UNIT-1
INTRODUCTION TO FINANCIAL MANAGEMENT

1. **What is Financial Management?**
   "Financial management is the operational activity of a business that is responsible for obtaining and effectively utilizing the funds necessary for efficient operations."

2. **Define Financial Management?**
   "Financial management is the activity concerned with planning, raising, controlling and administering of funds used in the business." (OR)
   "Financial management is that area of business management devoted to a judicious use of capital and a careful selection of the source of capital in order to enable a spending unit to move in the direction of reaching the goals."

3. **What is Profit Maximization?**
   Earnings profits by a corporate or a company is a social obligation and it's the only means through which the efficiency of organization can be measured. Profit is required for every organization because it keep the organization to be alive in the business.

4. **What are the objectives OR aims of Finance function?**
   - Anticipating financial needs
   - Acquiring financial resources
   - Allocating funds in business
   - Administrating the allocation funds

5. **Mention the steps in financial planning.**
   - Establishing Objectives
   - Policy formulation
   - Forecasting
   - Formulation of procedure

6. **Mention any four functions of financial management.**
   - Estimation of the financial requirements
   - Selection of the right sources of funds
   - Allocation of funds
   - Analysis and interpretation of financial performance

7. What is financial planning?

Planning the financial requirements for future course of action is called financial Planning.

8. What do you mean by wealth maximization?

It refers to gradual growth of the value of assets of the firm in terms of benefits it can produce is called wealth maximization.

9. What are the Objectives OR Goals of Financial Management and Explain?

Objectives of Financial Management:
Financial management is one of the functional areas of business. Therefore, its objectives must be consistent with the overall objectives of business.
The overall objective of financial management is to provide maximum return to the owners on their investment in the long-term. This is known as wealth maximization. Maximization of owners' wealth is possible when the capital invested initially increases over a period of time.

Wealth maximization means maximizing the market value of investment in shares of the company. Wealth of shareholders - Number of shares held Market price per share.

In order to maximize wealth, financial management must achieve the following specific objectives:
(a) To ensure availability of sufficient funds at reasonable cost (liquidity).
(b) To ensure effective utilization of funds (financial control).
(c) To ensure safety of funds by creating reserves, re-investing profits, etc. (minimization of risk).
(d) To ensure adequate return on investment (profitability).
(e) To generate and build-up surplus for expansion and growth (growth)
(f) To minimize cost of capital by developing a sound and economical combination of corporate securities (economy).
(g) To coordinate the activities of the finance department with the activities of other departments of the firm (cooperation).

Profit Maximization:

Very often maximization of profits is considered to be the main objective of financial management. Profitability is an operational concept that signifies economic efficiency. Some writers on finance believe that it leads to efficient allocation of resources and optimum use of capital. It is said that profit maximization is a simple and straightforward objective. It also ensures the survival and growth of a business firm. But modern authors on financial management have criticized the goal of profit maximization.

The following objections against the profit maximization objective:

Objections against the Profit Maximization Objectives:

(i) The concept is ambiguous or vague. It is amenable to different interpretations, e.g., long run profits, short run profits, volume of profits, rate of profit, etc.

(ii) It ignores the timing of returns. It is based on the assumption of bigger the better and does not take into account the time value of money. The value of benefits received today and those received a year later are not the same.

(iii) It ignores the quality of the expected benefits or the risk involved in prospective earnings stream. The streams of benefits may have varying degrees of uncertainty. Two projects may have same total expected earnings but if the earnings of one fluctuate less widely than those of the other it will be less risky and more preferable. More uncertain or fluctuating the expected earnings, lower is their quality.

(iv) It does not consider the effect of dividend policy on the market price of the share. The goal of profit maximization implies maximizing earnings per share which is not necessarily the same as maximizing market-price share. According to Solomon, "to the extent payment of dividends can affect the market price of "the stock (or share), the maximization of earnings per share will not be a satisfactory objective by itself."

(v) Profit maximization objective does not take into consideration the social responsibilities of business. It ignores the interests of workers, consumers, government and the public in general. The exclusive attention on profit maximization may misguide managers to the point where they may endanger the survival of the firm by ignoring research, executive development and other intangible investments.

10. Explain the Scope of Financial Management?

The major scope of financial management are as follows:

1. Investment Decision
2. Financing Decision
3. Dividend Decision
4. Working Capital Decision

1. **Investment Decision:**

The investment decision involves the evaluation of risk, measurement of cost of capital and estimation of expected benefits from a project. Capital budgeting and liquidity are the two major components of investment decision. Capital budgeting is concerned with the allocation of capital and commitment of funds in permanent assets which would yield earnings in future.

Capital budgeting also involves decisions with respect to replacement and renovation of old assets. The finance manager must maintain an appropriate balance between fixed and current assets in order to maximize profitability and to maintain desired liquidity in the firm.

Capital budgeting is a very important decision as it affects the long-term success and growth of a firm. At the same time, it is avery difficult decision because it involves the estimation of costs and benefits which are uncertain and unknown.

2. **Financing Decision:**

While the investment decision involves decision with respect to composition or mix of assets, financing decision is concerned with the financing mix or financial structure of the firm. The raising of funds requires decisions regarding the methods and sources of finance, relative proportion and choice between alternative sources, time of floatation of securities, etc. In order to meet its investment needs, a firm can raise funds from various sources.

The finance manager must developthe best finance mix or optimum capital structure for the enterprise so as to maximize the long-termmarket price of the company's shares. A proper balance between debt and equity is required so thatthe return to equity shareholders is high and their risk is low.

Use of debt or financial leverage effects both the return and risk to the equity shareholders. The market value per share is maximized when risk and return are properly matched. The finance department has also to decide the appropriate time to raise the funds and the method of issuing securities.

3. **Dividend Decision:**

In order to achieve the wealth maximization objective, an appropriate dividend policy must be developed. One aspect of dividend policy is to decide whether to distribute all the profits in the form of dividends or to distribute a part of the profits and retain the balance. While deciding the optimum dividend payout ratio (proportion of net profits to be paid out to shareholders).

The finance manager should consider the investment opportunities available to the firm, plans for expansion and growth, etc. Decisions must also be made with respect to dividend stability, form of dividends, i.e., cash dividends or stock dividends, etc.

4. **Working Capital Decision:**

Working capital decision is related to the investment in current assets and current liabilities. Current assets include cash, receivables, inventory, short-term securities, etc. Current liabilities consist of creditors. bills payable, outstanding expenses, bank overdraft, etc. Current assets are those assets which are convertible into a cash within a year. Similarly, current liabilities are those liabilities, which are likely to mature for payment within an accounting year.

11. Explain the Functions of Financial Management?

Following are Financial Management Functions:

1. **Financial Planning and Forecasting**

It is the financial manager's responsibility to plan and estimate the business's financial needs. He needs to provide details regarding the amount of money that would be required to purchase different assets for the company.

The management through the financial manager needs to know what they need to spend on working capital and fixed assets for the business too. Another vital duty of the financial manager is to make futuristic plans for funds that the company would need. And the manner in which the funds will be realized and used is also of utmost importance to the financial manager.

2. **Determination of capitalcomposition**

Once the Planning and Forecasting have been made, the capital structure have to be decided. The mix of debt and equity used to finance the company's future profitable investment opportunities is referred to as capital structure.

3. Fund Investment

The financial manager has to ensure that funds made available to the business are used adequately to grow the business. The cost of acquiring the said fund and value of the returns need to be compared and balanced. The financial manager also needs to look into the channels of the business that is yielding higher returns and improve them.

4. Maintain Proper Liquidity

Cash is the best source for maintaining liquidity. The business requires it to buy raw materials, pay salaries and tackle other financial needs of the company. However, the financial manager has to determine if there is a demand for liquid assets. He also has to arrange these assets in a manner that the business won't experience scarcity of funds.

5. Disposal of Surplus

Selling surplus assets and investing in more productive ways will increase profitability and therefore increase the ROCE.

6. Financial Controls

Financial control may be construed as the analysis of a company's actual results, approached from different perspectives at different times, compared to its short, medium and long-term objectives and business plans.

