UNIT -IV

CAPITAL AND CAPITAL BUDGETING

Capital is defined as wealth, which is created over a period of time through abstinence to spend. There are different forms of capital property, cash or titles to wealth. It is the aggregate of funds used in the short run and long run. An economist views capital as the value total assets available with the business. An accountant sees the capital as the different between the assets and liabilities.

Significance of capital

1. **To promote a business**: Capital is required at the promotion stage. A large variety of expenses have to be incurred on project reports, feasibility studies and reports, preparation and filing of various documents, and for meeting various other expenses in connection with the raising of capital from the public.
2. **To conduct business operations smoothly**: Business firms also need capital for the purpose of conducting their business operations such as research and development, advertising, sales promotion, distribution and operation expenses.
3. **To expand and diversify:** The firm requires a lot of capital for expansion and diversification purposes. This includes development expense such as purchase of sophistical machinery and equipment and also payment towards sophisticated technology.
4. **To meet contingencies**: A firm needs funds to meet contingencies such as sudden fall in sales, major litigation, nature calamities like fire, and so on.
5. **To pay taxes**: The firm has to meet its statutory commitments such as income tax and sales tax, excise duty and so on.
6. **To pay dividends and interests:** The business has to make payment towards dividends and its interest to shareholders and financial institutions respectively.
7. **To replace the assets:** The business needs to replace its assets like plant and machinery after a certain period of use. For this purpose the firm needs funds to make suitable replacement of assets in place of old and worn out assets.
8. **To support welfare programmes**: The company may also have to take up social welfare programmes such as literacy drive, and health camps, It may have to donate to charitable trusts, educational institutions or public services organizations.
9. **To wind up**: At the time of winding up, the company may need funds to meet liquidation expenses

Types of capital

A) Fixed capital
B) Working capital

FIXED CAPITAL

Fixed capital is that portion of capital which invested in acquiring long term assets such as land and buildings, plant and machinery, furniture and fixtures, and so on, fixed capital forms the skeleton of the business. It provides the basic assets as per the business needs.

Features of fixed assets:

1. **Permanent in nature**: fixed capital is more or less permanent in nature, it is generally not withdrawn as long as the business carries on its business.
2. **Profit generation**: fixed asset are the sources of profits but they can never generate profits by themselves. They use stocks, cash and debtors to generate profits.
3. **Low liquidity**: the fixed assets cannot be converted into cash quickly. Liquidity refers to conversion of assets into cash.
4. **Amount of fixed capital** : the amount of fixed capital of a company depends on a number of factors such as size of the company, nature of business, method of production and so on. A manufacturing company such as steel factory may require relatively large finance when compared to a service organization such as a software company.
5. **Utilized for promotional and expansion**: the fixed capital is mostly needed at the time of promoting the company to purchase the fixed assets or at the time of expansion. In other words, the need for fixed capital arises less frequently.

Types of fixed assets

1. **Tangible fixed assets** : these are physical items which can be seen and touched. Most of the common fixed assets are land, buildings, machinery, motor vehicles, furniture and so on.
2. **Intangible fixed assets** : these do not have physical form. They cannot be seen or touched. But these are very valuable to business. Examples are goodwill, brand names, trademarks, patents, copy rights and so on.
3. **Financial fixed assets** : these are investments in shares, foreign currency deposits, government bonds , shares held by the business in other companies and so on.

WORKING CAPITAL

Working capital is the flesh and blood of the business. It is that portion of capital that makes a company work. It is not just possible to carry on the business with only fixed assets. Working capital is a must, working capital is also called circulating capital. It is used to meet regular or recurring needs of the business. The regular needs refer to the purchase of materials, payment of wages and salaries, expenses like rent, advertising, power and so on. In short, working capital is the amounts needed to cover the cost of operating the business.

