure of what financial management should seek to maximise in making investment and financing decisions on behalf of owners (shareholders).

v. Shareholders Wealth Maximisation means maximising the net present value (or wealth) of a course of action to shareholders.

vi. The Net Present Value (NPV) of course of action is the difference between the present value of its benefits and present value of its costs.

vii. A financial action that has a positive NPV creates wealth for ordinary shareholders and therefore, desirable/preferable and vice versa.

viii. A financial action resulting in negative NPV should be rejected since it would destroy shareholders wealth. Between a numbers of mutually exclusive projects the one with the highest NPV should be adopted. The

ix. The wealth will be maximised if this criterion is followed in making financial decisions.

x. From shareholders point of view, the wealth created by corporation through financial decisions or any decision is reflected in the market value of company shares.

xi. For example, take Infosys Co., whose share price is increasing year by year, even by issue of bonus shares, and the company is trying to put its shares at popular trading level.

xii. Therefore, the wealth maximisation principle implies that the fundamental objective of a firm is to maximise market value of its shares.

III. EARNING PER SHARE (EPS) MAXIMISATION:

i. Apart from the above discussed goals, there are several alternative goals, which will again help to maximise value of the firm or market price per share. They are:

ii. Maximisation of Return on Equity(ROE)

iii. Maximisation of Earnings Per Share (EPS)

iv. Management of Reserves for Growth and Expansion.

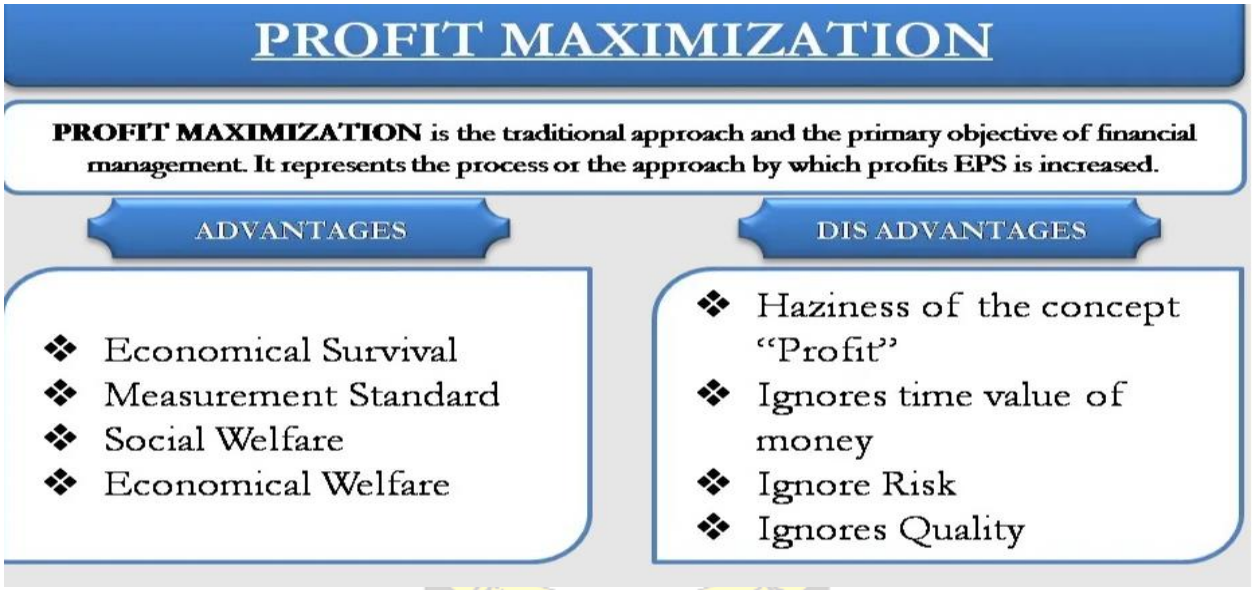
v. If we adopt maximizing earnings per share as the financial objective of the firm, this will also not ensure the maximization of owner's economic welfare.

vi. It also suffers from the flows already mentioned, i.e., ignores time and risk of the expected benefits. Apart from these problems, maximization of earnings per share has certain deficiencies as a financial objective.

5. PROFIT MAXIMIZATION VS WEALTH MAXIMIZATION:

Profit maximization refers to the practice of maximizing profits in a business. It is important to remember that not all profits are created equal, and some profits are generated when a company sells inferior products to its competitors.

Therefore, a company needs to communicate their brand purpose clearly and effectively. Furthermore, a company cannot simply ignore the impact of intangible assets by focusing on maximizing profits. In such cases, customers may feel that the company has harmed them.



WEALTH MAXIMIZATION:

Wealth maximisation is a strategy for companies that seek to maximise profits while meeting the needs of all stakeholders. It also helps a business build reserves for future growth, recognise the value of regular dividends, and retain a fair market price for its stock.

Advantages of wealth maximization

1) Exactness or avoiding the ambiguity
2) Time value of money
3) It promotes the economic welfare of the shareholders
4) It helps for achieving the other objectives
5) Payment of regular dividend
6) It is useful in taking investment decisions
7) Quality of benefits

Disadvantages of wealth maximization

1) Govt. restriction
2) Reduce the profit ability
3) Most of the shares are held by few people
4) Firms wealth is not considered
5) Wealth maximization is a prescriptive idea

Profit Maximization Vs Wealth Maximization

Profit Maximization	Wealth Maximization
It does take into account time value of money.	It takes into account time value of money
It does not take into consideration the uncertainty of future earnings	It takes into account the risk factor
It does not consider the effect of dividend policy on market price of shares	It takes into account the effect of dividend policy on Market Price of shares.
It does not differentiate between the short term and long term profits	It considers the different strategies for long term and short term profits.

UNIT -2

THE INVESTMENT DECISON

1. WHAT IS CAPITAL BUDGETING?

Capital Budgeting is defined as the process by which a business determines which fixed asset purchases or project investments are acceptable and which are not. Using this approach, each proposed investment is given a quantitative analysis, allowing rational judgment to be made by the business owners. Capital budgeting also known as Investment Decision making.

Capital asset management requires a lot of money; therefore, before making such investments, they must do capital budgeting to ensure that the investment will procure profits for the company. The companies must undertake initiatives that will lead to a growth in their profitability and also boost their shareholder's or investor's wealth.

Features of Capital Budgeting

Capital Budgeting is characterized by the following features:

- There is a long duration between the initial investments and the expected returns.
- The organizations usually estimate large profits.

- The process involves high risks.
- It is a fixed investment over the long run.
- Investments made in a project determine the future financial condition of an organization.
- All projects require significant amounts of funding.
- The amount of investment made in the project determines the profitability of a company.

2. Capital Budgeting Process:

A) Project identification and generation:

The first step towards capital budgeting is to generate a proposal for investments. There could be various reasons for taking up investments in a business. It could be addition of a new product line or expanding the existing one. It could be a proposal to either increase the production or reduce the costs of outputs.

B) Project Screening and Evaluation:

This step mainly involves selecting all correct criteria's to judge the desirability of a proposal. This has to match the objective of the firm to maximize its market value. The tool of time value of money comes handy in this step.

Also the estimation of the benefits and the costs needs to be done. The total cash inflow and outflow along with the uncertainties and risks associated with the proposal has to be analyzed thoroughly and appropriate provisioning has to be done for the same.

C) Project Selection:

There is no such defined method for the selection of a proposal for investments as different businesses have different requirements. That is why, the approval of an investment proposal is done based on the selection criteria and screening process which is defined for every firm keeping in mind the objectives of the investment being undertaken.

D) Project Implementation:

Money is spent and thus proposal is implemented. The different responsibilities like implementing the proposals, completion of the project within the requisite time period and reduction of cost are allotted. The management then takes up the task of monitoring and containing the implementation of the proposals.

E) Project review:

The final stage of capital budgeting involves comparison of actual results with the standard ones. The unfavorable results are identified and removing the various difficulties of the projects helps for future selection and execution of the proposals.

CAPITAL BUDGETING METHODS:

Although we shall learn all the capital budgeting methods, the most common methods of selecting projects are:

1. Payback Period (PB)
2. Internal Rate of Return (IRR) and
3. Net Present Value (NPV)

1 Payback Period Method

The term payback period refers to the amount of time it takes to recover the cost of an investment. Simply put, it is the length of time an investment reaches a breakeven point.

Formula:

$$\text{Payback Period} = \frac{\text{Initial Cash Investment}}{\text{Annual Cash Flow}}$$

Features of Payback Period

- The payback period is a simple calculation of time for the initial investment to return.
- It ignores the time value of money. All other techniques of capital budgeting consider the concept of the time value of money. Time value of money means that a rupee today is more valuable than a rupee tomorrow. So other techniques discount the future inflows and arrive at discounted flows.

- It is used in combination with other techniques of capital budgeting. Owing to its simplicity the payback period cannot be the only technique used for deciding the project to be selected.

Example of Payback Period Method:

An enterprise plans to invest $100,000 to enhance its manufacturing process. It has two mutually independent options in front: Product A and Product B. Product A exhibits a contribution of $25 and Product B of $15. The expansion plan is projected to increase the output by 500 units for Product A and 1,000 units for Product B.

Here, the incremental cash flow will be calculated as:

(25*500) = 12,500 for Product A

(15*1000) = 15,000 for Product B

The Payback Period for Product A is calculated as:

1		
2	Initial Cash Investment	$100,000
3	Incremental Cash Flow	$12,500
4	**Payback Period of Product A (Years)**	**8**

Product A = 100,000 / 12,500 = 8 years

Now, the Payback Period for Product B is calculated as:

1		
2	Initial Cash Investment	$100,000
3	Incremental Cash Flow	$15,000
4	**Payback Period of Product A (Years)**	**6.7**

Product B = 100,000 / 15,000 = 6.7 years

This brings the enterprise to conclude that Product B has a shorter payback period and therefore, it will invest in Product B.

Advantages

1. It is easy to calculate.
2. It is easy to understand as it gives a quick estimate of the time needed for the company to get back the money it has invested in the project.
3. The length of the project payback period helps in estimating the project risk. The longer the period, the riskier the project is. This is because the long-term predictions are less reliable.
4. In the case of industries where there is a high obsolescence risk like the software industry or mobile phone industry, short payback periods often become determining a factor for investments.

Disadvantages

The following are the disadvantages of the payback period.

1. It ignores the time value of money
2. It fails to consider the investment total profitability (i.e. it considers cash flows from the initiation of the project until the payback period and fails to consider the cash flows after that period.
3. It may cause the company to place importance on projects which are short payback period, thereby ignoring the need to invest in long-term projects**(i.e, A company cannot just determine project feasibility only based on the number of years in which it is going to give your return back, there are number of other factors which it does not consider)**
4. It does not take into account the social or environmental benefits in the calculation.

2. NET PRESENT VALUE METHOD (NPV):

The Net Present Value (NPV) is a method that is primarily used for financial analysis in determining the feasibility of investment in a project or a business. It is the present value of future cash flows compared with the initial investments.

Formula:

NPV = Cash Flows /(1- i)^t – Initial Investment

Where

- i stands for the **Required Rate of Return** or Discount Rate
- t stands for Time or Number of Period

Pros	Cons
• Considers the time value of money	• Relies heavily on inputs, estimates, and long-term projections
• Incorporates discounted cash flow using a company's cost of capital	• Doesn't consider project size or return on investment (ROI)
• Returns a single dollar value that is relatively easy to interpret	• May be hard to calculate manually, especially for projects with many years of cash flow
• May be easy to calculate when leveraging spreadsheets or financial calculators	• Is driven by quantitative inputs and does not consider nonfinancial metrics

Example #1

Company A ltd wanted to know their net present value of cash flow if they invest 100000 today. And their initial investment in the project is 80000 for the 3 years of time, and they are expecting the rate of return is 10 % yearly. From the above available information, calculate the NPV.

Solution:

Calculation of NPV can be done as follows,

	A	B
1	Particulars	Value
2	Intial Investment	80000
3	Cash Flow	100000
4	Time	3
5	Rate of Return	10%
6	NPV	57174.21

NPV = Cash flows /(1- i)t – Initial investment

= 100000/(1-10)^3-80000

NPV = 57174.21

So in this example, NPV is positive, so we can accept the project.