Conclusion

The financial management is a hot topic in the business world because of the importance of finance to the business. The reason for establishing a company is to make a profit and also run for many years. However, it's the financial manager's responsibility that the finances of the company are used adequately.

12. Explain the role of Finance Manager?

1) **Anticipate financial needs:** The financial manager has to forecast expected event in business and note their financial implications. He anticipates the financial need by consulting array of documents such as cash budget, the pro-forma income statement, the pro-forma balance sheet. the statement of the sources and uses of funds etc. financial needs can be anticipated by forecasting expected funds in a business and recording their financial implications.

2) **Acquiring financial resources:** this implies knowing when, where and how to obtain the funds which is business needs. Funds should be acquired well before the need for them is actually felt. The financial manager should know how to tap the different sources of both funds. He may requireshort term and long-term funds. The terms and condition of generating different financial sources may vary significantly at a given point of time.

3) **Allocating funds in business:** Allocating funds in a business means investing them in best planof assets. Assets are balanced by weighting their profitability against liquidity. Profitability refers to earning of profit. Liquidity means closeness of money. The financial manager should steer a prudent course between over financing and under-financing besides preserving a proper balance among various assets.

4) **Administration the allocating funds:** Once funds are allocated on various investment opportunities, it is the basic responsibilities of the finance manager to watch the performance of each rupee that has been invested. He has to adopt the close supervision and marking of flow of funds.

5) **Analysis the performance of finance:** Once the funds are administered, it is very comfortable for the finance manager to take decisions. Through budgeting, he will be able to compare the actual standards. The return on the investment must be continues and consistent.

6) **Accounting and reporting to the management:** Now, the role of the finance manager is changing. The department of finance has gained substantial recognition. He not only acts as line executive but also staff. He has to advise and supply information about performance of finance to the top management and is possible for maintaining up-to-date records of the performance of financial decision.

13. What are the Functional area of financial manager?

Following are the functional areas of finance manager:

a. Estimation of financial requirement

The requirement of finance to a business concern in continuous. It is needed in all the stage of business cycle namely, initial growth, saturation and declining stage. Fonds is needed to establish the industry both for meeting capital expenditure and revenue expenditure. Total estimation of funds for the first assignment of the subject financial management.

b. Selection of right source of funds

After estimating the total fund of business concern, it is the second important step of the finance manager to select the right type of sources of fund at right time and right cost. Each financial instrument is associated with different types of cost. Equity has the cost of dividend or expectation of the shareholders; debentures or borrowing has the cost of interest, preference share has cost of dividend.

c. Allocation of funds

After mobilizing the total funds of firm, it is responsibility of finance manager to distribute the funds to capital expenditure and revenue expenditure. The evaluation of different proposal of project mustbe made before making a final decision on investment.

d. Analysis and interpretation of financial performance

It is another important task of finance managers. He is expected to watch the performance of each portfolio that can be measures in terms of profitability and returns on the investments. Ratio analysis and comparison of actual with standard help the finance manager to have maximum control over the entire entire operation of the business unit.

e. Analysis of cost-volume-profit

It is another important tool of financial management that helps the management to evaluate different proposal of investments. Make or buy decision, Deletion and continuation of a product line decision can be made by adopting CVP/BEP analysis.

f. Capital budgeting

It is a technique through which finance managers evaluate the investment proposals. In how many years the original investment will be recovered? At what percentage of return a business should run? Is the issue that are handled by him? Payback period, ARR, IRR, NPV are some of modern technique, very popular in capital budgeting.

g. Working capital management

Working capital is rightly an adjunct of fixed capital investment. It is a financial lubricant which keeps business operations going. It is the lifeblood of a firm. Cash account receivables (Drs) and inventory are the components of working capital. They rotate in a sequence (cash to stock to sale to cash or account receivable).

h. Profit planning and control

Profit planning and control is yet another important function of financial management. Profit planning guides management in attaining the corporate goals Profit is surplus of income over the Expenditure. It may be earned though sales, or through operating revenue or by reducing cost of operations.

i. Fair return to the investor

Return are the divisible profits available to the investors. Equity holder normally expect fair amount of profit and capital appreciation for their investment. Unless and until this is fulfilled by the company, the confidence of the investors will be at stake. It is also a social and economic obligation on the part of the company in protects the interest of the investors.

j. Maintaining liquidity and Wealth Management

This is considered to be prime objectives of a business firm. Liquidity of a firm increases the borrowing capacity. Expansion and diversification activities can be comfortable executed.

14. Meaning of Finance

Finance refers to flow of funds in the organization. Finance function is most important of all the business functions it remain focus of the all activities.

The need for money is a continues to start with the development and expansion of business needs and more funds. This funds to be rise from different sources the success of finance function will be depending upon the planning.

13. Expalin the Organization of finance function

Finance function is key to the success of any business to make the function more effective a sound organization structure is essentials. A sound structure defines who is who, who reports to whom and functions responsibilities of each individual.

In large firms a separate finance department may be created at top level under the direct supervision of board of directors (BODs). The department may be headed by a key person called vice-president (finance) or director (finance) or chief finance officer (CFO), who is directly concerned with planning and control. He/she is also associated with policy formulation and decision making of the firm. The two subordinates known as 1. Treasurer 2. Controller.

- **Treasure:** the main concern of the treasurer is mainly financing activities and investment activities including cash management, relationship management with commercial and investment banker, credit management, portfolio management, inventory management, insurance/risk management, investors, dividend disbursement.

- **Controller:** on the other hand, the functions of controller are related to the management and control of assets, the main functions include cost accounting, financial accounting, and internal audit, and financial statement preparation, preparation of budgets, taxation, general ledger and data processing.