Definition of working capital

Working capital define as a current assets excess of current liabilities

Its also define in mathematically formula as

working capital = current assets – current liabilities

features of working capital

1. Short life span: working capital changes in its form cash to stock, stock to debtors, debtors to cash, the cash balances may be kept idle for a week or so, debtors have a life span of a few months , raw materials are held for a short – time until they go into production, finished goods as held for a short – time until they are sold.
2. Smoothly flow of operations: adequate amount of working capital enables the business to conduct its operations smoothly. It is there fore, called the flesh and blood of the business.

3. Liquidity: the assets represented by the working capital can be converted into cash quickly within a short period of time unlike fixed assets.
4. Amount of working capital: the amount of working capital of a business depends on many factors such as size and nature of the business, production and marketing policies, business cycles and so on.
5. Utilized for payment of current expenses: the working capital is used to pay for current expenses such as suppliers of raw materials, payment of wages and salaries, rent and other expenses and so on.

Components of working capital:

Current assets: current assets are those assets which are converted into cash with in accounting period or within the year. For example, cash in hand, cash at bank, sundry debtor, bill receivable, prepaid expenses etc.

Current liabilities: current liabilities are those liabilities to pay outside with in the year. For example sundry creditor, bill payable, bank overdraft, outstanding expenses.

Gross working capital:

In the broader sense, the term working capital refers to the gross working capital. The notion of the gross working capital refers to the capital invested in total current assets of the enterprise. Current assets are those assets, which in the ordinary course of business, can be converted into cash within a short period, normally one accounting year.

Net working capital:

In a narrow sense, the term working capital refers to the net working capital. Networking capital represents the excess of current assets over current liabilities

METHODS AND SOURCES OF FINANCE

Methods of finance

1. Long term finance
2. Medium term finance
3. Short term finance

SOURCES OF FINANCE

1. **Long term finance**: long term finance available for a long period say five years and above. The long term methods outlined below are used to purchase fixed assets such as land and buildings, plant and so on.

a) **Own capital** : irrespective of the form of organization such as soletrader, partnership or a company, the owners of the business have to invest their own finances to start with. Money invested by the owners, partners or promoters is permanent and will stay with the business throughout the life of business.

b) **Share capital** : normally in the case of a company, the capital is raised by issue of shares. The capital so raised is called share capital. The share capital can be of two types, preference share capital and equity share capital.

c) **Debentures**: debentures are the loans taken by the company. It is a certificate or letter by the company under its common seal acknowledging the receipt of loan. A debenture holder is the creditor of the company. A debenture holder is entitled to a fixed rate of interest on the debenture amount.

d) **Government grants and loans**: government may provide long term finance directly to the business houses or by indirectly subscribing to the shares of the companies. The government gives loans only if the project satisfies certain conditions, such as setting up a project in a notified area, or ventures into projects which are beneficial for the society as a whole.

2. Medium term finance

a. Bank loans ; bank loans are extended at a fixed rate of interest. Repayment of the loan and interest are scheduled at the beginning and are usually directly debited to the current account of the borrower. These are secured loans.

b. Hire purchase: it is a facility to buy a fixed asset while paying the price over a long period of time. In other words , the possession of the asset can be taken by making a down payment of a part of the price and the balance will be repaid with a fixed rate of interest in agreed number of installments.

c. Leasing or renting: where there is a need for fixed assets, the asset need not be purchased. It can be taken on lease or rent for specified number of years. The company who owns the assets is called lessor and the company which takes the asset on lease is called lessee. The agreement between the lessor and lessee is called a lease agreement.

d. Venture capital: this form of finance is available only for limited companies. Venture capital is normally provided in such projects where there is relatively a higher degree of risk. For such projects, finance through the conventional sources may not be available. Many banks offer such finance through their merchant banking divisions, or specialist banks which offer advice and financial assistance. The financial assistance may take form of loans and venture capital.