Example #2

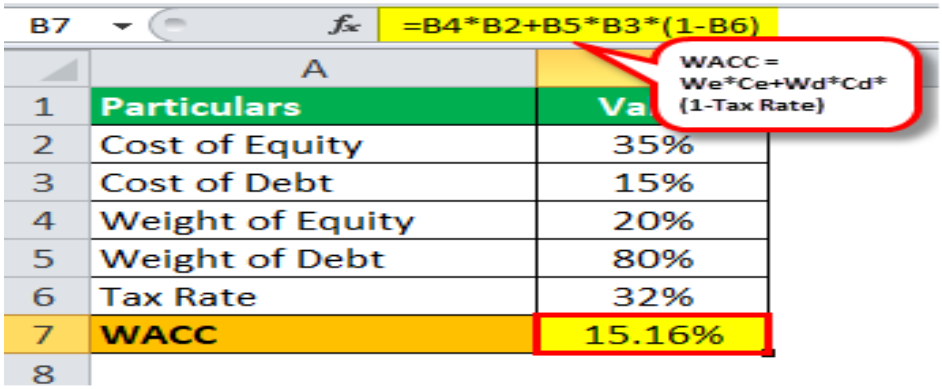
Maruti is in the business of auto and ancillary, and they want to start their subsidiary business as an expansion plan for assembling the auto part, so they had provided the below information for calculating the NPV. They want to know should this project will be feasible or not.

- **Cost of equity – 35%**
- **Cost of debt – 15%**
- **The weight of equity – 20%**
- **The weight of debt – 80 %**
- **Tax rate – 32%**
- **Cash flow is given below for 7 year**
- **2010= -12000**
- **2011=10000**
- **2012=11000**
- **2013=12000**
- **2014=13000**
- **2015=14000**
- **2016=15000**

Find the NPV with the help of WACC.

Solution:

Calculation of WACC can be done as follows,



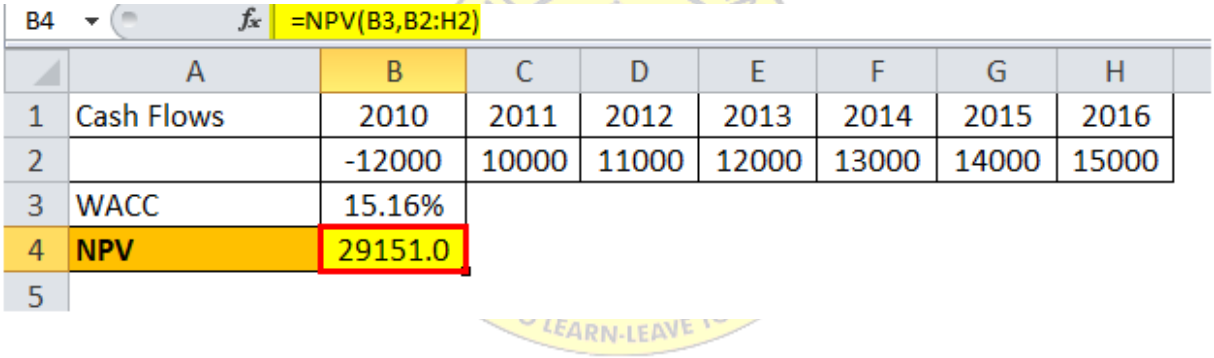
	A	
1	Particulars	Va
2	Cost of Equity	35%
3	Cost of Debt	15%
4	Weight of Equity	20%
5	Weight of Debt	80%
6	Tax Rate	32%
7	WACC	15.16%
8		

WACC formula = We*Ce+Wd*Cd*(1-tax rate)

= 20*35+80*15*(1-32)

WACC = 15.16%

Calculation of NPV can be done as follows,



	A	B	C	D	E	F	G	H
1	Cash Flows	2010	2011	2012	2013	2014	2015	2016
2		-12000	10000	11000	12000	13000	14000	15000
3	WACC	15.16%						
4	NPV	29151.0						
5								

NPV = 29151.0

In this example, we are getting a positive net present value of future cash flows, so in this example also we will accept the project.

ACCOUNTING RATE OF RETURN:

The **Accounting Rate of Return (ARR)** is the average net income earned on an investment (e.g. a fixed asset purchase), expressed as a percentage of its average book value.

Accounting Rate of Return = Average Net Income ÷ Average Book Value

or

ARR = Average Annual Profit / Average Investment

Where:

- **Average Annual Profit** = Total profit over Investment Period / Number of Years
- **Average Investment** = (Book Value at Year 1 + Book Value at End of Useful Life) / 2

Net income (i.e. the "bottom line") is a company's accrual-based accounting profit after all operating costs (e.g. COGS, SG&A and R&D) and non-operating costs (e.g. interest expense, taxes) are deducted.

The average book value refers to the average between the beginning and ending book value of the investment, such as the acquired fixed asset.

Average Book Value = (Beginning Book Value + Ending Book Value) ÷ 2

Where:

- **Beginning Book Value**: The beginning book value is straightforward, as it refers to the initial outlay on the date of purchase.
- **Ending Book Value**: On the other hand, the ending book value is the residual book value, i.e. the initial investment net of the accumulated depreciation until the end of the fixed asset's useful life (and date of sale).

Advantages Of Accounting Rate Of Return:

1. Simple Method

The Accounting Rate of Return (ARR) is a commonly used, straightforward method of comparing capital projects that anybody can understand. Since it is based on accounting data, further specific reports are not necessary to calculate ARR.

2. Easy Calculation

The ARR approach is straightforward to compute and comprehend. Calculating the ARR of multiple projects is quite simple. It is relatively simple to grasp and calculate, similar to the payback period. Over the course of the project's economic life, the overall earnings or savings are taken into account.

3. Measures Profitability

ARR assesses the profitability of an investment because it is based on accounting profit. This approach takes into account the idea of net earnings or profits after taxes and depreciation. For computing the rate of return, this technique alone takes the accounting notion of profit into consideration. Additionally, it is simple to determine the accounting profit from the accounting records. This is a crucial element in evaluating an investment proposal

4. Easy Decision Making

Making a choice about an appropriate capital project is simple. ARR is useful in calculating a project's annual percentage rate of return. The project with the lower ARR is disregarded in favour of the one with a higher ARR.

5. Comparison Between Multiple Projects

The projected rate of return from each project is provided by ARR, making it useful for comparing various projects. This strategy makes it easier to compare projects for new products to initiatives for cost-cutting or other projects with a competitive nature.

6. Return on Investment

Since owners are very interested in returns on investment, this approach meets their needs. The firm's present performance may be measured using this way.

Disadvantages Of Accounting Rate Of Return

1. Ignores the Time Value Of Money

One of the greatest issues with the ARR is this. This way of prioritizing utterly disregards the "time's worth of money," a crucial idea in the business world. The idea is that money that is physically in your possession is worth more than the same amount after a certain amount of time. This is true because an investor may invest the cash they already have and generate income or interest from it. Therefore, it makes no difference whether the earnings are bigger in the early years or the latter years under this strategy. The project that was earlier profitable should have generally been selected since the average return would have equalized both investments. However, this strategy does not give the project that priority.

2. Ignores the Cash Flow

After covering all cash and non-cash expenses, net earnings are used as the basis for the concept and computation of ARR. The cash flow is entirely disregarded throughout the procedure. Whether an investment generates returns quickly or slowly has no bearing on how ARR is calculated.

3. Ignores Risk and Uncertainty

The uncertainty and risk associated with any investment are not taken into account by the ARR concept. It treats every one of them equally. Any project's risk can change depending on its length, the type of work involved, the setting in which it is carried out, etc. Even if investment returns somewhat decline, every investor wants to reduce their risk. Such characteristics are disregarded by ARR, which determines the superiority of a project solely based on its ability to generate returns

4. Multiple Time Frame for Investments

For projects when the capital investment is spread out over several years, this technique is not helpful in appraising the project. It just determines the total earnings and average return, regardless of when and how much money has been invested.

Example:-The working results of two machine and given below. Calculate ARR

	Machine x	Machine y
Cost	45000	45000
Sales per year	100000	80000
Total cost for year	36000	30000
(excluding depreciation)		
Expected life	2 years	3 years

This of the two should be preferred

Sol:-competitive average income.

	Machine x	Machine y
Sales per year	100000	80000
(-)cash per year	36000	30000
(total)	64000	50000
(-)depreciation	2250	15000
Net profit	41500	35000
Average income	41500	35000
Average invest ment	22500	22150

ARR = average income / average investment*100

"x" = 41500/22500*100

=184 %

"y" =35000/22500*100

= 156 %

Machine "x "has high ARR hence, machine "x "should be preferred.

INITIAL RATE OF RETURN(IRR):

Initial rate of return (IRR):-This method IRR Is that rate at which the sum of discounted cash inflow. (DCF) equals the sum of discounted cash outflow. It is the rate at which the net present value of the investment is zero , is called internal rate of return because it depend mainly on the outing and proceeds associated with the project and not on any rate determine outside the investment.

Consider the following example to better understand the application of the internal rate of returns (IRR).

The DEF Group wants to diversify its business and plan to take up a new project that requires an initial investment of $400000. They will pay it off in 4 years. It will generate $40000 in the first year, $80000 in the second year, $1600000 in the third year, and $259600 in the fourth year. Find out the feasibility of this investment project if the discount rate is 8%.

Given:

- n = 4
- t = 0,1,2,3,4
- CF0= – $400000
- CF1= $40000
- CF2= $80000
- CF3= $160000
- CF4= $259600
- Discount Rate = 8%

Solution:

If the project's internal rate of return is 8%, then the NPV is:

$$NPV = \sum_{t=1}^{n}\left[\frac{CF_n}{(1+IRR)^t}\right] + CF_0 = \frac{CF_1}{(1+IRR)^1} + \frac{CF_2}{(1+IRR)^2} + \cdots \frac{CF_n}{(1+IRR)^t} + CF_0$$

$$NPV = \frac{40000}{(1+0.08)^1} + \frac{80000}{(1+0.08)^2} + \frac{160000}{(1+0.08)^3} + \frac{259600}{(1+0.08)^4} + (-400000)$$

$$NPV = 37037.04 + 68,587.11 + 1,27,013.16 + 1,90,813.75 - 400000$$

NPV = $23,451.06

Let us assume that the internal rate of return is 10% and that the NPV = 0.

$$NPV = \frac{40000}{(1+0.1)^1} + \frac{80000}{(1+0.1)^2} + \frac{160000}{(1+0.1)^3} + \frac{259600}{(1+0.1)^4} + (-400000)$$

$$NPV = 36363.64 + 66115.70 + 120210.37 + 1,77,310.29 - 400000$$

NPV = 0

Thus, if the IRR is 10%, the project will be at a break-even point. This project generates a positive NPV, and the discount rate is lower than the IRR. In other words, the IRR is more than the project's required rate of return; therefore, it is a profitable investment.

PROFITABILITY INDEX:

Profitability index shows the relationship between company projects future cash flows and initial investment by calculating the ratio and analyzing the project viability and it is calculated by one plus dividing the present value of cash flows by initial investment and it is also known as profit investment ratio as it analyses the profit of the project.

Profitability Index = Present Value of Future Cash Flows / Initial Investment Required

or

PI expressed through Net Present Value –

Profitability Index = 1 + (Net Present Value / Initial Investment Required)

How to Interpret the Profitability Index?

- **If the index is more than 1,** then the investment is worthy because then you may earn back more than you invest in. So if you find any investment whose PI is more than 1, go ahead and invest in it.
- **If the index is less than 1,** then it's better to step back and look for other opportunities. Because when PI is less than 1, that means you would not get back the money you would invest. Why bother to invest at all?
- **If the index is equal to 1**, then it's an indifferent or neutral project. You shouldn't invest in the project until and unless you consider it better than other projects available during the period. If you find that the PI of all other projects to be negative, then consider investing in this project.

Profitability index method:-

Problem: - a machine costing R.S 100000 is estimated to work for 5 years with scrap values of R.S 50000 the expected cash flows during its life time and present value of R.S 1 @10% are given below. Calculate profitability index and common up on the same.

