Module 3 Assignment

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**Module 3 Assignment**

**Q1- Why is the cost of capital the minimum acceptable rate of return on an investment?**

According to Module three the cost of capital is an important financial concept.

It links the company's long-term decisions with the wealth of the shareholders as determined in the market place.

Whenever, a business organizations raises funds, it has to keep in mind its cost.

Hence computation of cost of capital is very important and finance managers must have a close look on it.

The term cost of capital refers to the minimum rate of return which a firm must earn on its investments so that the market value of the company's equity shares does not fall.

The below are the definition and example of it, The rate of return the firm requires from investment in order to increase the value of the firm in the market place".

* The following are the basic characteristics of cost of capital:
* GG Cost of capital is a rate of return, it is not a cost as such.
* HH this return, however, is calculated on the basis of actual cost of different components of capital.
* II A firm's cost of capital represents minimum rate of return that will result in at least maintaining (If not increasing) the value of its equity shares.
* JJ It is related to long term capital funds.
* KK Cost of capital consists of three components:
* Return at Zero Risk Level. (r0)
* Premium for Business Risk (b)
* Premium for Financial Risk (f)
* LL The cost of capital may be put in the form of the following equation:
* K = ro + b + f

Where

* K = Cost of Capital
* ro = Return at Zero Risk Level
* b = Premium for Business Risk
* f = Premium for Financial Risk

**Q2- How is the Cost of Debt Capital ascertained? Give examples**.

The below are the examples of the Capital ascertained debt may be issued at par, or at premium or at of discount. It may be perpetual or redeemable. The technique of computation of cost in each case has been explained in the following paragraphs. (a)

*The formula for computing the Cost of Long Term debt at par is*

Kd = (1 – T) R

Where

Kd = Cost pf long term debt

T = Marginal Tax Rate

R = Debenture Interest Rate

For example, if a company has issued 10% debentures and the tax rate is 50%, the cost of debt will be

(1 - .5) 10 = 5%

(b*) In case the debentures are issued at premium or discount*, the cost of debt should

Be calculated on the basis of net proceeds realized. The formula will be as follows:

I

Kd = ------ (1 – T)

NP

Where

Kd = Cost of debt after tax

I = Annual Interest Payment

NP = Net Proceeds of Loans

T = Tax Rate

|  |  |  |  |
| --- | --- | --- | --- |
| Illustration No. 1: A company issue 10% irredeemable debentures of Rs. 10,000. The company is in 50% tax bracket. Calculate cost of debt capital at par, at 10% discount and at 10% premium | | | |
| Solution : | | | |
| Rs.1,000 | | | |
| Cost of debt at par | = | | ----------------- \* (1 - .50) |
| Rs.10,000 | | | |
| = | | 5% | |
| Rs.1,000 | | | |
| Cost of debt issued at | = ----------------- | | \* (1 - .50) |
| 10% discount | | Rs.9,000 | |
| = | | 5.55% | |
| Rs.1,000 | | | |

### Q3- How will you calculate the Cost of Preferences Share Capital?.

The below is the clear examples of the above a company issued.

Rs. 100 preference shares with a 7% dividend on a price of Rs. 110 with a provision to redeem the capital at the end of 5 year period

Calculate cost of preference share capital.

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| Year | Dividend |  | Principal | Rate | Present Value at 7% |
| 1 | 7 | - | 7 | .935 | 6.545 |
| 2 | 7 | - | 7 | .873 | 6.111 |
| 3 | 7 | - | 7 | .816 | 6.712 |
| 4 | 7 | - | 7 | .763 | 5.341 |
| 5 | 7 | 100 | 107 | .713 | 76.291 |
|  | **35** | **100** | **135** |  | **100** |

There is no need to use any other discount rate. The cost of preference capital is 7%.

**Q4-The following details are available:**

Equity (Expected Dividend 12%) Rs. 1000000

Tax Rate 50%

10% Preference Rs. 500000

8% Loan Rs. 1500000

**Your are required to calculate Weighted Average Cost of Capital?**

**Solution**:

##### WACC is calculated by multiplying the cost of each capital source (debt and equity) by its relevant weight, and then adding the products together to determine the value. In the above formula, E/V represents the proportion of equity-based financing, while D/V represents the proportion of debt-based financing.

1. Total capital = Amount of outstanding debt + Amount of Preference share + Market value of common equity. ...
2. Cost of debt = Interest Expense \* (1 – Tax Rate) ÷ Amount of outstanding debt. ...
3. Weightage of Preference Share = Amount of preference share ÷ Total capital

##### **Q5- What is Net Present Value and how does it change by variation in discount rate?**

The Net present value (NPV) is determined by calculating the costs (negative cash flows) and benefits (positive cash flows) for each period of an investment. The period is typically one year, but could be measured in quarter-years, half-years or months.

Q6- Distinguish between NPV and PI. Which of these you consider better?

The NPV and PI are both based on a given rate of discount and, therefore, the NPV and PI values change as soon as the rate of discount is changing. Hence, any project which is acceptable at, say, 10% rate of discount may not be the same at, say, 12% rate. Therefore, there is need to find out a technique which is autonomous in itself and not dependent upon any externally determined rate of interest. The relationship between, the rate of discount and the NPV can be presented in the following diagram.