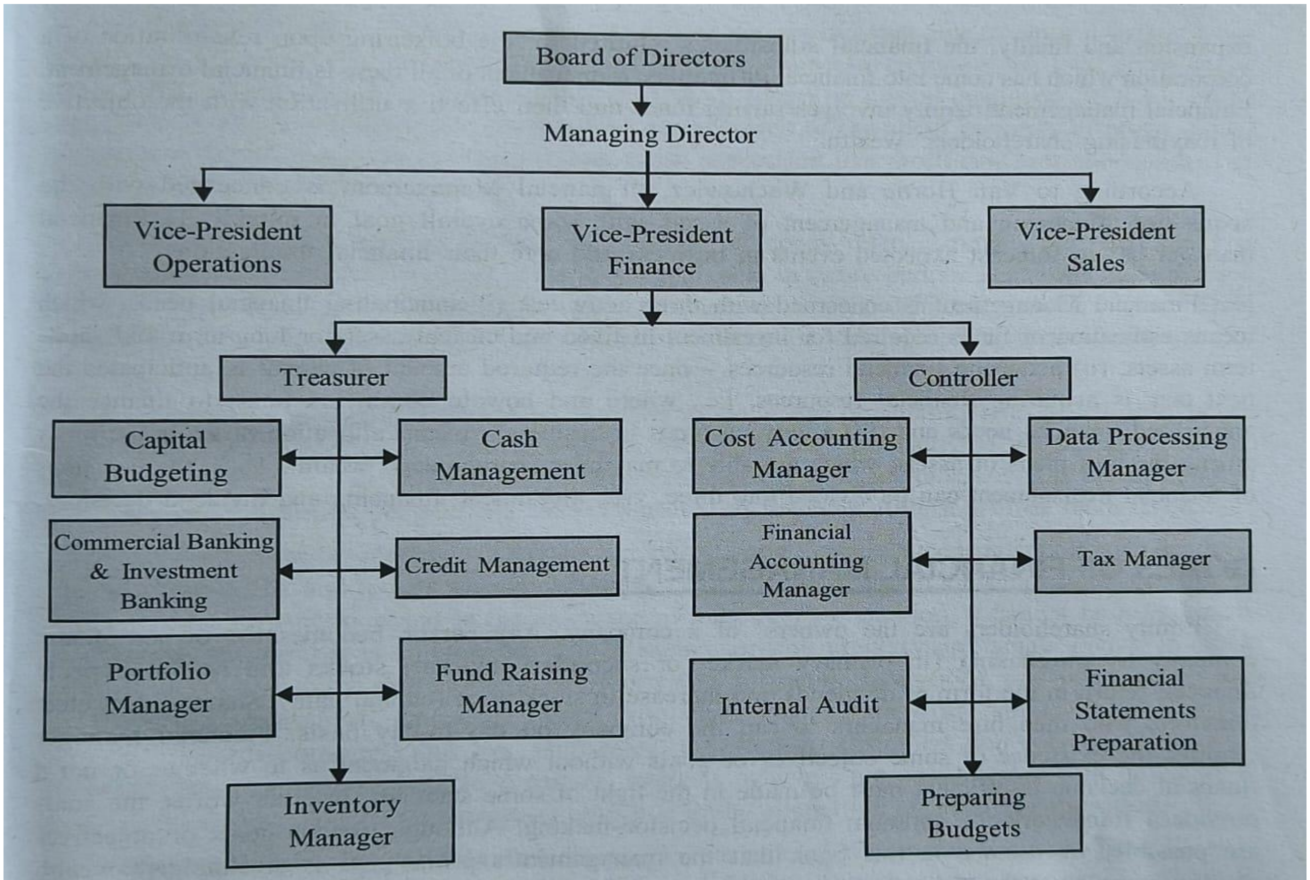

Figure 1.1: Organisation of Finance Function

14. Explain the Aims or objectives of finance function

- **Accruing sufficient funds:** The main aim of financial function is to assess the financial needs of an enterprise and the finding out. Suitable sources for rising the funds the selection of different sources is based on requirements of the enterprise, if the funds are need for longer periods them long-term sources share capital, dentures, term loans.
- **Proper utilizations of funds:** The planning and control of financial functions aims at increasing the profitability of the concerned to its true that the money is generates the money. To increase the profitability sufficient funds will have to invest finance function should plan to avoid inadequacy of funds or wastages of funds. If the cost of rising the funds is more than profitability will be go down.
- **Maximizing the concern value:** Finance function is also maximizing the value of the firm and value is linked with its profitability**.**
- **Increasing the profitability:** Proper planning and controlling of finance function should be done with optimum use of resources**.**

15. Explain the objectives / Need/ Importance of financial plan

- **Ensure availability of sufficient funds:** it ensure availability of sufficient funds to invest in feasible projects, thereby achieving company goals,
- **Balance risk and costs:** while raising the required funds there is a need to balance risk and costs to protect the investor.
- **Simplicity:** here simplicity means the firm should issue few securities, as issue of verity of securities complicate.
- **Flexibility:** flexibility means the plan should allow adjustment to the financial plan according to the changing business environment.
- **Liquidity:** Liquidity refers to the ability of an enterprise to honor the currently maturing obligations. Hence, the financial plan should be able to provide funds not only when it running under profits, but also in the periods of depression or abnormal business period.
- **Optimum Use:** Financial plan should ensure sufficient funds only for genuine needs. Plan should not allow the firm to suffer shortage of cash or should have excess of funds than the need, which will be a waste. Put in simple words, the funds should be raised according to the needs and should be utilized properly.
- **Economy:** The main objective of the financial manager is to raise funds at the least cost, the same is the case in financial plan. Plan should help the firm in raising funds at minimum cost. It should not impose disproportionate burden on the firm, and the plan should ensure optimum debt-equity mix.

16. Explain the steps in financial planning

The financial planning process can be broken down into six steps.

1. Projection of Financial Statements: Financial statements are profit & loss account and balance sheet. Projection of financial statement is very much needed, since it helps analyze the effects of the operating plan on projected profits and various financial plans.

2. Determinations of Funds Needed: Anticipation of funds needed to invest on fixed assets (Plant & Machinery and equipment) as well as current assets (inventories and receivables) for R&D programs and for major promotional campaigns.

3. Forecast the Availability of Funds: The required funds may be generated from two sources, internal and external sources. This step involves estimation of funds to be generated internally, which automatically identifies the amount of funds to be raised from outside.

5. **Establish and Maintain Systems of Controls:** Planning and control are the twins of management. Control system is necessary to see the proper and effective utilization of funds within the firm. It makes sure the basic financial plan is carried out properly.
6. **Develop Procedures:** Developing procedures ensures consistency of actions. Procedures should be developed for adjusting the basic plan if the economic forecasts upon which the plan was based do not materialize. For example, if the economy turns out to be stronger than that was forecast, then the procedures will help. This step is really a "feedback loop" which triggers modifications to the financial plan.
7. **Establish Performance-based Management Compensation System:** It is very much needed to reward managers for doing what stockholders want them to do, i.e., maximization of share prices.

17. Explain the principles of a sound financial plan

1. **Simplicity:** Here, 'simplicity' means that a financial plan should be easily understandable by a layman. It should be free from complications and/or suspicion - arising statements. This is possible only when there are few types of securities, since more types of securities lead to suspicion in the minds of the investors.
2. **Foresight:** Financial plan should be prepared only after taking into consideration 'today" and 'future needs of funds. It may be difficult to forecast the exact funds required over a future period, due to change in the business environment, financial plan should be prepared after assuming some changes in environment.
3. **Flexibility:** Financial plan of a corporation must be flexible enough, to meet the changing capital requirements of the corporation. It should be prepared in such a way that it should allow raise in additionally needed funds and to reduce the capital whenever needed.
4. **Liquidity:** A firm can have liquidity only when a reasonable amount of current assets is kept in the form of liquidity cash. Adequate liquidity also gives flexibility to the financial plan.
5. **Economy:** The cost of (capital) procurement of funds should be kept in mind while formulating a financial plan. Economy means funds should be raised at a minimum cost.
6. **Contingencies:** Contingencies should be provided by making a provision. Contingencies are unexpected things. But provision for anticipated contingencies does not earn sufficient return that is equal to the cost of source of funds.
7. **Optimum Risk:** Just raising of required funds at minimum cost does not help the firm to maximize the wealth of shareholders. There is a need to utilize the raised funds properly, only then there will be a meaning for any financial plan. Funds should be provided for genuine needs of the firm.

18. Explain the factors affecting financial plan?

1. **Nature of the Industry:** Consideration of nature of the industry is very important in financial planning. Here, nature of industry refers to whether the industry is capital-intensive or labor-intensive. The nature of industry helps to decide the (amount) quantum of capital and the sources of procurement.
2. **Status of the Company in Industry:** Status of the company is one, which is considered by the investors while investing in equities or debentures. Hence, a financial manager needs to assess his/her company's status in terms of size, age and goodwill, area of operation and the promoters and management's goodwill, because these affect financial planning.
3. **Evaluation of Alternative Sources of Finance:** Procurement of needed funds at minimum cost is possible only when there is debt and equity combination. For determination of optimum debt-equity or finance mix, the financial manager needs to evaluate various sources of finance in the light of cost, availability, contractual conditions (debt case), limitations, etc., before going to formulate the financial planning.
4. **Attitude of Management towards Control:** Management's attitude towards control is another factor that should be considered while formulating a financial plan. Any firm or management that is interested in retaining the control, would not like to raise funds by issue of equity shares to the public, if at all they issue, they would purchase a majority of the issues to hold control.
5. **Magnitude of External Capital Requirements:** A financial manager has to formulate a financial plan after taking into account short-term and long-term financial needs of the firm. In simple words, a financial manager needs to consider the working capital and fixed capital requirements, while formulating a financial plan.
6. **Capital Structure:** Construction of capital structure is a part of financial structure. Capital structure should be determined with a combination of debt and equity, but financial manager should try to minimize fixed charge.
7. **Flexibility:** Flexibility is the main principle of financial plan. It should be flexible enough to adjust according to the needs of the changing conditions. It should allow to raise and to repay whenever necessary, without difficulty and delay, which is possible only by determination of capital structure.
8. **Government Policy:** Government policies, financial controls and other statutory provisions should also be taken into consideration while formulation of a firm's financial plan.