Years	1	2	3	4	5	6
p.v @10%	0.909	0.826	0.751	0.683	0.621	0.621
Cash flows	50000	40000	30000	30000	20000	50000

SOL:-

YEARS	CASH FLOWS	P.V@10%	PRESENT VALUE
1	50000	0.909	40450
2	40000	0.826	33040
3	30000	0.751	22530
4	30000	0.683	20460
5	20000	0.621	12420
6	50000	0.621	31050
Total			164980

Profitability index method =p.v inflows/initial investment

=164980/100000

=1.64%

NPV V/S IRR DEBATE:-

NPV	IRR
• Net present value is the difference between the present value of cash inflows and the present value of cash out flows over a period of time	• Internal rate of return is a calculation used to estimatation the profitability of potential investment
• The net present value method is generally used for the purpose of evaluating projects to continue for a long term	• IRR method is more often used for the purpose of evaluating project to continue for a shorten period
• Discount rate is know as factor in NPV method	• Discount rate is unknown factor is IRR method
• It assumes that the cash inflows can be re invested at the cash of capital in the new projects	• It assumes that the cash inflows can be re invested at the IRR rate in the new process
• NPV provides net return qualitively	• Initial rate of return provides percentages

UNIT – 3

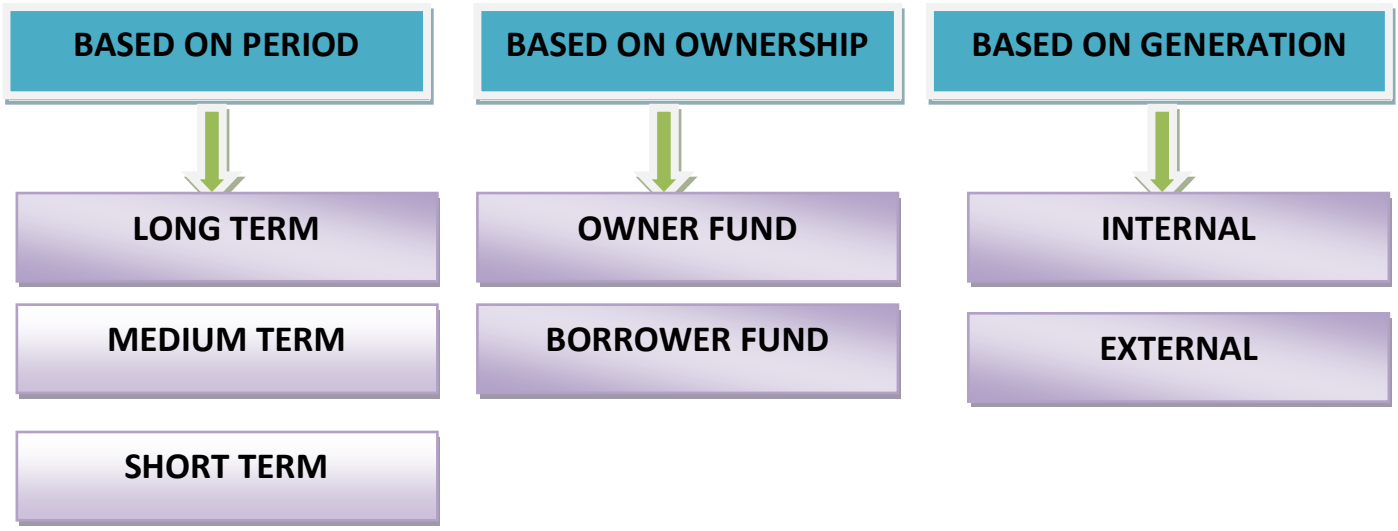
THE FINANCE DECISION

1. SOURCES OF FINANCE:

Business finance is the funds required to establish, operate business activities, and expand in the future. Funds are specifically required various purchase type of tangible assets such as furniture, machinery, buildings, offices, factories, or intangible assets like patents, technical expertise, and trademarks, etc.

Apart from the assets mentioned above, other things that require funding are the day-to-day operational activities of a business. This activity includes purchasing raw materials, paying salaries, bills, collecting money from clients, etc. It is essential to have sufficient amount of money to survive and grow the business.

CLASSIFICATION OF SOURCES OF FUNDS



Businesses can raise capital through various sources of funds which are classified into three categories.

1. Based on Period – The period basis is further divided into three dub-division.

- **Long Term Source of Finance –** This long term fund is utilized for more than five years. The fund is arranged through preference and equity shares and debentures etc. and is accumulated from the capital market.
- **Medium Term Source of Finance –** These are short term funds that last more than one year but less than five years. The source includes borrowings from a public deposit, commercial banks, commercial paper, loans from a financial institute, and lease financing, etc.
- **Short Term Source of Finance –** These are funds just required for a year. Working Capital Loans from Commercial bank and trade credit etc. are a few examples of these sources.

2. Based on Ownership – This sources of finance are divided into two categories.

- **Owner's Fund –** This fund is financed by the company owners, also known as owner's capital. The capital is raised by issuing preference shares, retained earnings, equity shares, etc. These are for long term capital funds which form a base for owners to obtain their right to control the firm's management and operations.
- **Burrowed Funds –** These are the funds accumulated with the help of borrowings or loans for a particular period of time. This source of fund is the most common and popular amongst the businesses. For example, loans from commercial banks and other financial institutions.

3. Based on Generation – This source of income is categorized into two divisions.

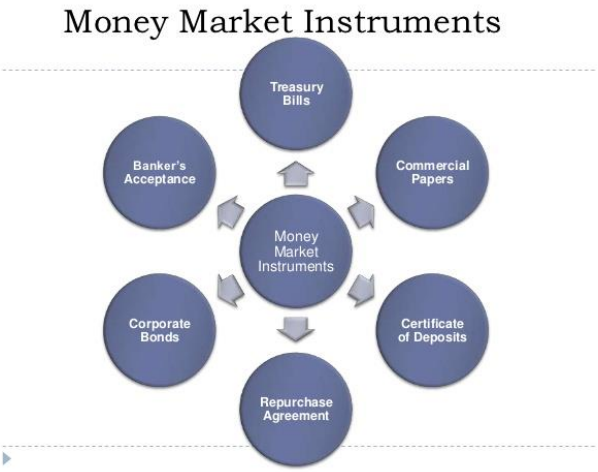
- **Internal Sources –** The owners generated the funds within the organization. The example for this reference includes selling off assets and retained earnings, etc.
- **External Source –** The fund is arranged from outside the business. For instance, issuance of equity shares to public, debentures, commercial banks loan, etc.

2.A BRIEF SURVEY OF FINANCIAL INSTRUMENTS:

Financial instruments are documents that act as financial assets to one organization and as a liability for another organization. These can either be in the form of debentures, bonds, cash, and cash equivalents, bank deposits, equity shares, preference shares, swaps, forwards and futures, call or notice money, letters of credit, caps and collars, financial guarantees, receivables and payables, loans and borrowings, etc.

MONEY MARKET INSTRUMENTS:

Money market instruments are short-term financing instruments which can be converted easily to cash. Interbank loans (loans between banks), money market mutual funds, commercial paper, Treasury bills and securities lending and repurchase agreements, are all examples of money markets instruments.



1] Commercial Papers

Sometimes large corporates and companies will issue commercial papers to raise short term funds. These commercial papers are promissory notes that are unsecured, short-term, negotiable, transferable (via endorsement) with a fixed maturity period of less than 365 days.

The companies prefer commercial papers than borrowing funds because they can get funds at lower rates than the prevailing market rate of interest. And large credit-worthy companies will have no trouble collecting funds via commercial papers. They are issued at a discount and redeemed at par.

2] Treasury Bills

Treasury Bills or T-Bills are issued by the government, usually through the Reserve Bank of India. They are instruments of short-term borrowing. T-bills are sold to commercial banks and to the public as well. They are generally considered to be an extremely safe investment, as the government is unlikely to default.

T-bills are also in the form of promissory notes. They have a maturity period between 14 days and 364 days. T-bills are highly liquid and freely endorsable. These are also issued at lower than face value and redeemed at face value. The difference in amounts is the interest known as the discount.

3] Call Money

Most banks have to maintain some minimum cash balance as per the instructions of the RBI, known as the cash reserve ratio (CRR). This ratio changes from time to time as per the liquidity in the economy.

So banks sometimes borrow money from each other for a short duration to maintain their CRR. This is known as the call money market. The interest rate on such call money is known as the call rate.

4] Commercial Bills

Commercial bills or bills of exchange are the most common negotiable instruments used in the world of trade. These negotiable instruments are used to fulfill the working capital requirements of businesses. They have a short-term maturity (usually 60 or 90 days) and are easily transferable.

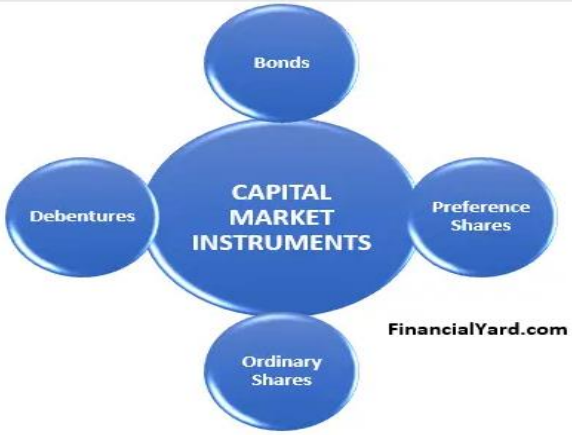
The drawer of the bill can wait until the due date, i.e. the date o which the drawee will honor the bill. Or if he doesn't wish to wait he can discount the trade bill with a bank before the maturity period is over. This makes the bills very flexible and easily marketable.

5] Certificate of Deposits

These are instruments of the money market that can only be issued by banks and financial institutes. And they are negotiable and unsecured and usually in bearer form. Banks issue these in times where funds are low but the demand for credit is high. They help channel savings into investment. They are usually issued for 90 to 365 days. Banks cannot discount certificate of deposits.

CAPITAL MARKET INSTRUMENTS:

Capital market instruments typically consist of debt instruments and stock. The capital market is where governments and companies raise long term funds, normally 1 year or longer. There is a primary market, where new listings take place and a secondary market where existing securities trade. Some of the selected capital market instruments are Bonds, Debentures, Preference shares and Ordinary shares.



1. Bonds (Gilts)

This is an agreement, contract or guarantee between an issuer (the borrower) and an investor (the lender). The bond represents the borrower's promise to pay interest along with the capital based on the specified terms. Bonds are one of the common capital market instruments.

a. Government Bonds

National governments issue bonds in order to raise capital for road construction, power stations and building hospitals. In most countries the government is regarded as the most creditworthy entity thus government bonds carry a low *risk.* In fact, government bonds are deemed risk free. The interest rate on governments bonds is deemed as a benchmark risk free rate on investments. That simply means it is the minimum return an investor should expect from a risk-free investment.

b. Corporate Bonds

Large firms issue bonds in order to raise funds for large capital projects.

2. Debentures

A debenture is a capital market instrument which is normally issued by companies in order to borrow money from investors. It is a fixed interest-bearing security. The principal amount is payable at a set future date. The term of maturity along with the interest rate is stated in the trust deed of the debenture. Debenture holders have a claim on a company's revenue. In the event that a company fails to pay interest or capital, debenture holders will be paid off first when the company is *liquidated.* However, the risk of debentures is higher than that of government bonds.

3. Preference Shares

Preference shares are another example of capital market instruments. Preference shares are issued at a fixed annual rate of dividend that means, investors

receive fixed dividends as a reward for investing in preference shares. A company is liable for outstanding dividends unless the preference shares are non-cumulative.

4. Ordinary Shares (Equity)

Equity shares are also an example of capital market instruments. These are shares that represent part ownership of a business enterprise. These shares are an interest in management, profits and assets of the company. Share certificates are proof of ownership but these days the share certificates are held by brokers in nominee accounts. Ordinary shareholders receive dividends after preference shareholders have been paid out. Ordinary shares also rank last in the event of liquidation. The return of ordinary shares are capital growth of the shares and dividend pay-outs. Ordinary shares are high risk investments with the level of risk specific to the particular company.

HYBRID INSTRUMENTS:

Hybrid Financing is the financial instrument that partakes some characteristics of debt and some characteristics of equity. Simply, it is the financial security that possesses the characteristics of both the debt and equity.

Preference Capital :

The **Preference Capital** is that portion of capital which is raised through the issue of the preference shares. This is the hybrid form of financing that has certain characteristics of equity and certain attributes of debentures.