3. <u>SHORT TERM FINANCE</u>

a. Commercial paper: it is new money market instrument introduced in india in recent times. Cps are issued in large denominations by the leading, nationally reputed, highly rated and credit worthy, large manufacturing and finance companies in the public and private sector. The proceeds of the issue of commercial paper are used to finance current transactions and seasonal and interim needs for funds.

b. Bank overdraft: this is special arrangement with the banker where the customer can draw more than what he has in his saving/ current account subject to a maximum limit. interest is charged on a day to day basis on the actual amount overdrawn .

c. Trade credit: this is short term credit facility extended by the creditors to the debtors, normally, it is common for the traders to buy the materials and other supplies from the suppliers on credit basis. After selling the stocks the traders pay the cash and buy fresh stocks again on credit. Sometimes , the suppliers may insist on the buyer to sign a bill.

CASH BUDGET :

Cash Budget refers to the estimation of cash inflows and outflows made by the management of the business entity over a given period where such estimations are made to evaluate whether the business has adequate cash & cash equivalents to meet its operating needs in the near future.

Cash is called the lifeblood of a business, especially when it comes to smaller companies. That is why it is crucial for a business to monitor and report all expenses, gains and investments to control its finances.

IMPORTANCE OF CASH BUDGET

1. Beneficial in Proper Planning

Having a cash budget helps company management make sound strategic choices. The company or organisation would be aware of any potential cash surplus or deficit scenario in the near future. In both cases, it is possible to plan ahead of time to avoid an unexpected crisis or the setback of an investment opportunity.

A cash deficit, on the other hand, can serve as a warning to cut back on spending. It can also arrange funds timely through equity or debt.

2. Helpful in Dealing with Seasonal Variations

A cash budget may be desirable in the long run. However, due to the seasonal nature of businesses, they may still show cash deficits in certain months or periods. Management can carefully plan how to deal with seasonal variations ahead of time. For periods of stress or low sales, proposed cash outflows can be curtailed or avoided in a timely manner. It will aid the company in avoiding a cash deficit.

Furthermore, managers can anticipate periods with a cash surplus. Sitting on idle cash can result in the loss of an investment opportunity. It may result in the company losing out on substantial profits.

3. Increasing the Value of the Brand

A cash budget is a tool for adequately timing the company's expenditures based on its cash resources. As previously stated, it also allows management time to prepare for using surplus cash when it becomes available. In addition, it aids in the timely payment of materials to suppliers, early debt repayment, timely salary disbursement, proper streamlining of production activities to ensure timely customer deliveries, and so on. As a result, the company's goodwill and brand value grow. This, in turn, aids the company's revenues and profits.

BENEFITS OF CASH BUDGET

The cash budget has the following advantages:

- Provides information on varying cash receipts and usage sources
- Provides information on potential future inflows and outflows
- Includes information on excess requirements of cash
- Includes information on how to acquire deficit cash
- Beneficial for contingencies where cash balances are low, as well as in demonstrating ways to fill such gaps
- Ensures that timely payments are being made
- Provides investment of surplus funds for more profit
- Allows for the planning of both short-term as well as long-term loan repayments
- Provides for the establishment of a contingency cash pool to control unplanned outflows of cash

CAPITAL BUDGETING

Capital budgeting is the process of making investment decision in long-term assets or courses of action. Capital expenditure incurred today is expected to bring its benefits over a period of time. These expenditures are related to the acquisition & improvement of fixes assets.

Capital budgeting is the planning of expenditure and the benefit, which spread over a number of years. It is the process of deciding whether or not to invest in a particular project, as the investment possibilities may not be rewarding. The manager has to choose a project, which

gives a rate of return, which is more than the cost of financing the project. For this the manager has to evaluate the worth of the projects in-terms of cost and benefits. The benefits are the expected cash inflows from the project, which are discounted against a standard, generally the cost of capital.

Methods of capital budgeting

The capital budgeting appraisal methods are techniques of evaluation of investment proposal will help the company to decide upon the desirability of an investment proposal depending upon their; relative income generating capacity and rank them in order of their desirability. These methods provide the company a set of norms on the basis of which either it has to accept or reject the investment proposal. The most widely accepted techniques used in estimating the cost-returns of investment projects can be grouped under two categories.