UNIT-2
TIME VALUE OF MONEY

INTRODUCTION

It refers to the time as get a value. The rupee value is keepon changing over a period of time. The purchasing power of Rupee either it is increase or it decrease but never remains Constant. A rupee as more value today then rupee is received after a year it is mainly because time as on opportunity of cost. The time value of annuity of unit of money is different in difference time period. The present Value of rupee is received after some time will be less than a Rupee received today. Since the rupee received today is more valued. The rational investors individual utilized the available funds.
The time value money is also referring as time preference for money since today value of money is more the investor prefer to invest than tomorrow it is known as time preference for money.

The concept of time value is that the value of money received today is more than the value of the same amount received after a certain period of time. In simple terms, money received in the future is not as valuable as money received today.

MEANING OF TIME VALUE OF MONEY

It refers to value of money is existing in a given amount of interest which is earned during a period of time. The time value of money can be explained as a central concept financial theory.

NEEDS OR REASONS FOR TIME VALUE OF MONEY

- **Re investment opportunity:** money is received today can be re-invest to get the future returns. if the rate of return is greater than 0 money as a net productivity of time, because given some of money a two point of time does not have same value. It means that with availability of profitable investment opportunity a given some of money can also be made to grow with passage of time.

- **Uncertainty:** the present is more certain than the future which is full of unfounded as a result they are a general reference for present rupees and future rupees which may or may not be received in full because of uncertainty.

- **Inflation:** during the inflation the value of money go a decreasing and price level goes on increasing as a result people generally prefer the present value to the future.

- **Personal consumption preference:** mainly individual have a strong preference for immediate rather than daily consumption.

METHODS OR TECHNIQUES OF TIME VALUE OF MONEY

1. Compounding techniques or future value of techniques
    - Future value of single flow
    - Future value of multiple flow
    - Future value of annuity
2. Discounting techniques

UNIT-3
CAPITAL STRUCUTRE AND LEAVERAGES

1.What is Capital Structure?

"Capital structure is the combination of debt and equity securities that comprise a firm's financing of its assets, "Capital structure refers to the mix of long-term sources of funds, such as, debentures, long-term debts, preference share capital and equity share capital including reserves and surplus."

2. Explain the importance of Capital Structure?

The importance or significance of Capital Structure:

- **Increase in value of the firm:**

A sound capital structure of a company helps to increase the market price of shares and securities which, in turn, lead to increase in the value of the firm.

- **Utilization of available funds:**

A good capital structure enables a business enterprise to utilize the available funds fully. A properly designed capital structure ensures the determination of the financial requirements of the firm and raise the funds in such proportions from various sources for their best possible utilization. A sound capital structure protects the business enterprise from over-capitalization and under-capitalization.

- **Maximization of return:**

A sound capital structure enables management to increase the profits of a company in the form of higher return to the equity shareholders i.e., increase in earnings per share. This can be done by the mechanism of trading on equity i.e., it refers to increase in the proportion of debt capital in the capital structure which is the cheapest source of capital. If the rate of return on capital employed (i.e., shareholders' fund + long-term borrowings) exceeds the fixed rate of interest paid to debt-holders, the company is said to be trading on equity.

- **Minimisation of cost of capital:**

A sound capital structure of any business enterprise maximises shareholders' wealth through minimisation of the overall cost of capital. This can also be done by incorporating long-term debt capital in the capital structure as the cost of debt capital is lower than the cost of equity or preference share capital since the interest on debt is tax deductible.

- **Solvency or liquidity position:**

A sound capital structure never allows a business enterprise to go for too much raising of debt capital the because, at the time of poor earning, the solvency is disturbed for compulsory payment of interest to debt-supplier.

- **Flexibility:**

A sound capital structure provides a room for expansion or reduction of debt capital so that, according to changing conditions, adjustment of capital can be made.

- **Undisturbed controlling:**

A good capital structure does not allow the equity shareholders control on business to be diluted.

- **Minimisation of financial risk:**

If debt component increases in the capital structure of a company, the financial risk (ie, payment of fixed interest charges and repayment of principal amount of debt in time) will also increase. A sound capital structure protects a business enterprise from such financial risk through a judicious mix of debt and equity in the capital structure.

3. What are the factors determining Capital Structure?
The following factors influence the capital structure decisions:

- **Risk of cash insolvency:** Risk of cash insolvency arises due to failure to pay fixed interest liabilities. Generally, the higher proportion of debt in capital structure compels the company to pay higher rate of interest on debt irrespective of the fact that the fund is available or not. The non-payment of interest charges and principal amount in time call for liquidation of the company.

- **Risk in variation of earnings:** The higher the debt content in the capital structure of a company, the higher will be the risk of variation in the expected earnings available to equity shareholders. If return on investment on total capital employed (i.e., shareholders' fund plus long-term debt) exceeds the interest rate, the shareholders get a higher return.
  On the otherhand, if interest rate exceeds return on investment, the shareholders may not get any returnat all.

- **Cost of capital:** Cost of capital means cost of raising the capital from different sources offunds. It is the price paid for using the capital. A business enterprise should generate enough revenue to meet its cost of capital and finance its future growth. The finance manager should consider the cost of each source of fund while designing the capital structure of a company.

- **Control:** The consideration of retaining control of the business is an important factor in capital structure decisions. If the existing equity shareholders do not like to dilute the control, they may prefer debt capital to equity capital, as former has no voting rights.

- **Trading on equity:** The use of fixed interest-bearing securities along with owner's equity as sources of finance is known as trading on equity. It is an arrangement by which the company aims at increasing the return on equity shares by the use of fixed interest-bearing securities (ie., debenture, preference shares etc.). If the existing capital structure of the company consists mainly of the equity shares, the return on equity shares can be increased by using borrowed capital. This is so because the interest paid on debentures is a deductible expenditure for income tax assessment and the after-tax cost of debenture becomes very low.
  Any excess earnings over cost of debt will be added up to the equity shareholders. Ifthe rate of return on total capital employed exceeds the rate of interest on debt capital or rate of dividend on preference share capital, the company is said to be trading on equity.

- **Government policies:** Capital structure is influenced by Government policies, rules and regulations of SEBI and lending policies of financial institutions which change the financial pattern of the company totally. Monetary and fiscal policies of the Government will also affect the capital structure decisions.

- **Size of the company:** Availability of funds is greatly influenced by the size of company. A small company finds it difficult to raise debt capital. The terms of debentures and long-term loans are less favourable to such enterprises. Small companies have to depend more on the equity shares and retained earnings. On the other hand, large companies issue various types of securities despite the fact that they pay less interest because investors consider large companies less risky.

- **Needs of the investors:** While deciding capital structure the financial conditions and psychology of different types of investors will have to be kept in mind. For example, a poor or middle-class investor may only be able to invest in equity or preference shares which are usually of small denominations, only a financially sound investor can afford to invest in debentures of higher denominations. A cautious investor who wants his capital to grow will prefer equity shares.

- **Flexibility:** The capital structures of a company should be such that it can raise funds as and when required. Flexibility provides room for expansion, both in terms of lower impact on cost and with no significant rise in risk profile.

- **Period of finance:** The period for which finance is needed also influences the capital structure. When funds are needed for long-term (say 10 years), it should be raised by issuing debentures, or preference shares. Funds should be raised by the issue of equity shares when it is needed permanently.

- **Nature of business:** It has great influence in the capital structure of the business companies having stable and certain earnings prefer debentures or preference shares and companies having no assured income depends on internal resources.

- **Legal requirements:** The finance manager should comply with the legal provisions while designing the capital structure of a company.

- **Purpose of financing:** Capital structure of a company is also affected by the purpose of financing. If the funds are required for manufacturing purposes, the company may procure it from the issue of long-term sources. When the funds are required for non-manufacturing purposes i.e., welfare facilities to workers, like school, hospital etc. the company may procure it from internal sources.

- **Corporate taxation**

- **Cashinflows**

- **Provision for future**

- **EBIT-EPS analysis**

LEVERAGES

The main aim of any business unit is to maximize the wealth of the firm and increased return to the equity holders. Earnings per share is a barometer through which performance of an industrial unit can be measured. This could be achieved by applying the principal of financial leverage

Meaning of Leverage: Leverage has been defined as "the action of a lever, and mechanical advantage gained by it". A lever is a rigid piece that transmits and modifies force or motion where forces are applied at two points and turns around a third. In simple words, it is a force applied at a particular point to get the desired result.