Convertible Debentures:

The **Convertible Debentures** are a type of loan that can be converted into the stock of the company after a stipulated time period at the option of the holder

or the issuer in special circumstances. These are issued with the intent to raise money to expand or maintain the business operations at a considerable low-interest rate.

Stock Warrants:

The **Stock Warrants** are like the options that give the holder the right, but not the obligation to buy or sell the security at a specific time and a specific date. Unlike options, these are issued by the company itself and are traded more over the counter than on an exchange.

Stock Option:

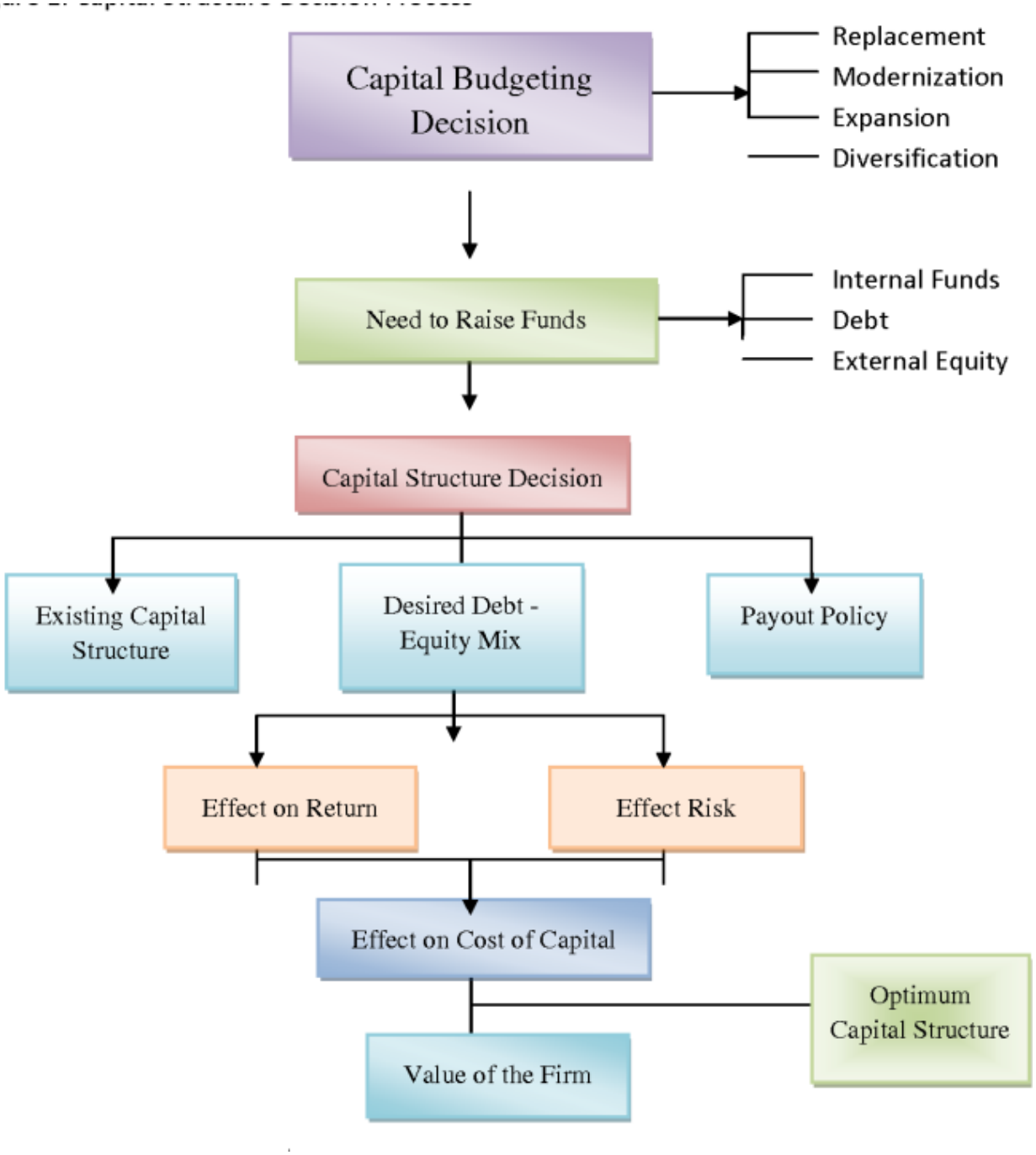
The **Stock Option** is a security that gives the right to its holder, but not the obligation to buy or sell the outstanding stocks at a specific price and a specific date. The stock options are traded on the securities exchange like other shares.

3. THE CAPITAL STRUCTURE DECISION IN PRACTICE:

CAPITAL STRUCTURE

The Capital Structure of a company refers to the mix of the long-term finances used by the firm. It is the financing plan of the company. Let us take a look at the capital structure of a company that has recently gone in for public issue.

KADAPA
ENTER TO LEARN-LEAVE TO SERVE



Step 1: capital budgeting decision will be taken for replacement or expansasion or modernization and diversification of the business.

Step 2: raise of funds through internal or external sources of funds.

Step 3: capital structure decisions may be existing capital structure, (on desired debt equity mix or payout policy).

Step 4: step 3 gives effect on return or risk.

Step 5: cost of the capital impact on value of the firm that leads to optimum capital structure

The effective capital structure decision gives between scope for the business to develop and increase the value of the firm through the capital structure decision.

4. EBIT – EPS ANALYSIS:

The EBIT-EBT analysis is the method that studies the leverage, i.e. comparing alternative methods of financing at different levels of EBIT. Simply put, EBIT-EPS analysis examines the effect of financial leverage on the EPS with varying levels of EBIT or under alternative financial plans.

It examines the effect of financial leverage on the behavior of EPS under different financing alternatives and with varying levels of EBIT. EBIT-EPS analysis is used for making the choice of the combination and of the various sources. It helps select the alternative that yields the highest EPS.

$$EBIT = \frac{EPS * Number\ of\ Common\ Shares\ Outstanding}{(1 - Tax\ Rate)} + Interest\ Expense$$

$$EPS = \frac{\left((EBIT - Interest\ Expense) * (1 - Tax\ Rate)\right)}{Number\ of\ Common\ Shares\ Outstanding}$$

ADVANTAGES OF EBIT-EPS ANALYSIS:

Various advantages derived from EBIT-EPS analysis may be enumerated below-

(i) Financial Planning

Use of EBIT-EPS analysis is indispensable for determining sources of funds. In case of financial planning the objective of the firm lies in maximizing EPS. EBIT-EPS analysis evaluates the alternatives and finds the level of EBIT that maximizes EPS.

(ii) Comparative Analysis

EBIT-EPS analysis is useful in evaluating the relative efficiency of departments, product lines and markets. It identifies the EBIT earned by these different departments, product lines and from various markets, which helps financial planners rank them according to profitability and also assess the risk associated with each.

(iii) Performance Evaluation

This analysis is useful in comparative evaluation of performances of various sources of funds. It evaluates whether a fund obtained from a source is used in a project that produces a rate of return higher than its cost.

(iv) Determining Optimum Mix

EBIT-EPS analysis is advantageous in selecting the optimum mix of debt and equity. By emphasizing on the relative value of EPS, this analysis determines the optimum mix of debt and equity in the capital structure. It helps determine the alternative that gives the highest value of EPS as the most profitable financing plan or the most profitable level of EBIT as the case may be.

LIMITATIONS OF EBIT-EPS ANALYSIS

Although EBIT-EPS analysis is a good way to check the earning sensitivity of a company, it has certain limitations too.

No Consideration of Risk

The EBIT-EPS analysis does not consider the risk associated with a business project. It simply shows whether the earnings are enough for a corporation. It is not needed in case of a profit larger than returns, but it can be hurting if the opposite situation is there. When the profits are low, but the interest is high, then businesses may be in turmoil.

Contradictory Results

When new equity shares are not considered in a different alternative financial plan, the results arising out of this can get erroneous. The comparison of plans also becomes difficult when the number of alternatives increases.

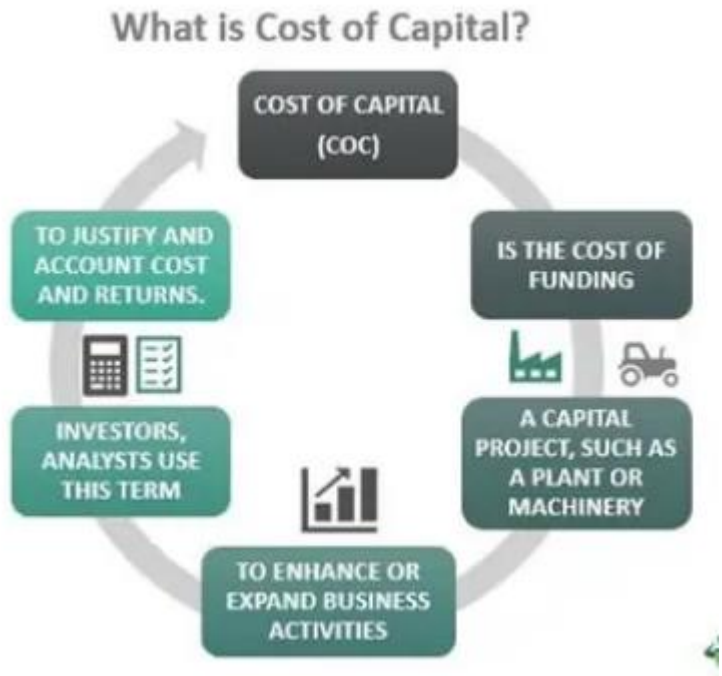
Over-capitalization of Funds

This analysis ignores the over-capitalization of the funds. Beyond a certain point, additional capital should not be employed to generate a return in excess of the payments that should be made for its use. The analysis does not address such cases.

5.COST OF CAPITAL:

Cost of capital (COC) is the cost of financing a project that requires a business entity to look into its deep pockets for funds or borrowings. Businesses and investors use the cost of employing capital to account for and justify the equity or debt funding required for such projects.

Cost of capital is a method of accounting for the returns on an investment that helps an investor to offset the costs. It enables the investors to detect any risks or loopholes in the process that might lower their returns and increase risks.



Components of cost of capital?
These include,
1) Cost of Debt
2) Cost of Preference Capital
3) Cost of Equity Capital

Calculation

Let us look at the formula of cost of capital to estimate returns on different kinds of investments or borrowings,

#1 – Determining the Cost of Debt –

$$\textbf{Cost of Debt} = \frac{\text{Net Average of Interest Payable}}{\text{Total Debt Value}} \times (1\text{-Tax Rate})$$

Thus, to determine the **effective interest rate**, i.e., post payment of any **corporate tax**, the total interest is multiplied by (1-Tax Rate).

#2 – Determining the Cost of Equity –

The cost of capital for equity is much more volatile (represented as 'X') than the cost of debt. It is because the demand and supply **market forces** play a greater role in determining investors' returns. Thus,

$$\textbf{Cost of Equity} = R1 + X\,(R2)$$

where,

- R1 = Risk-free Rate of Returns
- R2 = Market rate of Returns

#3 – Weighted Average Cost of Capital (WACC) –

The weighted average COC (WACC) is a company's overall debt and equity capital cost. The company pays this premium to its investors as a reward for the risks undertaken. Its calculation involves,

$$= \{C(E) \times \frac{\text{Percentage of capital in equity}}{\text{Total debt and capital equity}}\} + \{C(D) \times \frac{\text{Percentage of capital in debt}}{\text{Total debt and capital equity}}$$

where,

- C (E) = is the cost of equity
- C (D) = is the cost of debt (after tax)

6. DIVIDEND DECISION

The dividend is that portion of the profit that is distributed to the shareholders. The decision involved here is how much of the profit earned by the company after paying the taxes is to be distributed to the shareholders. It also includes the part of the profit that should be retained in the business. When the current income is re-invested, the retained earnings increase the firm's future earning capacity. This extent of retained earnings also influences the financing decision of the firm. The dividend decision should be taken keeping in view the overall objective of maximizing shareholders' wealth.

Factors affecting Dividend Decision:

- **Amount of Earnings:** Dividends are paid out of the current and previous year's earnings. More earnings will ensure greater dividends, whereas fewer earnings will lead to the declaration of a low rate of dividends.

- **Stability of Earning:** A company that is stable and has regular earnings can afford to declare higher dividend as compared to those company which doesn't have such stability in earnings.