**Q7- What are the limitations of using the NPV and IRR methods in practice?**

**Give your assessment**.

The advantage to using the NPV method over IRR using is that NPV can handle multiple discount rates without any problems. Each year's cash flow can be discounted separately from the others making NPV the better method. The two capital budgeting methods have the following differences: Outcome. The NPV method results in a dollar value that a project will produce, while IRR generates the percentage return that the project is expected to create. Purpose The Limitations of NPV It gives the absolute value and therefore, comparison between two different projects is not easy, especially when they are of different sizes.

* (A) Many a times, it is not possible to know in advance the rate of interest at which discounting is to be done. Similarly a given NPV may not be appropriate if the rate of interest has changed.
* (B) It may lead to wrong decision making especially when limited funds are available and we have to choose between different options.

**Q8- What purpose do capital markets serve?**

Capital markets serve two purposes. Firstly, they bring together investors holding capital and companies seeking capital through equity and debt instruments. Secondly, and almost more importantly, they provide a secondary market where holders of these securities can exchange them with one another at market prices

**Q9- What are the factors that would go into deciding whether a company should resort to debt or equity for financing its requirement of long-term funds?**

There are four basic factors that determine how a firm is financed:

(1) The firm's economic potential.

(2) The size and maturity of the company.

(3) The nature of the firm's assets.

(4) The personal preference of the owners as they consider the tradeoffs between debt and equity.

Therefore the Capital Market securities include government bonds issued by the union and state governments, corporate bonds issued by corporations and companies, mortgages issued by households, corporate bodies or individuals, and equity shares issued by companies.

Bonds are long-term debt obligations issued by governments and corporate bodies to support their operations. Mortgages are long-term debt obligations created to finance the purchase of real estate. Stocks (also called equity securities) are certificates representing partial ownership in the companies that issue them. The latter are included in capital markets because they have no maturities and are therefore, considered as long-term sources of funds. Bonds and mortgages represent debt, whereas equities represent ownership.

Debt instruments bear amount and timings of interest and principal payments to investors who purchase them. Securities have specific return and risk characteristics. The return is generally higher, when risk is perceived to be higher. Long-term securities of the capital markets, are expected to fetch higher returns, as the risk or uncertainty, of the expected return, is higher.

Equity securities have higher expected return than most long-term debt securities, but they also exhibit a higher degree of risk. Growth in GDP and investment, should be closely related. As growth occurs, demand for goods increases and capacity constraints become binding.

Investment, financed by issuance of debt or equity is likely to follow. Exactly when, investment and issuance will be expected to occur, is unclear.

**Q10- Discuss the role of an underwriter in managing an IPO.**

To manage the IPO or Underwriter it’s also a new stock offering serves as the intermediary between the company seeking to issue shares in an initial public offering (IPO) and investors. ... After the road show, the underwriter and company determine of the final price for the IPO based on the orders received during the road show Underwriters are the main link between an insurance company and an insurance agent. Insurance underwriters use computer software programs to determine whether to approve an applicant. They take specific information about a client and enter it into a program. ... Underwriters analyze the risk factors on an application. Underwriting and Valuation the IPO process consists of determining the value of a company, creating public shares, and raising money by selling those shares to investors. The process of issuing and selling stock in an IPO is called underwriting.

**Q11- Why is a stock exchange an important institution of the capital markets?**

The capital market functions through the stock exchange market. A stock exchange is a market which facilitates buying and selling of shares, stocks, bonds, securities and debentures. It is not only a market for old securities and shares but also for new issues shares and securities A securities market is any place where buyers and sellers come together to trade in securities. A person who buys bonds issued by the government through the RBI is part of the securities market. The securities market is actually divided into two broad classes, the original securities exchange market, and the over the counter (OTC) market. The organized securities market is further divided into national, regional and local exchanges.

The National Stock Exchange (NSC) and the Bombay Stock Exchange (BSE), Mumbai form part of the national stock exchanges. The over-the-counter market is the informal market and handles securities transactions in the office of brokers and dealers registered to engage in securities business. Stock exchanges facilitate the trading of existing stocks in the secondary markets.

Brokerage firms serve as intermediaries between the buyers and sellers in the secondary markets. Brokers receive orders from customers and pass the orders on to the exchange, through a telecommunication network. Orders, are frequently executed a few minutes later. Full service brokers offer advice to customers, on stock to buy or sell; discount brokers only execute the 107

Transactions desired by customers. Stock exchanges provide a secondary market, allowing investors, a flexibility in spending which would not be possible if they were to hold securities until they were redeemed. For example, investors who bought shares in a primary issue, intending to hold on to them, can nevertheless meet unforeseen cash requirements by selling securities to other investors.

There is however, a price for this flexibility, which is that the price the seller receives depends upon market conditions which are uncertain.

The variances of prices means that agents associated with secondary markets have to be very nimble to avoid risking their capital. Stock exchanges provide a secondary market, allowing investors, a flexibility in spending which would not be possible if they were to hold securities until they were redeemed. For example, investors who bought shares in a primary issue, intending to hold on to them, can nevertheless meet unforeseen cash requirements by selling securities to other investors. There is however, a price for this flexibility, which is that the price the seller receives depends upon market conditions which are uncertain. The variances of prices means that agents associated with secondary markets have to be very nimble to avoid risking their capital.

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