"Leverage is the employment of an asset or funds for which the firm pays a fixed cost or fixed return".

Types of leverages:

1. **Financial leverage:** It is tool with which a financial manager can maximize the return to the equity shareholders. The capital of a company consists of Equity, preference, Debentures, Public deposits and other long-term source of funds. He has to carefully select the securities to mobilize the funds. The proper blend of debt to equity should be maintained. The ratio through which he balances the mix of debt applied on the capital mix offers benefits to the equity shareholders is known as Trading on equity.

$$\textbf{Financial Leverage} = \frac{\text{Operating income /EBIT}}{\text{EBT}}$$

2. Operating Leverage: There are two major classifications of costs in the organization. They are (a) Fixed Cost, (b) Variable Cost.
The operating leverage has a bearing on fixed costs. There is a tendency of the profits to change, if the firm employs more of fixed costs in its operation process, greater will be the operating cost irrespective of the size of the production. The operating leverage will be at a low degree when fixed cost are less in the production process. Operating leverage shows the ability of a firm to use fixed operating costs to increase the effect of change in sales on its operating profits.

$$\textbf{Operating Leverage} = \frac{\text{Contribution}}{\text{(EBIT) Operating Profi}}$$

3. **Combined Leverage:** This leverage shows the relationship between a change in sales and the corresponding variation in taxable income. If the management feels that a certain percentage change in sales would result in percentage change to taxable income, they would like to know thelevel or degree of change and hence they adopt this leverage.

Combined Leverage =Operating Leverage (*) Financial Leverage

DIFFERENCE BETWEEN OPERATING AND FINANCIAL LEVERAGE

operating leverage	Financial leverage
1. It is related to the investment activities (capital expenditure decision)	1. It is more concerned with financial matters (mixing of debt equity in capital structure)
2. The fluctuation in the EBIT can be predict with the help of operating leverage	2.The changes of EPS can be predicted by financial leverage
3. Financial manager uses the operating leverage to identify the items of assets side of the balance sheet	3.The uses of financial leverage to make decisions in the liability side of the balance sheet
4. Operating leverage is used to predict business risk	4. Financial leverage is used to analyse the financial risk

OPTIMUM CAPITAL STRUCTURE

It means the capital strucutre or combination of debt and equity that leads the maximum value of the firm. Optimal capital strucutre maximize the value of the company at hence the wealth of its owners and minimizes the company cost of capital. There every firm should aim at achieving the optimal capital strucutyre and then to maintain it.

The following consideration should be kept in mind while maximizing the value of the firm is achieving the good of optimal capital structure

1. **Return on investment:** If the return on investment is higher than the fixed cost of funds having a fixed cost such as Debentures, loans and preference shares. it increases space earnings per share and market value.
2. **Debts as a source of finance:** when debt is used as a source of finance. the firm saves a considerable amount in payment to tax as interest is allowed as deductible expenses in computation of tax.
3. **Avold high financial risk:** The firm should avoid undue financial risk attached with the use of increased debt financing If the shareholder perceive high risk is using future debt capital it with reduce the market price of shares.
4. **Capital structure should be flexible:** The firm should prepare capital structure that should be flexible as per change in circumstance of the firm.

UNIT-4

CAPITAL BUDGETING

Definition: The Investment Decision relates to the decision made by the investors or the top-level management with respect to the amount of funds to be deployed in the investment opportunities. The decision of investing funds in the long-term assets is known as Capital Budgeting.
Thus, Capital Budgeting is the process of selecting the asset or an investment proposal that will yield returns over a long period.

The first step involved in Capital Budgeting is to select the asset, whether existing or new on the basis of benefits that will be derived from it in the future.

The next step is to analyse the proposal's uncertainty and risk involved in it. Since the benefits are to be accrued in the future, the uncertainty is high with respect to its returns. Finally, the minimum rate of return is to be set against which the performance of the long-term project can be evaluated.

Capital Budgeting Techniques

Definition: The Capital Budgeting Techniques are employed to evaluate the viability of long-term investments. The capital budgeting decisions are one of the critical financial decisions that relate to the selection of investment proposal or the course of action that will yield benefits in the future over the lifetime of the project.

Since the capital budgeting is related to the long-term investments whose returns will be fetched in the future, certain traditional and modern capital budgeting techniques are employed by the firm to judge the feasibility of these projects.

The traditional method relies on the non-discounting criteria that do not consider the time value of money, whereas the modern method includes the discounting criteria where the time value of money is taken into the consideration.

Traditional Methods

The traditional methods comprise of the following evaluation techniques:

1. Payback Period Method
2. Average Rate of Return or Accounting Rate of Return Method

Modern Methods

The modern methods comprise of the following evaluation techniques:

1. Net Present Value Method
2. Internal Rate of Return
3. Modified Internal Rate of Return
4. Profitability Index

Payback Period

Definition: The Payback Period helps to determine the length of the required to recover the initial cash outlay in the project. Simply, it is the method used to calculate the time required to earn back the cost incurred in the investments through the successive cash inflows.

The formula to calculate it:

Payback Period=Initial Outlay/Cash Inflows

Accept-Reject Criteria: The projects with the lesser payback are preferred

Merits of Payback Period

1. It is very simple to calculate and easy to understand.
2. This method is helpful to analyze risk, ie. to determine how long the investments will be at risk.
3. It is beneficial for the industries where the investments become obsolete very quickly.
4. It measures the liquidity of the projects.

Demerits of Payback Period

1. The major drawback of this method is that it ignores the Time Value of Money.
2. It does not take into consideration the cash flows that occur after the payback period.
3. It does not show the liquidity position of the company, but only tells the ability of a project to return the initial outlay.
4. It does not measure the profitability of the entire project since it only focuses on the time required to recover the initial investment cost.
5. This method does not consider the life-span of investment, what if the life of an asset gets over very much before the initial investment cost is realized.

Average Rate of Return:

Definition: The Average Rate of Return or ARR, measures the profitability of the investments on the basis of the information taken from the financial statements rather than the cash flows. It is also called as Accounting Rate of ReturnThe formula for calculating the average rate of return is

Average Rate of Return Average Income/ Average Investment over the life of the project

Where, Average Income Average= average of post tax operating Profit

Average Investment = (Book value of investment in the beginning + book value of investmentsat the of post-tax operating end)/2

Accept-Reject Criteria: The projects having the rate of return higher than the minimum desired returns are accepted.

Merits of Average Rate of Return

1. It is very simple to calculate and easy to understand
2. The measures the profitability of the entire project since it considers the cash flows throughout the life of the project.
3. It is based on the accounting information which is readily available and easily understood by the businessmen.

Demerits of Average Rate of Return

1. It is based on the accounting information and not on the actual cash flows since the cash flow approach is considered superior to the accounting approach.
2. It does not take into consideration, the Time Value of Money
3. It is inadequate to differentiate between the projects on the basis of amounts required for the investment, in case the proposals have the same rate of return.

Net Present Value

Definition: The Net Present Value or NPV is a discounting technique of capital budgeting wherein the profitability of investment is measured through the difference between the cash inflows generated out of the cash outflows or the investments made in the project.

Formula for NPV

NPV Total Present Values - Initial Investment

Accept-Reject Criteria: If the NPV is positive, the project is accepted.

Merits of Net Present Value

1. It takes into consideration the Time Value of Money.
2. It measures the profitability of the entire project by considering the profits throughout its life.
3. It is easy to alter the discount rate, by just changing the value of the denominator.
4. This method is particularly suitable for the mutually exclusive projects
5. It is consistent with the objective of maximizing the net wealth of the company.

Demerits of Net Present Value

1. The forecasting of cash flows is difficult because of several uncertainties involved in the operations of the firm.
2. It is difficult to compute the discount rate precisely. And this is one of the crucial factors in the computation of net present value as with the change in the discount factor the NPV results also changes.
3. Another problem is that it is an absolute measure, it accepts or rejects the projects only on the basis of its higher value irrespective of the cost of initial outlay.