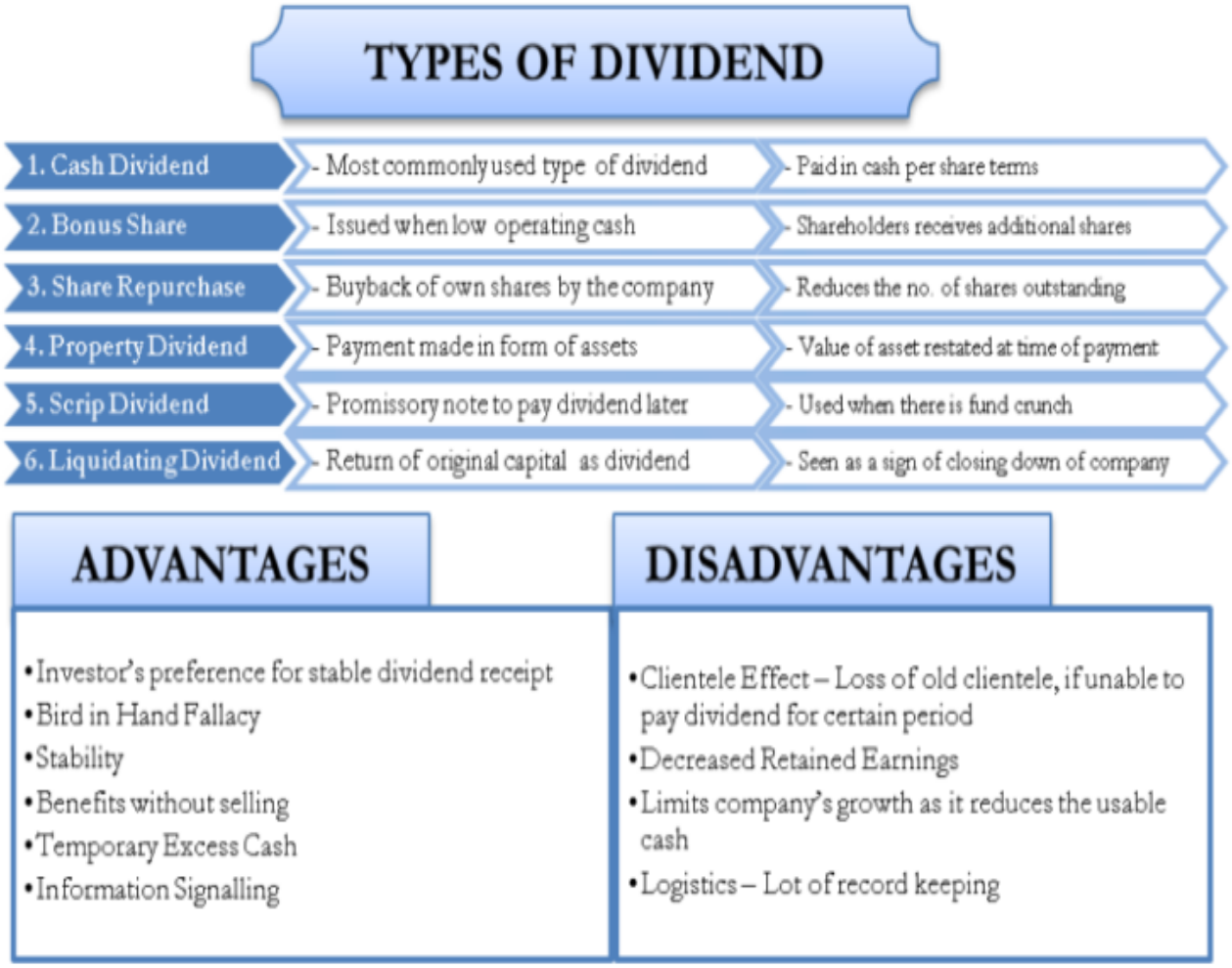
- **Stability of Dividend:** Some companies follow the policy of playing a stable dividend because it satisfies the shareholders and helps in increasing companies reputation. If earning potential is high, it is declared as a high dividend, whereas if the earning is temporary or not increasing, then it is declared as a low or normal dividend.

- **Growth Opportunities:** Companies with growth opportunities prefer to retain more money out of their earnings to finance the new project. So, companies that have growth prospects in near future will declare fewer dividends as compared to companies that don't have any growth plan.

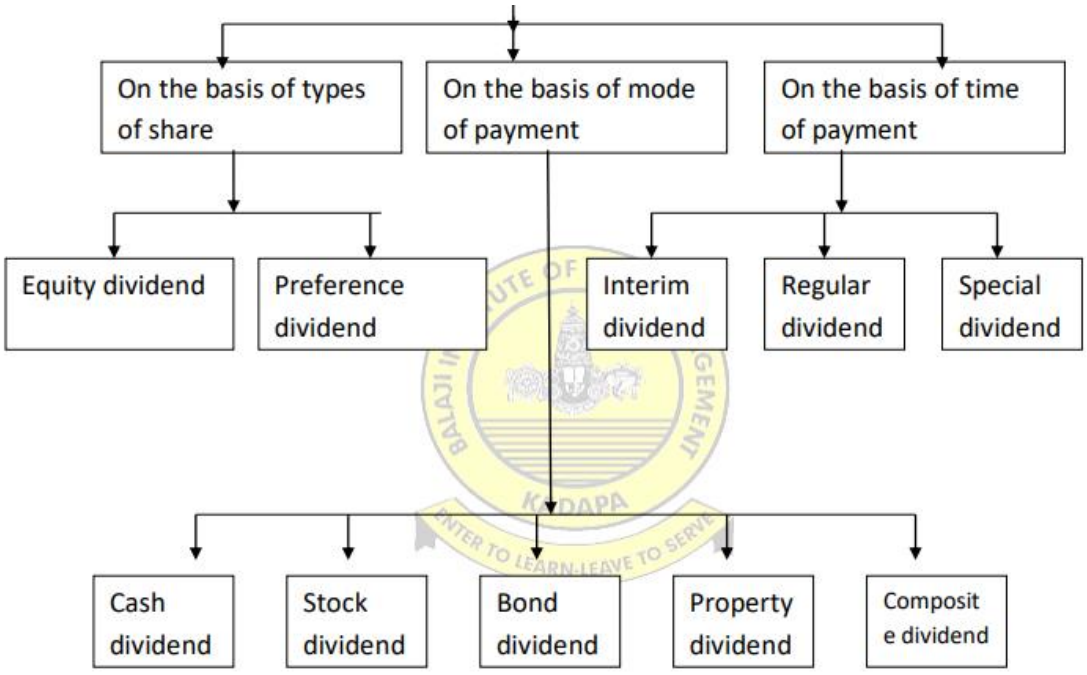
- **Cash flow Position:** Payment of dividends is related to the outflow of cash. A company may be profitable, but it may have a shortage of cash. In case the company has surplus cash, then the company can pay more dividends, but during a shortage of cash, the company can declare a low dividend.

- **Taxation Policy:** The rate of dividends also depends on the taxation policy of the government. In the present taxation policy, dividend income is tax-free income to the shareholders, so they prefer higher dividends. However, dividend decision is left to companies.

- **Stock market reaction:** The rate of dividend and market value of a share are directly related to each other. A higher rate of dividends has a positive impact on the market price of the shares. Whereas, a low rate of dividends may hurt the share price in the stock market. So, management should consider the effect on the price of equity shares while deciding the rate of dividend.



7. FORMS OF DIVIDEND:



I. on the basis of types of shares:

a) Equity dividend: equity dividend given to the equity share holder this dividend given to the equity share holder at the dividend given only companies in profits only.

b) Preference dividend: preference dividend paid to the preference share holders irrespective of company profits. Preference share holders get the preference dividend at the end of the financial year

with a fixed rate of dividend preference share holder having a right to get dividend even company in losses.

II. ON THE BASIS OF MODE OF PAYMENT:

a) **Cash dividend**: payment of dividend to the share holders in the form of cash is called cash dividend.

b) Stock dividend: some times company gives dividend in the form of stock.

c) Bond dividend: share holders normally get the dividend in cash but company can give dividend in the form of property also based on the situation company cash also right to give property dividend

d) Composite dividend: composite dividend paid in the form of cash and above other forms also it is a combination of cash and other forms.

III. ON THE BASIS OF TIME OF PAYMENT:

a) Interim dividend: interim dividend paid at quality or half year or when every cost is sufficient at the time share holders get this dividend.

b) Regular dividend: regular dividend given to the share holders at the end of every financial year.

c) Special dividend: special dividend given to the share holders at special occasions or if the company got high returns.

8. PROBLEMS ON WEIGHTED AVERAGE COST OF CAPITAL:

Formula for WACC:

$$Kw = \frac{\Sigma XW}{\Sigma W}$$

Kw = Weighted Average Cost of Capital

X = Cost of specific source of finance'

W= Weight(proportion of a specific source of finance)

Q1. The following is the capital structure of a company.

Source	Amount (Rs.)	Before tax cost (%)
Equity capital	3,00,000	15
Retained earnings	2,00,000	13
Preference capital	1,50,000	16
Debentures	3,50,000	12

Assume tax rate at 30%. Compute weighted average cost of capital.

Source	Capital Amount	Before Tax cost	After Tax Cost = C	Proportion of Each Source as against total capital (W)		W x C
a	b	c	d	e	f	d x f
Equity Capital	300000	15	15	300000/1000000	0.3	4.5
Retained Earnings	200000	13	13	200000/1000000	0.2	2.6
Preference Capital	150000	16	16	150000/1000000	0.15	2.4
Debentures	350000	12	**8.4**	350000/1000000	0.35	2.94

Total Capital	1000000	Weighted Average Cost of Capital	**12.44**

Tax benefit available only in case of Debenture capital, hence all other specific cost remains same.

Cost of Debenture capital after tax= Debenture Interest (1-Tax)

= 12%(1-30/100)

= 12%(1-.30)

= 12%(0.70)

= 8.4%

Q.no.2 ABC Ltd. Is planning for the most desirable capital structure. The cost of debt (after tax) and equity capital at various levels of debt and equity mix is estimated as follows.

Debt as % of total Capital employed	Cost of debt (%)	Cost of equity (%)
0	10	15
20	10	15
40	12	15
50	13	18
60	14	20

Determine the composite cost of capital for each level of debt and equity and identify the optimum capital structure.

Debt as % of total Capital employed	Combination of Debt and Equity	Debt Capital	Equity Capital	Cost of debt (%)	Cost of equity (%)	Kd = Debt Capital X Cost of Debt	Ke=Equity Capital x Cost of Equity	TOTAL COST = Debt Capital X Cost of Debt + Equity Capital x Cost of Equity = Kd+Ke
0.00	If out of 100, Zero % is Debt, that means entire capital money has	0.00	100.00	10.00	15.00	0 x 10%	100 x 15%	15.00

	been obtained from Equity Share holders. So Equity capital portion is 100%							
20.00	If out of 100, 20 % is Debt, that means entire capital money has been obtained from Equity Share holders. So Equity capital portion is 80%	20.00	80.00	10.00	15.00	20 x 10%	80 x 15%	14.00
40.00	If out of 100, 40 % is Debt, that means entire capital money has been obtained from Equity Share holders. So Equity capital portion is 60%	40.00	60.00	12.00	15.00	40 x 12%	60 x 15%	13.80
50.00	If out of 100, 50 % is Debt, that means entire capital money has been obtained from Equity Share holders. So Equity capital portion is 50%	50.00	50.00	13.00	18.00	50 x 13%	50 x 18%	15.50
60.00	If out of 100, 60 % is Debt, that means entire capital money has been obtained from Equity Share holders. So Equity capital portion is 40%	60.00	40.00	14.00	20.00	60 x 14%	40 x 20%	16.40

The optimum debt equity mix in this problem would be with 40% debt and 60% equity , as the total cost of this combination is the least when compared to other options ie 13.80%

Q.3 The details of the company's capital structure are as follows –

TYPE OF CAPITAL	BOOK VALUE	MARKET VALUE	SPECIFIC COST
Equity Capital	100000	180000	15%
Preference Capital	50000	120000	12%
Debentures	60000	100000	6%
Retained Earnings	40000	-	15%