1. Traditional methods
2. Discounted Cash flow methods

1. Traditional methods

These methods are based on the principles to determine the desirability of an investment project on the basis of its useful life and expected returns. These methods depend upon the accounting information available from the books of accounts of the company. These will not take into account the concept of „time value of money‟, which is a significant factor to determine the desirability of a project in terms of present value.

A. Pay-back period method: It is the most popular and widely recognized traditional method of evaluating the investment proposals. It can be defined, as „the number of years required to recover the original cash out lay invested in a project‟.

According to Weston & Brigham, "The pay back period is the number of years it takes the firm to recover its original investment by net returns before depreciation, but after taxes".

According to James. C. Vanhorne, "The payback period is the number of years required to recover initial cash investment.

The pay back period is also called payout or payoff period. This period is calculated by dividing the cost of the project by the annual earnings after tax but before depreciation under this method the projects are ranked on the basis of the length of the payback period. A project with the shortest payback period will be given the highest rank and taken as the best investment.

The shorter the payback period, the less risky the investment is the formula for payback period is

Merits:
1. It is one of the earliest methods of evaluating the investment projects

2. It is simple to understand and to compute.
3. It dose not involve any cost for computation of the payback period
4. It is one of the widely used methods in small scale industry sector
5. It can be computed on the basis of accounting information available from the books.

Demerits:
1. This method fails to take into account the cash flows received by the company after the pay back period.
2. It doesn‟t take into account the interest factor involved in an investment outlay.
3. It doesn‟t take into account the interest factor involved in an investment outlay.
4. It is not consistent with the objective of maximizing the market value of the company‟s share.
5. It fails to consider the pattern of cash inflows i. e., the magnitude and timing of cash in flows.

B. Accounting (or) Average rate of return method (ARR):

It is an accounting method, which uses the accounting information repeated by the financial statements to measure the probability of an investment proposal. It can be determine by dividing the average income after taxes by the average investment i.e., the average book value after depreciation.

According to „Soloman‟, accounting rate of return on an investment can be calculated as the ratio of accounting net income to the initial investment.

Merits:

1. It is very simple to understand and calculate.
2. It can be readily computed with the help of the available accounting data.
3. It uses the entire stream of earning to calculate the ARR.

Demerits:

1. It is not based on cash flows generated by a project.
2. This method does not consider the objective of wealth maximization
3. IT ignores the length of the projects useful life.
4. It does not take into account the fact that the profits can be re-invested.

II: Discounted cash flow methods:

The traditional method does not take into consideration the time value of money. They give equal weight age to the present and future flow of incomes. The DCF methods are based on the concept that a rupee earned today is more worth than a rupee earned tomorrow. These methods take into consideration the profitability and also time value of money.

A. Net present value method (NPV)

The NPV takes into consideration the time value of money. The cash flows of different years and valued differently and made comparable in terms of present values for this the net cash inflows of various period are discounted using required rate of return which is predetermined.

According to Ezra Solomon, “It is a present value of future returns, discounted at the required rate of return minus the present value of the cost of the investment.”

NPV is the difference between the present value of cash inflows of a project and the initial cost of the project.

According the NPV technique, only one project will be selected whose NPV is positive or above zero. If a project(s) NPV is less than „Zero‟. It gives negative NPV hence. It must be rejected. If there are more than one project with positive NPV‟s the project is selected whose NPV is the highest.

NPV = PRESENT VALUE OF CASH INFLOW – PRESENT VALUE OF CASH OUTFLOW

Merits:

1. It recognizes the time value of money.
2. It is based on the entire cash flows generated during the useful life of the asset.
3. It is consistent with the objective of maximization of wealth of the owners.
4. The ranking of projects is independent of the discount rate used for determining the present value.

Demerits:

1. It is different to understand and use.
2. The NPV is calculated by using the cost of capital as a discount rate. But the concept of cost of capital. If self is difficult to understood and determine.
3. It does not give solutions when the comparable projects are involved in different amounts of investment.
4. It does not give correct answer to a question whether alternative projects or limited funds are available with unequal lines.