Profitability Index

Definition: The Profitability Index measures the present value of returns derived from per rupee invested. It shows the relationship between the benefits and cost of the project and therefore, it is also called as, Benefit-Cost Ratio.

The profitability Index helps in giving ranks to the projects on the basis of its value, the higher the value the top rank the project gets. Therefore, this method helps in the Capital Rationing.

The formula to calculate the Profitability Index is:

Pl-Present value of future cash inflows/ Presentvalue of cash outflows

Accept-Reject Criteria: The project is accepted when the value of PI exceeds 1. If the value is equal to 1, then the firm is indifferent towards the project and in case the value is less than I the proposal is rejected.

Merits of Profitability Index

1. It takes into consideration, the Time Value of Money
2. The profits are considered throughout the life of the project,
3. This method helps in giving the ranks to the projects.
4. It helps in assessing the risk involved in cash inflows through the cost of capital.
5. It also helps in assessing the increase or decrease in the firm's value due to the investments.

Demerits of profitability Index

1. Unlike the NPV, the Profitability Index may sometimes do not offer the correct decision with respect to the mutually exclusive projects.
2. The cost of capital is must to compute this ratio.

INTERNAL RATE OF RETURN

Definition: The Internal Rate of Return or IRR is a rate that makes the net present value of any project equal to zero. In other words, the interest rate that equates the present value of cash inflow with the present value of cash outflow of any project is called as Internal Rate of Return.

Accept- Reject criteria: If the project's internal rate of return is greater than the firm's cost of capital, accept the proposal.

Merits of Internal Rate of Return

1. IRR takes into account the Time Value of Money.
2. It considers the cash flows over the entire life of the project.
3. IRR is consistent with the goal of wealth maximization.
4. While computing the NPV the discount rate taken is normally the cost of capital, but in the case of IRR, there is no need for the cost of capital because the rate of return generated by the project itself is used to evaluate the efficiency of the project. Thus, the rate is internal to the project.

Demerits of Internal Rate of Return

1. It is quite difficult and involves tedious calculations.
2. IRR produces multiple discount rates, which might be confusing.
3. While evaluating the mutually exclusive proposals, the project having the highest value is chosen over the other that may not be necessarily the most profitable or be in line with the objectives of the firm of wealth maximization.
4. It is assumed that the cash flows are reinvested at an internal rate of return.

DIVIDEND POLICY

1. **Give meaning of Dividend?**

Dividend is the portion of earnings which is distributed among the shareholders is known as dividend.

2. **What do you mean by dividend policy?**

Dividend policy is the process of determine the division of earnings between payments to shareholders and retained earnings.

3. **Brief the different forms/types of dividends.**

Following are the different types of dividends:

Scrip Dividend: When earnings of the company good for dividend, but the company's cash position is temporarily weak and does not permit cash dividend, it may declare dividend in the form of scrip. In this method of dividend, the shareholders are issued transferable promissory notes which may or not be interest bearing.

Bond Dividend: Sometimes, the dividends are paid in bond or notes than have a long enough term to fall beyond the current liability group. Effect of both scrip and bond dividend is the same except that the payment is postponed in the bond dividends.

Property Dividends: This involves a payment with assets other than cash. This form of dividend may be followed wherever there are assets that are no longer necessary in the operation of the business.

Cash Dividend: Cash dividend is the dividend which is distributed to the shareholders in cash out of the earnings of the business.

Stock Dividend: It is the dividend which is paid to the shareholders in kind i.e., additional shares to the existing shareholders instead of cash.

4. What is Stock Dividend? State the reasons for issuing stock dividend and state the merits and demerits of Stock Dividend?

It is the dividend which is paid to the shareholders in kind ie, additional shares to the existing shareholders instead of cash. Such shares are known as bonus shares and this process is known as capitalization of profit. This dividend is declared to only Equity shareholders and it may take two forms:

Making the partly paid equity share fully paid up without asking for cash to the shareholders or issuing or allotting equity shares to existing shareholders in a definite proportion out of profit or surplus of the company.

Reasons for issuing Stock dividend (OR) Objectives of Stock Dividend

a. Conservation of cash
b. Lower rate of dividend
c. Financing expansion programmes
d. Transferring the formal ownership of surplus and reserves to the shareholders
e. Enhancing prestige
f. Widening share market
g. True presentation of earning capacity

Advantages of Stock Dividend (OR) Bonus Share:

a. **Maintenance of Liquidity position:** By issuing bonus share, company does not pay cashto the shareholders and by this company can maintain its liquidity position
b. **Satisfaction of shareholders:** By issue of bonus shares, the equity of shareholders in thecompany increase and confidence of investors will increase in the soundness of the company.
c. **Economical issue of capitalization:** The issue of bonus shares involves minimum cost and hence it is the most economical issue of securities.
d. **Enhance prestige:** By issuing bonus share, the company increases its credit standing andits borrowing capacity goes high in the eyes of lending institutions.
e. **Increases in their equity:** By issuing bonus shares, the equity shareholders is increased inthe company.
f. **Marketability of shares increases:** When the company issues bonus shares, the marketability of its shares is increases. By this the shareholders are benefited.
g. **Increase demand for shares:** When a company issue bonus share, its image increases, hence there will be increase in demand for the shares of the company.

5. What is dividend policy? Explain factors which determine the dividend policy?

Dividend policy is the process of determine the division of earnings between payments to shareholders and retained earnings,

Following are the factors determine the dividend policy:

Stability of earnings: If earnings are relatively stable, a firm is in a better position to predict what its future earnings will be and such companies are more likely to pay out a higher percentage of its earnings in dividends than a concern which has fluctuating earnings.

Financing policy of the company: Dividend policy may be affected and influenced by financing policy of the company. If the company decides to meet its expense from its earnings, then it will have to pay less dividend to shareholders.

Liquidity of Funds: The liquidity of funds is an important consideration in dividend decisions.

According to Guthmann and Dougall, although it is customary to speak to paying dividends out of profits, a cash dividend only be paid from money in the bank. The presence of profits is an accounting phenomenon and a common legal requirement, with the cash and working capital position is also necessary in order to judge the ability of the corporation to pay a cash dividend.

Dividend, policy of competitive concerns: Another factor which influences is the dividend policy of other competitive concerns in the market. If the other competing concern, are paying higher rate of dividend than this concern, the shareholders may prefer to invest their money in those concern rather than in this concern.

Past Dividend Rate: If the firm already exists, the dividend rate may be decided on the basis of dividends declared in the previous year. It is better for the concern to maintainability in the rate of dividend and hence, generally the directors will have to keep in mind the rate of dividend declared in the past.

Debt Obligations: A firm which has incurred heavy indebtedness, is not in a position to pay higher dividends to shareholders. Earning retention is very important for such concerns which are following a programme of substantial debt reduction.

Ability to Borrow: Every company requires finance both for expansion programmes as well as for meeting unanticipated expenses. Hence, the companies have to borrow from the market, well established and large firms have better access to the capital market than new and small, firms and hence, they can pay higher rate of dividend.

Growth needs of the company: Another factor which influences the rate of dividend is the growth needs of the company. In case the company has already expanded considerably, it does not require funds for further expansions.

Profit Rate: Another important consideration for deciding the dividend is the profit rate of the firm. The internal profitability rate of the firm provides a basis for comparing the productivity of retained earnings to the alternative return which could be earned elsewhere.

Legal requirements: while declaring dividend, the board of directors will have to consider the legal restriction. The Indian companies act 1956, prescribes certain guidelines in respect of declaration and payment of dividends and they are to be strictly observed by the company for declaring dividends.

Policy of control: Policy of control is another important factor which influences dividend policy. If the company feels that no new shareholders should be added, then it will have to pay less dividends. Generally, it is felt, that new shareholders, can dilute the existing control of the management over the concern.

Corporate taxation policy: Corporate taxes affect the rate of dividends of the concern. High rates of dividend are affected.

Tax position of shareholders: The tax position of shareholders is another influencing factor on dividend decisions. In a company if a large number of shareholders have already high income from other sources and are bracketed in high dividends because the large part of the dividend income will go away by way of income tax, hence they prefer capital gains to cash gains that is dividend capital gains.