Calculate the weighted average cost of capital using –

A. Book Value as weights
B. Market Value as weights

Solution : Book Value as weights

TYPE OF CAPITAL	BOOK VALUE	Proportion percentage to the total capital		SPECIFIC COST	Weighted cost in % = Proportion x specific cost
Equity Capital	100000	100000/ 250000	0.4	15%	6.00%
Preference Capital	50000	50000/ 250000	0.2	12%	2.40%
Debentures	60000	60000/ 250000	0.24	6%	1.44%
Retained Earnings	40000	40000/ 250000	0.16	15%	2.40%
TOTAL CAPITAL	**250000**			**WACC**	**12.24%**

Solution : Market Value as weights

TYPE OF CAPITAL	MARKET VALUE	Proportion percentage to the total capital		SPECIFIC COST	Weighted cost in % = Proportion x specific cost
Equity Capital	180000	180000/ 400000	0.45	15%	6.75%
Preference Capital	120000	120000/ 400000	0.3	12%	3.60%
Debentures	100000	100000/ 400000	0.25	6%	1.50%
TOTAL CAPITAL	**400000**			**WACC**	**11.85%**

UNIT – 4

INTRODUCTION TO WORKING CAPITAL

1. WORKING CAPITAL:

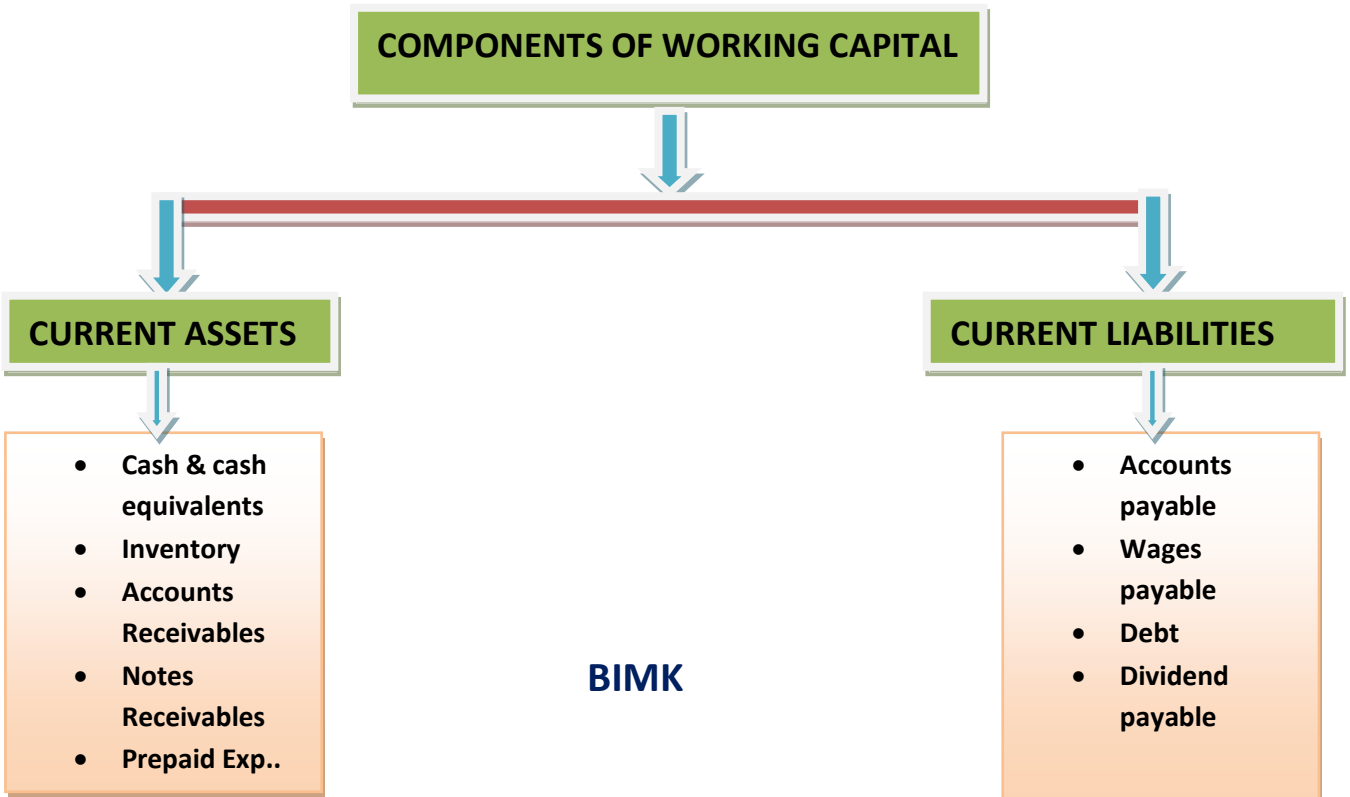
Working capital, also known as net working capital (NWC), is the difference between a company's current assets—such as cash, accounts receivable/customers' unpaid bills, and inventories of raw materials and finished goods—and its current liabilities, such as accounts payable and debts. It's a commonly used measurement to gauge the short-term health of an organization.

Working capital is also a measure of a company's operational efficiency and short-term financial health. If a company has substantial positive NWC, then it could have the potential to invest in expansion and grow the company. If a company's current assets do not exceed its current liabilities, then it may have trouble growing or paying back creditors. It might even go bankrupt.

FORMULA:

Working Capital = Current Assets - Current Liabilities

COMPONENTS OF WORKING CAPITAL:



Current Assets

Current assets are economic benefits that the company expects to receive within the next 12 months. The company has a claim or right to receive the financial benefit, and calculating working capital poses the hypothetical situation of the company liquidating all items below into cash.

- **Cash and Cash Equivalents**: All of the money the company has on hand. This includes foreign currency and certain types of investments such as money market accounts with very low risk and very low investment term periods.
- **Inventory**: All of the unsold goods being stored. This includes raw materials purchased to manufacture, partially assembled inventory that is in process, and finished goods that have not yet been sold.
- **Accounts Receivable**: All of the claims to cash for inventory items sold on credit. This should be included net of any allowance for doubtful payments.
- Notes Receivable: All of the claims to cash for other agreements, often agreed to through a physically signed agreement.
- **Prepaid Expenses**: All of the value for expenses paid in advance. Though it may be difficult to liquidate these in the event of needing cash, they still carry short-term value and are included.
- **Others:** Any other short-term asset. An example is some companies may recognize a short-term deferred tax asset that reduces a future liability.

Current Liabilities

Current liabilities are simply all debts a company owes or will owe within the next twelve months. The overarching goal of working capital is to understand whether a company will be able to cover all of these debts with the short-term assets it already has on hand.

- Accounts Payable**:** All unpaid invoices to vendors for supplies, raw materials, utilities, property taxes, rent, or any other operating expense owed to an outside third party. Credit terms on invoices are often net 30 days, so essentially all invoices are captured here.
- **Wages Payable:** All unpaid accrued salary and wages for staff members. Depending on the timing of the company's payroll, this may only accrue up

to one month's worth of wages (if the company only issues one paycheck per month). Otherwise, these liabilities are very short-term in nature.

- **Current Portion of Long-Term Debt:** All short-term payments related to long-term debt. Imagine a company finances its warehouse and owes monthly debt payments on the 10-year debt. The next 12 months of payments are considered short-term debt, while the remaining 9 years of payments are long-term debt. Only 12 months are included when calculating working capital.
- **Accrued Tax Payable:** All obligations to government bodies. These may be accruals for tax obligations for filings not due for months; however, these accruals are usually always short-term (due within the next 12 months) in nature.
- **Dividend Payable:** All authorized payments to shareholders. A company may decide to decline future dividend payments but must fulfill obligations on already authorized dividends.
- Unearned Revenue**:** All capital received in advance of having completed work. Should the company fail to complete the job, it may be forced to return capital back to the client.

Characteristics of working capital:

1. Short term capital: Working capital is a short term capital.
2. Investment in current assets: Working capital (Gross) is used in current assets such as bill receivables, debtors, short term marketable securities, bank balance, cash, etc.
3. Liquidity: Liquidity is the basic feature of working capital. All the current assets in which working capital is employed are converted into cash easily.
4. Less risk: Working capital gets circulated for short term and it is easily convertible cash (i.e. it has high liquidity). Hence, there is less risk in working capital.
5. Changing form: The form of working capital keeps on changing constantly. For example, raw material is converted into semi-finished goods and finally into finished goods. Finished goods are converted into debtors if they get sold on credit, and into cash, if sold on cash.
6. To pay day-to-day expenses: Working capital is needed constantly to pay day-to-day expenses.
7. No depreciation: Since the form of working capital keeps on changing, its depreciation is not calculated.
8. Requirement according to type and form of business: Need of working capital depends upon the form and type of business. Thus its ratio is different in each business.

3. FACTORS DETERMING THE WORKING CAPITAL:-

1. NATURE OPF THE BUSINESS: -

The working capital requirement of a firm basically depends upon the nature of its business. Example in the public sector like electricity, railways the need of cash is very less comparatively. So the nature of the business determine the working capital how much needed for the business operations.

2. SCALE OF BUSINESS/SIZE OF BUSINESS: -

Size of business decided how much working capital required the business size is large the working capital are also required more the business size is small less working capital is required.

3. PRODUCTION POLICY: -

Based on the production policy working capital is needed. Because if the company is producing products four times in a year the working capital requirement. Is more if the company produce product twice in a year less working capital required comparatively four times in a year

4. SEASONAL VARIATIONS: -

In certain industries raw material is not available so they have to buy raw materials in build, during the season to ensure an uninterrupted flow for the production.

8. WORKING CAPITAL CYCLE: -

In manufacturing concern the working cycle starts with the purchase of raw material and with bills receivable from the sales. The company working capital cycle determines the requirement of working capital longer the period of the cycle large working capital required.

9. CREDIT POLICY: -

The credit polity means the dealings with debtors and creditors influence the working capital requirement if the creditors given more time for repayment to creditors comparatively our debtors. Then less working capital required.

10.BUSINESS CYCLE: -

Business cycle refers to alternatives expansion and contraction in general business activity. In a period of boom i.e. when the products are highly demanded and rise of raw material cost then large amount of working capital required.

11.GROWTH RATE OF BUSINESS: -

If the business is growing and business operations are expedite the working capital requirement is more.

12.EARNING CAPACITY AND DIVIDEND POLICES: -

Some firms have more earning capacity then others due to quality of their products, highly earning capacity may generate. Cash profits from operation the dividend polices may also influence the working capitals requirements.

13.PRICE LEVEL CHANGES:-

Based on the price level changes the working capital is needed.

4. WORKING CAPITAL CYCLE:

It is the time to taken to convert net assets and net liabilities into cash. There are several day-to-day business activities which required readily available cash. A working capital cycle can be long and short depending upon the time taken to convert into cash.

Step 1: When a company produces a product, they purchase raw material from a supplier on credit. For example, a company purchases raw material, and they have to make the payment in 90 days.

Step 2: After producing the final product, the company sells the product to customers in 85 days.

Step 3: As the product is sold on credit, the company receives the payment in 20 days.

Step 4: Once, the payment is received by the company, the working capital cycle is complete.

Working Capital Cycle Formula:

Working Capital Cycle Formula= Inventory Days + Receivable Days - Payable Days

Inventory Days: The number of days it takes for a company to convert its inventory into sales. The formula for inventory days is:

Inventory Days = (Average Inventory / Cost of Goods Sold) x 365

For example, if a company has an average inventory of Rs.1,00,000 and a cost of goods sold of Rs.5,00,000, the inventory days would be:

Inventory Days = (1,00,000 / 5,00,000) x 365 = 73 days

This means it takes the company 73 days to sell its inventory.

Receivable Days: The number of days it takes for a company to collect payment from its customers. The formula for receivable days is:

Receivable Days = (Accounts Receivable / Total Sales) x 365

For example, if a company has accounts receivable of Rs. 50,000 and total sales of Rs. 10,00,000, the receivable days would be:

Receivable Days = (50,000 / 10,00,000) x 365 = 18.25 days

This means it takes the company 18.25 days to collect payment from its customers.

Payable Days: The number of days it takes for a company to pay its suppliers. The formula for payable days is:

Payable Days = (Accounts Payable / Cost of Goods Sold) x 365

For example, if a company has accounts payable of Rs. 25,000 and cost of goods sold of Rs. 5,00,000, the payable days would be:

Payable Days = (25,000 / 5,00,000) x 365 = 18.25 days

This means it takes the company 18.25 days to pay its suppliers.

Putting it all together, the working capital cycle for this company would be:
Working Capital Cycle = 73 days (inventory days) + 18.25 days (receivable days) - 18.25 days (payable days) = 73 days

This means it takes the company 73 days to convert its inventory into cash and use that cash to pay off its current liabilities. The shorter the working capital cycle, the more efficient the company is at managing its working capital.

What are the Phrases of Working Capital Cycle?

There are four phrases of working capital cycle which includes cash, receivables, inventory, and billing.

- **Cash:** Maintaining a health cash inflow and outflow
- **Receivables:** Terms of payment for good and services for money owned.
- **Inventory:** Time taken to sell the inventory
- **Billing:** Tie taken to make the payment

Why is the Working Capital Cycle Important?

• **Cash flow management:** The working capital cycle helps businesses to monitor their cash flow more effectively. By tracking how long it takes to turn inventory into cash, companies can plan their working capital requirements more accurately, ensuring they have enough money to meet their obligations and invest in future growth.

• **Efficient use of resources:** By reducing the time it takes to convert inventory into cash, businesses can use their resources more efficiently, lowering their inventory holding costs and freeing up cash for other purposes.

• **Improved creditworthiness:** Companies with a shorter working capital cycle are generally seen as more creditworthy. This is because they can more easily meet their financial obligations and are less likely to default on loans or payments.

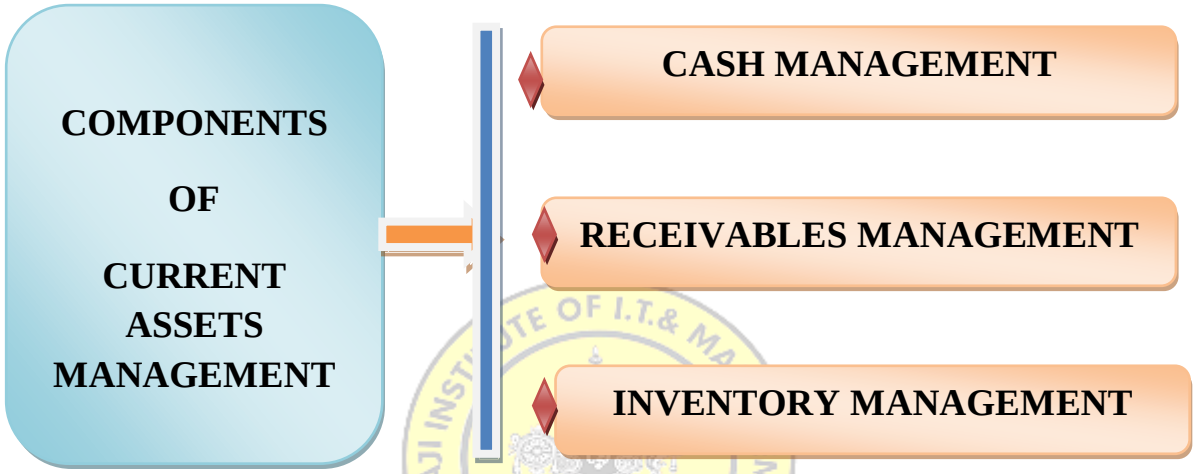
• **Effective supplier management:** A business with a longer working capital cycle may struggle to pay its suppliers on time, which can damage its relationships with them. By improving its working capital cycle, a company can improve its supplier relationships and negotiate better terms and pricing.

• **Better decision-making:** Companies that have a good understanding of their working capital cycle can make more informed decisions about when to buy or sell inventory, when to extend credit to customers, and when to seek financing.

• **Increased profitability:** A shorter working capital cycle can lead to increased profitability, as it allows businesses to generate cash more quickly, reduce their borrowing costs, and reinvest in their operations.

5. MANAGEMENT OF CURRENT ASSETS:

Current Asset Management represents the management of cash, marketable securities, cash equivalents, stock inventory, accounts receivable, and other liquid assets. The ultimate goal is to efficiently manage these resources to ensure operational continuity, meet short-term obligations, and maximize profits.



CASH MANAGEMENT:

The skill of controlling cash inflows and cash outflows is known as cash management. It is an essential step in making sure that any business can survive.

Cash management includes several steps:

1. Develop a cash budget in order to forecast cash inflows and outflows.
2. Implementing cash-flow management strategies, such as offering discounts for early payment.
3. Creating a cash-flow management strategy, such as negotiating payment terms with suppliers.
4. Invest excess cash in low-risk, short-term instruments such as money market funds or short-term government securities.
5. Monitoring cash balances and making necessary changes to the cash management plan.

Objectives of Cash Management:

1. Controls Cash Flow

The most vital objective of a cash management system is limiting your cash outflow as well as accelerating cash inflow. A business owner might always want to increase the amount of cash flowing into the business. However, minimising the cash outflow will result in reduced operational expenses.

An efficient cash management system that is integrated with cash management software will increase your real-time cash visibility which will give you greater control of your cash flow.

2. Efficient Cash Planning

The right cash management system will help you to optimise cash and plan effectively. It helps in planning capital expenditure and determining the ratio of equity and debt to acquire finances. With the right planning, you will have the right amount of liquid cash so that you do not fall short of it.

3. Meet Unforeseen Expenses

The company might have to face certain unexpected circumstances like a breakdown of machinery. Having surplus cash will help in coping with this situation in the best manner.

4. Ease of Investment

Cash management helps in the optimum utilisation of available funds by creating an adequate balance between cash in hand and investments. It will help you to invest the idle funds in the right proportion at the right opportunity as it is one of the aims of cash management.

5. Avoiding Insolvency

If companies do not have proper planning for cash management, a situation might arise when the business will be unable to pay its bills. This situation may occur due to a lack of liquid cash or not being able to make a profit from the money available.

Cash Management Strategies

Here are some cash management strategies that businesses can use to optimise their use of cash resources:

1. Cash Forecasting and Budgeting

Businesses can better manage their cash flow and anticipate potential shortfalls by accurately forecasting cash inflows and outflows and creating a budget.

2. Negotiating Payment Terms

Negotiate with customers and suppliers to help businesses manage cash flows more effectively. They could, for example, offer early payment discounts to customers or request extended payment terms from suppliers.

3. Efficient Billing and Collection Process

This can help businesses receive payment from customers more quickly and reduce the time it takes to convert accounts receivable into cash

4. Minimize Expenses

Reducing unnecessary expenses can help businesses conserve cash and improve their cash flow. For example, they could negotiate better prices from suppliers or implement cost-cutting measures.

5. Maintain Adequate Cash Reserve

Businesses should keep enough cash on hand to cover unexpected expenses, and emergencies, and to capitalise on unanticipated opportunities.

Benefits of Cash Management

The benefits of cash management are listed below:

- Estimating cash profits is possible, as opposed to only gains from unpaid bills, sales of credit, etc.
- It aids in the detection of cash theft.
- It makes it possible to shorten the cycle of working capital.
- It assists in rewarding those debtors who pay their debts more quickly.
- It quickens an organisation’s activities.

Limitations of Cash Management

1. Poor Cash Flow Management

Companies must be intensely aware of receipts and cash payment timings. They should also ensure that they receive ample amounts to pay forward as payables.

2. Delayed Collection of Cash

Revenue is estimated at the time of a transaction, but money might get delayed for up to 90 days. Companies may record high profits on the basis of their revenue. Still, they can face cash deficits if they have delayed sale collections even after running profits regularly.

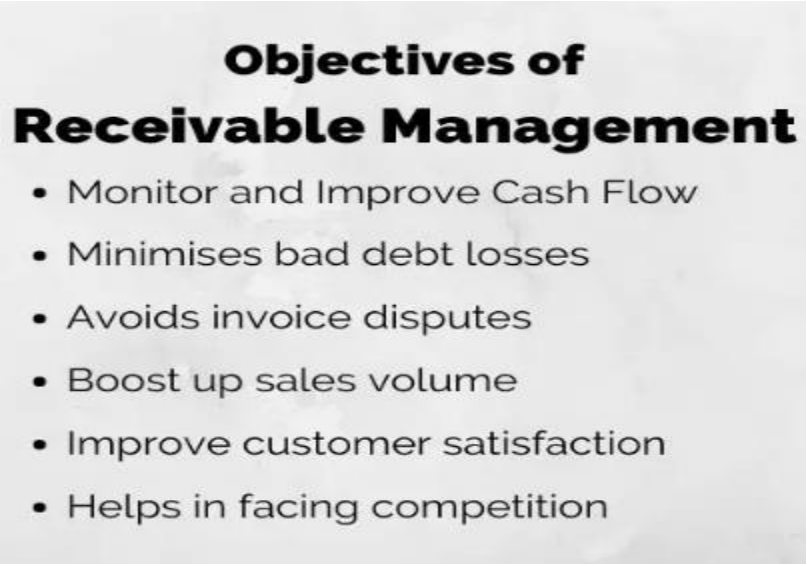
RECEIVABLES MANAGEMENT:

Account receivables refer to the outstanding invoices or money which is yet to be paid by your customers. Until it is paid, such invoices or money is accounted as accounts receivables. Also known as bills receivables.

Management of Receivables is also known as:

- Payment Collection
- Collection Management
- Accounts Receivables

OBJECTIVES:



Monitor And Improve Cash Flow

Receivable management monitors and control all cash movements of organizations. It maintains a systematic record of all sales transactions. Receivable management helps business in deciding appropriate investment in trade debtors. It aims that a sufficient amount of cash needed for day-to-day activities is maintained at business.

Minimises Bad Debt Losses

Bad debts are harmful to organisations and may lead to heavy losses. Receivable management takes all necessary steps to avoid bad debts in business transactions. It designs and implement schedules for collection of outstanding amount timely and informs the collection department on due dates. Customers are notified for amount standing against them and charges interest on delay in payments.

Avoids Invoice Disputes

Receivable management has an efficient role in avoiding any disputes arising in business. Disputes adversely affect the relationship between customers and business organizations. Complete and fair record of all transactions with customers are maintained on a daily basis. There is no chance of confusion and dispute arising as all sales transactions are accurately maintained. Automated receivable management systems present full evidence in a short time in case of dispute arising for resolving them.

Boost Up Sales Volume

Receivable management increase the sales and the profitability of the organization. By extending the credit facilities to their customers business are able to boost up their sales volume. More and more customers are able to do transactions with the business by purchasing products on a credit basis. Receivable management helps business in managing and deciding their investment in credit sales. This leads to increase in the number of sales and profit level.

Improve Customer Satisfaction

Customer satisfaction and retention are key goals of every business. By lending credit, it supports financially weaken customers who can’t purchase business products fully on a cash basis. This strengthens the relationship between customer and organisation. Customers are happy with the services of their business partners. Receivable management help in organising better credit facilities for their customers.

Helps In Facing Competition

Receivable management helps in facing stiff competition in the market. Several competitors existing in market offers different credit options to attract

more and more customers. Receivable management process analysis all information about market and helps the business in farming its credit lending policies. Customers are provided better services by extending credit at convenient rates. Appropriate amount and rates of credit transactions can be easily decided through receivable management process. All credit and payment terms are decided for every customer as per their needs.

Nature of Receivable Management

Regulate Cash Flow

Receivable management regulates all cash flows in an organization. It controls all inflow and outflow of funds and ensure that an efficient amount of cash is always available. Proper management of receivables enables organizations in efficient functioning at all the times.

Credit Analysis

It perform proper analysis of customer credentials for determining their credit ratings. Monitoring and scanning of customers before provide them any credit facility helps in minimizing the credit risk.

Decide Credit Policy

Receivable management decides the credit policy and standards as per which credit facility should be extended to customers. A company may have a lenient credit policy where customer credit-worthiness is not at all considered or a stringent policy where credit-worthiness is considered for providing credit.

Credit Collection

Receivable management focuses on efficient and timely collection of business payments from its customers. It works towards reducing the time gap in between the moments when bills are raised and payment is collected.

Maintain Up-To-Date Records

Receivable management maintains a systematic record of all business transactions on a regular basis. All transactions are maintained fairly in the form of proper billing and invoices which helps in avoiding any confusion or settling of disputes arising later.

INVENTORY MANAGEMENT:

What Is Inventory?

Inventory is the raw materials, components and finished goods a company sells or uses in production. Accounting considers inventory an asset. Accountants

use the information about stock levels to record the correct valuations on the balance sheet.