Effect of Trade Cycle: Trade cycle also influences the dividend policy of the concern. For example, during the period of inflation, funds generated from depreciation may not be adequate to replace the assets. Consequently, there is a need for retained earnings in order to preserve the earnings power of the firm

Attitude of the interested Group: A concern may have certain group of interested and powerful shareholders. These people have certain attitude towards payment of dividend and have a definite say in policy formulation regarding dividend payments. If they are not interested in higher rate of dividend, shareholders are not likely to get that.

6. What is stable dividend policy? Explain the advantages and disadvantages of dividend policy stable

Meaning: Stability or regularity of dividend is regarded as a desirable policy by the management of most business concerns. Most of the shareholders also prefer stable dividends because all other things being the same, stable dividends have a positive impact on the market price of the share.

Advantages of Stable Dividend Policy:

A stable dividend policy is advantageous to both the investors and the company on account of the following.

a. It is sign of continued normal operations of the company
b. It stabilizes the market value of shares
c. In creates confidence among the investors
d. In provides a source of livelihood to those investors who view dividends as a source offunds to meet day to day expense
e. It meets the requirements of institutional investors who prefer companies with stabledividends
f. It improves the credit standing and makes financing easier
g. It results in a continuous flow to the national income stream and thus helps in thestabilization of national economy.

Disadvantages of Stable Dividend policy:

Once the stable dividend policy is followed by a company, it is not easier to change, in case if company changes shareholders will be disappointed and they may withdraw their investment.

If the stable dividend policy changes it adversely affect the market price of the share in times of lower profits or losses.

FEATURES OR SIGNIFICANCE OF CAPITAL BUDGETING

- **Growth:** Fixed assets are earning assets, since they have decisive influence on the rate of return and direction of the firm's growth. A wrong decision can affect other projects, which are already running under profits. In other words, unwanted or unprofitable investments will result in heavy operating costs.

- **More Risky:** Investment in long-term assets increases average profit but it may lead to fluctuations in its earnings, then the firm will become more risky. Hence, investment decision decides the future the business concern.

- **Huge Investments:** Long-term assets involve more initial cash outflows, which make the firm imperative to plan its investment programmes very carefully and make an advance arrangement of funds either from internal sources or external sources or from both sources.

- **Irreversibility:** Long-term assets investments decisions are not easily reversible without much financial loss to the firm; due to the difficulty in finding a market for such used capital items. Hence, the firm will incur more loss in that type of capital assets.

- **Effect on Other Projects:** Whenever there is investment in long-term assets under expansion programme, its cash flows affect the projects under consideration, if it is not economically independe the effect may be an increase in the profits or a decrease in profits.

- **Difficult Decision:** Capital budgeting decision is very difficult due to: (a) the decision depends on the expected future cash inflows and (b) the uncertainty of the future and more risk.

STEPS / PROCESS OF CAPITAL BUDGETING

- **Idea Generation:** The search for promising project ideas is the first step in the capital budgeting process. In other words, the planning phase of a firm's capital budgeting process is concerned with articulation of its broad investment strategy and the generation and preliminary search of project proposals. Identifying a new worthwhile project is a complex problem.

- **Evaluation or Analysis:** In the preliminary screening when a project proposal suggests that the project is prima facie worthwhile, then it is required to go for evaluation. Analysis has to done from the aspects like, marketing, technical, financial, economic and ecological analysis. This phase focuses on gathering data, preparing, summarising relevant information about various alternatives projects available, which are being considered for inclusion in the capital budgeting process. Costs and benefits are determined based on the information gathered from all alternative projects.

- **Selection:** Selection or rejection of a project follows analysis phase. Projects are evaluated by using a wide range of evaluation techniques, which are divided into traditional (non-discounted) and modern (discounted). Selection or rejection of a project depends on the techniques used to evaluate and its acceptance rule. The acceptance rules are different for each and every method. Apart from the use of techniques of evaluation there are few techniques available for measurement (range, standard deviation, coefficient of variation) and incorporation of risk (risk-adjusted discount rate, certainty equivalent. probability distribution approach and decision tree approach) in capital budgeting.

- **Financing the Selected Project:** After the selection of the project, the next step is financing. Generally, the amount required is known after selection of the project. Under this phase financing arrangements have to be made. There are two broad sources available such as equity (shareholders funds-paid-up share capital, share premium, and retained earnings) and debt (loan funds - term loans, debentures, and working capital advances). While deciding the capital structure, the decision-maker has to keep in mind some factors, which influence capital structure.

- **Execution or Implementation:** Planning is paper work and implementation is physically implementing the selected project. Implementation of an industrial project involves the stages like, engineering designs, negotiations and contracting, construction, training, and plant commissioning Translating an investment proposal from paper work to concrete work is complex, time consuming and a risky task.

- **Review of the Project:** Once the project is converted from paper work into concrete work, then there is a need to review the project. Performance review should be done periodically, in which phase the actual performance is compared with the predetermined performance.

UNIT-5
WORKING CAPITAL MANAGEMENT

1. **Give Meaning and Definition of Working Capital.**
   Working capital is the capital required to do the day-to-day business is called working capital OR Excess of Current assets over current liabilities are called as working capital.

2. **Mention objectives of working capital (OR) Need for working capital.**
   Every business needs some amount of working capital. The need for working capital arises due to time gap between production and realization of cash from sales. There is an operating cycle involved in the sales and realization of cash. There are gaps in purchase of raw materials and production, production and sales and sales and realization of cash.

   Thus, working capital is needed for the following purposes:

   For the purchase of raw materials, components and spares:

   - To pay wages and salaries
   - To incur day-to-day expenses and overhead costs such as fuel, power and office expenses etc.
   - To meet the selling costs as packing, advertising etc.
   - To provide credit facilities to the customers
   - To maintain the inventories of raw materials, work-in progress, stores and spares andfinished stock

3. Explain the kinds of working capital.
Following are the kinds of working capital:

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

Gross Working Capital; Gross working capital is the amount of funds invested in the various components of currents assets (OR) The aggregate of all currents assets is called Gross working capital.

Permanent Working Capital. Permanent working capital is the minimum amount of current assets which is needed to conduct a business even during the dullest season of the year. This amount varies from year to year.

Temporary or Variable working capital. It represents the additional assets which are required at different times during the operating year additional inventory, extra cash etc., Seasonal working capital is the additional amount of current assets particularly cash, receivable and inventory which are required during the more active business seasons of the year.

Balance sheet working capital: The balance sheet working capital is one which is calculated from the item appearing in the balance sheet. Gross working capital, which is represented by the excess of current assets and net working capital.

Cash working capital: Cash working capital is one which is calculated from the items appearing in the profit and loss account. It shows the real flow of money or value at a particular time and is considered to be the most realistic approach in working capital management. Negative Working Capital: Negative working capital emerges when current liabilities exceed current assets. Such a situation is not absolutely theoretical, and occurs when a firm is nearing of some magnitude.

Negative working capital: negative working capital emerges when current liablities exceed current assets. Such a situation is not absolutely theoretical and occurs when a firm is nearing of some magnitude.

4. **Explain the factors determining the working capital requirement.**

Following are the determinants of working capital:

Nature of Industry: The composition of assets is a function of the size of a business and the industry to which it belongs. Small companies have smaller proportions of cash, receivables and inventory than large corporations. This difference becomes more marked in large organization.

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

Cash requirement: Cash is one of the current assets which is essential for successful operations of the production cycle. Cash should be adequate and properly utilized. It would be very expensive to hold excessive cash. A minimum level of cash is always required to keep the operations going. Adequate cash is also required to maintain good credit relations.

Nature of Business: The nature of a business is an important determinant of the level of the working capital. Working capital requirements depend upon the general nature or type of business. They are relatively low in public companies, in which inventories and receivables relatively low in public companies, are rapidly covered into cash.

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

Volume of sales. This is the most important factor affecting the size and components of working capital. A firm maintains current assets because they are needed to support the operational activities which result in sales. The volume of sales and size of the working capital are directly related to each other. As the volume of sales increases, there is an increase in the investment of working capital in the cost of operations, in inventories and in receivables.