Inventory management helps companies identify which and how much stock to order at what time. It tracks inventory from purchase to the sale of goods.

Inventory management is also known to help:

- Order and time supply shipments correctly
- Prevent theft or loss of product
- Manage seasonal items throughout the year
- Deal with sudden demand or market changes
- Ensure maximum resource efficiency through cycle counting
- Improve sales strategies using real-life data

Inventory Management Techniques:

- **ABC Analysis:**
  This method works by identifying the most and least popular types of stock.

- **Batch Tracking:**
  This method groups similar items to track expiration dates and trace defective items.

- **Bulk Shipments:**
  This method considers unpacked materials that suppliers load directly into ships or trucks. It involves buying, storing and shipping inventory in bulk.

- **Consignment:**
  When practicing consignment inventory management, your business won't pay its supplier until a given product is sold. That supplier also retains ownership of the inventory until your company sells it.

- **DemandForecasting:**
  This form of predictive analytics helps predict customer demand.

- **FIFO and LIFO:**
  First in, first out (FIFO) means you move the oldest stock first. Last in, first out (LIFO) considers that prices always rise, so the most recently-purchased inventory is the most expensive and thus sold first.

- **Just-In-Time Inventory (JIT):**
  Companies use this method in an effort to maintain the lowest stock levels possible before a refill.

Benefits of Inventory Management

The two main benefits of inventory management are that it ensures you're able to fulfill incoming or open orders and raises profits. Inventory management also:

- **SavesMoney:**
  Understanding stock trends means you see how much of and where you have something in stock so you're better able to use the stock you have. This also allows you to keep less stock at each location (store, warehouse), as you're able to pull from anywhere to fulfill orders — all of this decreases costs tied up in inventory and decreases the amount of stock that goes unsold before it's obsolete.

- **Improves Cash Flow:**
  With proper inventory management, you spend money on inventory that sells, so cash is always moving through the business.

- **Satisfies Customers:**
  One element of developing loyal customers is ensuring they receive the items they want without waiting.

Inventory Management Challenges

- **Getting Accurate Stock Details:**
  If you don't have accurate stock details,there's no way to know when to refill stock or which stock moves well.

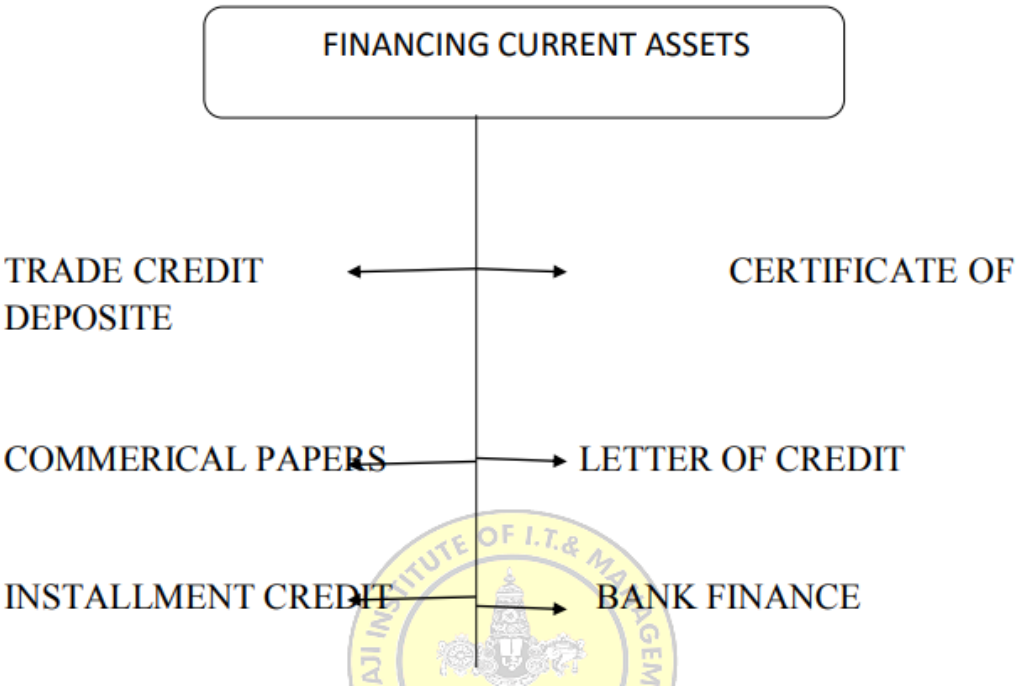
- **Poor Processes:**
  Outdated or manual processes can make work error-prone and slow down operations.

- **Changing Customer Demand:**
  Customer tastes and needs change constantly. If your system can't track trends, how will you know when their preferences change and why?

- **Using Warehouse Space Well:**
  Staff wastes time if like products are hard to locate. Mastering inventory management can help eliminate this challenge.

7. FINANCING CURRENT ASSETS:

Financing current assets a part of the current assets are finance through trade credit, letter credit and bank finance etc.



1. TRADE CREDIT: - Trade credit is an agreement between two parties. Buyer need to pay amount in due to the seller.

2. COMMERCIAL PAPER: - Commercial paper is a money market financial instrument issued by large size corporate bodies to rise short term founds to meet their temporary.

3. CERTIFICATE OF DEPOSITES: - It is also a financial instrument by using certificate of deposit companies get finance when ever needed short term finance.

4. LETTER OF CREDIT: - The repeated companies get finance from the bands by giving writing letter to the bank requesting sum of money for short term repayment.

5. INSTALLMENT CREDIT: - In this the company may payment large amount in smaller amount regularly. Up to clear of total payment.

6. BANK FINANCE: - Most of the companies for less amounts they approaches bank finance.

UNIT – 5

CORPORATE RESTRUCTURES

1. CORPORATE RESTRUCTURING:

Corporate restructure refers to the changes in ownership, business mix, assets mix with the view to enhance the share holder's value. Hence corporate restructuring may in valve owner ship restructuring, business restructure and assets restructure. A company moves affect owner ship restructuring through mergers and accusations. Corporate restructuring is an action taken by the corporate entity to modify its capital structure or its operations significantly.

CHARACTERISTICS OF CORPORATE RESTRUCTURING:

- To improve the Balance Sheet of the company (by disposing of the unprofitable division from its core business)
- Staff reduction (by closing down or selling off the unprofitable portion)
- Changes in corporate management
- Disposing of the underutilized assets, such as brands/patent rights.
- Outsourcing its operations such as technical support and payroll management to a more efficient 3rd party.
- Shifting of operations such as moving of manufacturing operations to lower-cost locations.
- Reorganising functions such as marketing, sales, and distribution.
- Renegotiating labour contracts to reduce overhead.
- Rescheduling or refinancing of debt to minimize the interest payments.
- Conducting a public relations campaign at large to reposition the company with its consumers.

Types of Corporate Restructuring Strategies

- **Merger:** This is the concept where two or more business entities are merged together either by way of absorption or amalgamation or by forming a new company. The merger of two or more business entities is generally done by the exchange of securities between the acquiring and the target company.
- **Demerger:** Under this corporate restructuring strategy, two or more companies are combined into a single company to get the benefit of synergy arising out of such a merger.
- **Reverse Merger:** In this strategy, the unlisted public companies have the opportunity to convert into a listed public company, without opting for IPO (Initial Public offer). In this strategy, the private company acquires a majority shareholding in the public company with its own name.

- **Disinvestment:** When a corporate entity sells out or liquidates an asset or subsidiary, it is known as “divestiture”.
- **Takeover/Acquisition:** Under this strategy, the acquiring company takes overall control of the target company. It is also known as the Acquisition.
- **Joint Venture (JV):** Under this strategy, an entity is formed by two or more companies to undertake financial act together. The entity created is called the Joint Venture. Both the parties agree to contribute in proportion as agreed to form a new entity and also share the expenses, revenues and control of the company.
- **Strategic Alliance:** Under this strategy, two or more entities enter into an agreement to collaborate with each other, in order to achieve certain objectives while still acting as independent organizations.
- **Slump Sale:** Under this strategy, an entity transfers one or more undertakings for lump sum consideration. Under Slump Sale, an undertaking is sold for consideration irrespective of the individual values of the assets or liabilities of the undertaking.

2.What Are Mergers and Acquisitions (M&A)?

- The terms "mergers" and "acquisitions" are often used interchangeably, but they differ in meaning.
- In an acquisition, one company purchases another outright.
- A merger is the combination of two firms, which subsequently form a new legal entity under the banner of one corporate name.
- A company can be objectively valued by studying comparable companies in an industry and using metrics.

- **Vertical**: Such a merger occurs between companies operating at different chain stages.
- **Horizontal**: It is a merger between firms operating in the same industry.
- **Conglomerate**: When a company functioning in one industry collaborates with a firm operating in another sector, it is called a **conglomerate** merger. This is done for diversification.
- **Congeneric**: Companies catering to the needs of the same consumer base often come together to form a new congeneric firm.

The various forms of acquisition are as follows:

- **Friendly:** When the acquirer and the target mutually agree on the acquisition, the transition is friendly.
- **Hostile:** If the acquirer forcefully takes over the target without the latter's consent, it becomes a **hostile takeover**.
- **Buyout:** Alternatively, the acquirer purchases 51% or more stocks, i.e., a controlling share in the target.

MOTIVES FOR MERGERS:-

1. Limited competition.
2. Utilize under-utilized market power.
3. Overcome the problem of slow growth.
4. Achieve diversification.
5. Gain economies of scale.
6. Establish relation between local market and forging market.
7. Replace existing management.
8. Create an image of aggressiveness.

(a) Limited competitors:-

The first motive for merger is competition is limited because of merger less completions chance of getting more profits

(b) Utilized market power:-

Merger facilitates to take advantage of market power to capture the market and grow in a market place.

(c) Overcome the problems of slow grow:-

Mergers are also improving the growth rate business operation because of reduce of competition and expenses.

(d) Achieve diversification:-

Another motive for merger is we can achieve diversification I.E we can add new produces and expand the business operations.

(d) Gain economic of scale:-

Merger facilitates to increase the and reduce the expenditure this leads to we can gain economic of scale.

(e) Replace of existing management:-

Merger replaces the old management with lot of new ideas and more scope for development.

(f) Establish relationship between Beal market and foreign market:-

In two companies one is domestic company Anther Company is foreign company that leads to high profit.

3. PRINCIPLES OF CORPORATE GOVERNANCE:

What Is Corporate Governance?

Corporate governance is the system of rules, practices, and processes by which a firm is directed and controlled. Corporate governance essentially involves balancing the interests of a company's many stakeholders, such as shareholders, senior management executives, customers, suppliers, financiers, the government, and the community.

Benefits of Corporate Governance

- Good corporate governance creates transparent rules and controls, provides guidance to leadership, and aligns the interests of shareholders, directors, management, and employees.
- It helps build trust with investors, the community, and public officials.
- Corporate governance can provide investors and stakeholders with a clear idea of a company's direction and business integrity.
- It promotes long-term financial viability, opportunity, and returns.
- It can facilitate the raising of capital.
- Good corporate governance can translate to rising share prices.
- It can lessen the potential for financial loss, waste, risks, and corruption.
- It is a game plan for resilience and long-term success.

The Principles of Corporate Governance:

FAIRNESS

The board of directors must treat shareholders, employees, vendors, and communities fairly and with equal consideration.

TRANSPARENCY

The board should provide timely, accurate, and clear information about such things as financial performance, conflicts of interest, and risks to shareholders and other stakeholders.

RISK MANAGEMENT

The board and management must determine risks of all kinds and how best to control them. They must act on those recommendations to manage them. They must inform all relevant parties about the existence and status of risks.

RESPONSIBILITY

The board is responsible for the oversight of corporate matters and management activities. It must be aware of and support the successful, ongoing performance of the company. Part of its responsibility is to recruit and hire a CEO. It must act in the best interests of a company and its investors.

ACCOUNTABILITY

The board must explain the purpose of a company's activities and the results of its conduct. It and company leadership are accountable for the assessment of a company's capacity, potential, and performance. It must communicate issues of importance to shareholders.

CONTROL:-

Corporate governance controls the employees and employees to use their rights and duties. This control helps employees and employees to use their right in right directions.

EMPOWERMENT:-

Empowerment is a process of means giving equal opportunities to all employees in the company decision making and also giving right to express employees opinion in different decisions.