Terms of purchase and sales: If the credit terms with respect to purchase are more favorable and those of sales less liberal, less cash will be invested in inventory. With more favorable credit terms, working capital requirement can be reduced.

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

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

Production Schedule: The production schedule of an organization requires systematic planning and organization of raw materials for continuous production.

Business Cycle: Business expands during periods of prosperity and declines during the period of depression. Consequently, more working capital is required during periods of prosperity and less during the periods of depression.

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

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

Production Cycle. The time taken to convert raw materials into finished stock is referred to as the production cycle or operating cycle. The longer the production cycle larger is the requirement of working capital and visa versa.

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

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

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

Profit planning and Control: The level of working capital is decided by the management in accordance with its policy of profit planning and control. Adequate profit assists in substantial generation of cash.

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

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

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

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

Firm's policies: These affect the levels of permanent and variable working capital changes in credit policy, production policy etc, are boundto affect the size of the working capital.

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

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

5. What is permanent variable working capital? And explain the Dangers of excessive working capital and also inadequate working capital.

Temporary or Variable working capital; It represents the additional assets which are required at different times during the operating year additional inventory, extra cash etc., Seasonal working capital is the additional amount of current assets particularly cash, receivable and inventory which are required during the more active business seasons of the year.

Dangers of excessive working capital:

- Too much working capital is as dangerous as too little of it. Excessive working capitalraises the following problems.
- A company may be tempted to overtrade and lose heavily
- A company may keep very big inventories and tie up its funds unnecessarily.
- There may be an imbalance between liquidity and profitability
- A company may enjoy high liquidity and at the same time, suffer from low profitability
- High liquidity may induce a company to undertake greater production which may not have a matching demand. It may find itself in an embarrassing position unless its marketing policies are properly adjusted to boost up the market for its goods.
- A company may invest heavily in its fixed equipment which may not be justified by actual sales or production.
- Excessive working capital may be a unfavourable as inadequacy of working capitalbecause of the large volume of funds not being used productively.

Dangers of Inadequate working capital;

- It is not possible for it to utilize production facilities fully for the want of working capital
- A company may not be able to take advantage of cash discount facilities.
- The credit worthiness of the company is likely to be jeopardized because of lack of

liquidity.

- A company may not be able to take advantage of profitable business opportunities
- The modernization of equipment and even routine repairs and maintenance facilities may be difficult to administer
- A company will not be able to pay its dividends because of the non-availability offunds.
- A company cannot afford to increase its cash sales and may have to restrict its activitiesto credit sales only.
- A company may have to borrow funds at exhorbitant rates of interest.

6. What is the importance (OR) Advantages of adequate working capital?

The main advantages of maintaining adequate working capital are as follows**:**

Solvency of the Business: Adequate working capital helps in maintaining solvency of the business by providing uninterrupted flow of production. Goodwill: Sufficient working capital enables a business concern to make prompt payments and hence helps in creating and maintaining goodwill.

Easy loans: A concern having adequate working capital, high solvency and good credit standing can arrange loans from banks and others on easy and favourable terms.

Cash discounts: Adequate working capital also enables a concern to avail cash discounts on the purchase and hence it reduces costs.

Regular supply of raw materials: Sufficient working capital ensures regular supply of raw materials and continuous production.

Regular payment of salaries, wages and other day to day commitments: A company which has ample working capital can make regular payment of salaries, wages and other day to day commitments which raises the morale of its employees, increases their efficiency, reduceswastages and costs and enhances production and profits

Exploitation of favourable market conditions: Only concerns with adequate working capital can exploit favourable market conditions such as purchasing its requirements in bulk when the prices are lower and by holding its inventories for higher prices.

Ability to face crisis: Adequate working capital enables a concern to face business crisis in emergencies such as depression because during such periods, generally there is much pressure on working capital

Quick and regular return on investments: Every investor wants a quick and regular return on his investments. Sufficiency of working capital enables a concern to pay quick and regular dividends to its investors as there may not be much pressure to plough back profits.

7. What are the different sources of Working Capital?

The following are the different sources of working capital:

Cash Credit: It refers to the credit extended by the suppliers of goods in the normal course of business. This an important source of short-term finance. It is most granted on open account basiswhereby suppliers sends goods to the buyer for the payment to be received in future as per terms of the sales invoice.

Accrued Expenses and Deferred Income: These are incomes received in advance before supply of goods or services. They represent funds received by a firm and constitute an important source of short-term finance. However, firms having great demand for its products and services, and those having good reputation in the market can demand deferred incomes.

Banking Borrowings: Commercial banks are the most important source of short-term capital. The major portion of working capital loans are provided by the commercial banks. They provide wide variety of loans tailored to meet the specific requirements of a concern. The different forms in which banks normally provides loans and advances are as follows:

Loans: When a bank makes an advance in lump-sum against some security it is called a loan. The entire loan amount is paid to the borrower either in cash or by credit to his account. The borrower is required to pay interest on the entire amount of loan from date of sanction.

Cash Credit: It is an arrangement by which a bank allows his customer to borrower money up to a certain limit against some tangible security or guarantee. The customer can withdraw from his cash credit limit according to his needs and he can also deposit any surplus amount with him. The interest is charged on daily balance.

Overdraft: It is an agreement with bank by which a current account holder is allowed to withdraw more than the balance to his credit up to certain limit. There are no restrictions for operation of overdraft limits. The interest is charged on daily overdrawn balances. It is allowed for very short period.

Purchasing and Discounting of bills: This is the most important form in which a bank lends without any collateral security. The seller draws a bill of exchange on the buyer of goods on credit. Such a bill may either be a clean bill or documentary bill which is accompanied by documents of title of goods such as railway receipt or letter of credit etc.

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Name of the Program: Bachelor of Commerce (B.Com.)

Course Code: COM.5.1

Name of the Course: Financial Management

Course Credits	No. of Hours per Week	Total No. of Teaching Hours
4 Credits	4 Hrs.	56 Hrs.

Pedagogy: Classroom lectures, Case studies, Tutorial Classes, Group discussion, Seminar & field work etc.,

Course Outcomes: On successful completion of the course, the students will be able to

a) Understand the Role of Financial Managers effectively in an organization.
b) Apply the compounding & discounting techniques for time value of money.
c) Take investment decision with appropriate capital budgeting techniques for investment proposals.
d) Understand the factors influencing the capital structure of an organization.
e) Understand the factors influencing the working capital requirements of an organization

Syllabus:	Hours
Module No. 1: Introduction to Financial Management	**10**
Introduction: Meaning of Finance-Finance Function-Objectives of Finance function-Organization of Finance function. Financial Management: Meaning and definition of Financial Management- Goals of Financial Management-Scope of Financial Management-Functions of Financial Management-Role of Finance Manager in India. Financial planning: Meaning –Need – Importance -Steps in financial Planning – Principles of a sound financial plan and Factors affecting financial plan.	
Module No. 2: Time Value of Money	**10**
Introduction – Meaning of time value of money-time preference of money- Techniques of time value of money: Compounding Technique-Future value of Single flow. Multiple flow and Annuity – Perpetuity-Discounting Technique-Present value of Single flow, Multiple flow – and Annuity. (Theory and Problems)	
Module No. 3: Capital Structure and Leverages	**12**
Introduction-Meaning and Definition of Capital Structure, Factors determining the Capital Structure, Concept of Optimum Capital Structure, EBIT-EPS Analysis. Leverages: Meaning and Definition, Types of Leverages- Operating Leverage, Financial Leverage and Combined Leverages. (Theory and Problems)	
Module No. 4: Capital Budgeting	**14**
Introduction-Meaning and Definition of Capital Budgeting, Features, Significance – Steps in Capital Budgeting Process. Techniques of Capital budgeting: Traditional Methods – Pay Back Period, and Accounting Rate of Return – DCF Methods: Net Present Value- Internal Rate of Return and Profitability Index- (Theory and Problems).	
Module 5: Working Capital Management	**10**
Introduction- Meaning and Definition, types of working capital, Operating cycle, Determinants of working capital needs-Sources of working capital- Merits of adequate working capital -Dangers of excess and inadequate working capital. (Theory only).	