**MODULE 3 ASSIGNMENTS:**

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**AFRICA CENTRE FOR PROJECT MANAGEMENT**

**DIPLOMA IN FINACIAL MANAGEMENT FOR NGOs**

1. **Why is the cost of capital the minimum acceptable rate of return on an investment?**

In business and for [engineering economics](https://en.wikipedia.org/wiki/Engineering_economics) in both [industrial engineering](https://en.wikipedia.org/wiki/Industrial_engineering) and [civil engineering](https://en.wikipedia.org/wiki/Engineering_economics_(civil_engineering)) practice, the minimum acceptable rate of return, often abbreviated MARR, or hurdle rate is the minimum [rate of return](https://en.wikipedia.org/wiki/Rate_of_return) on a project a manager or company is willing to accept before starting a project, given its risk and the [opportunity cost](https://en.wikipedia.org/wiki/Opportunity_cost) of forgoing other projects.[[1]](https://en.wikipedia.org/wiki/Minimum_acceptable_rate_of_return#cite_note-Park2007-1) A synonym seen in many contexts is minimum attractive rate of return.

The hurdle rate is frequently used as a synonym of cutoff rate, [benchmark](https://en.wikipedia.org/wiki/Benchmarking) and [cost of capital](https://en.wikipedia.org/wiki/Cost_of_capital). It is used to conduct preliminary analysis of proposed projects and generally increases with increased risk.

1. **How is the Cost of Debt Capital ascertained?**

The cost of debt is the effective interest rate a company pays on its debts. It’s the cost of debt, such as bonds and loans, among others. The cost of debt often refers to before-tax cost of debt, which is the company's cost of debt before taking taxes into account. However, the difference in the cost of debt before and after taxes lies in the fact that [interest expenses](https://www.investopedia.com/terms/i/interestexpense.asp) are deductible.

example of Cost of Debt

The cost of debt formula is the effective interest rate multiplied by (1 - tax rate). The effective tax rate is the weighted average interest rate of a company's debt. For example, say a company has a $1 million loan with a 5% interest rate and a $200,000 loan with a 6% rat

3**. How will you calculate the Cost of Preferences Share Capital?**

If the company issues new preference shares, the cost of preference capital would be: Kp = Annual dividend / Net proceeds after floatation costs, if any. Example: A limited company issues 8% preference shares which are irredeemable. The face value of share is $100 but they are issued at $105.

**4. The following details are available:**

Equity (Expected Dividend 12%) Rs. 1000000

Tax Rate 50%

10% Preference Rs. 500000

8% Loan Rs. 1500000

You are required to calculate Weighted Average Cost of Capital?

**5. What is Net Present Value and how does it change by variation in discount rate.**

Net Present Value

Net present value (NPV) is simply the sum of the discounted cash flows associated with a specific investment. The analytical formula for NPV for investments with a useful life of *T* is:

NPV=∑t=0TNCFt(1+k)t

NPV is an absolute appraisal criterion that measures the increase of enterprise value due to a specific investment; this is the most obvious criterion for assessing investments. Hence, the other methods are analyzed against this.

The economic meaning of NPV can be directly derived from its definition: It is the value of the enterprise realizable from the investment. The acceptance condition for the investment can be derived from its formulation:

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Single investments are accepted when they increase economic value (when NPV≥0).

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When alternative investments are considered, the most convenient investment is the one generating more value—hence, the investment with the highest NPV.

6. **Distinguish between NPV and PI. Which of these you consider better?**

Difference between net present value and profitability index

To put it another way, profitability index is constituted of the ratio between the present value of future cash flows and the initial investment. ... However, net present value gives you the dollar difference, while the profitability index gives the ratio.

**7. What are the limitations of using the NPV and IRR methods in practice? Give your assessment.**

The biggest disadvantage to the calculation of NPV is its sensitivity to the discount rate. After all, NPV is a summation of multiple discounted cash flows—both positive and negative—converted into present value terms for the same point in time (usually when the cash flows begin

The advantages and disadvantages of the [internal rate of return](https://efinancemanagement.com/investment-decisions/internal-rate-of-return-irr) are important to understand before applying this technique to specific projects. There must be a proper analysis conducted and an interpretation of most projects by this well-known technique of evaluation and selection of investment projects. This technique has certain limitations in analyzing certain special kinds of projects, such as mutually exclusive projects, an unconventional set of cash flows, different project lives, etc.

**8. 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 price

**9. 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?**

If you are hoping to start a new business, the first thing you will need to figure out is where you will get your financing from. Without a reliable source of financing at your disposal, it will not matter if your idea for a new business is the greatest in the world—you won’t even be able to turn your lights on.

Once you have secured financing, you will be able to focus on the more creative components of your business and move closer to turning your dreams into a reality. However, before you go applying for financing everywhere it happens to be available, ask yourself, “what kind of financing is best for my business?”

Generally speaking, all business financing options fall into [one of two categories](https://www.investopedia.com/ask/answers/042215/what-are-benefits-company-using-equity-financing-vs-debt-financing.asp). With debt financing, your business borrows from a lender and plans to pay that amount back (plus interest) over time. With equity financing, on the other hand, you are selling partial ownership of your business. While this type of financing does not need to be “paid back” in the future, you do lose some control of your business and you may also lose a portion of your profits.

Both debt and equity financing have pros and cons for all new business owners. The choice that is right for you will be very specific to your business. In this article, we will briefly discuss seven factors to consider when choosing between debt and equity financing options.

1. Long-Term Goals

As the owner of your new business, it will be critical for you to think about what you actually hope to achieve in the long-run. What is the purpose of starting your business? Where do you hope for your business to be in ten years? Twenty years? By answering these questions, it will be easier for you to decide how financially entrenched in your business you will actually be. Though you don’t need to come up with a future “exit strategy” this very minute, it is certainly a good thing to think about.

2. Available Interest Rates

Naturally, the opportunity cost of choosing equity over debt finance will be largely determined by how much you will actually need to pay to borrow money. If your business has access to low-interest rates or specialty loans (such as an SBA loan), the total cost of borrowing will be relatively lower. In order to make sure you are getting competitive quotes from potential lenders, it will be a good idea to compare multiple options before making any final decisions. Working to improve your business’ current credit score can also make a major difference.

3. The Need for Control

By surrendering partial ownership of your business you are, to a certain extent, giving up control. In order to make sure they can still outvote all other stakeholders, many business owners will maintain 51 percent ownership of the business while selling the remaining 49 percent. If having total or significant control of your business is something that’s important to you, be sure to limit the amount of equity you end up distributing.

4. Borrowing Requirements

There are many different things lenders will look at when deciding whether to issue a loan. In addition to a general financial background check, lenders will also want to see some hard numbers on paper. The factors they may look at include things such as your debt-to-equity ratios, your fixed monthly expenses, your overall business plan, and various others. These requirements can often be rather rigid, which is why your business needs to plan its financing strategy in advance.

5. Current Business Structure

Another variable that will impact the opportunity cost of borrowing (or issuing equity) is your *business structure*. If your business is already formally structured as a partnership, for example, this may complicate the process of selling equity. Additionally, if you hope to secure your equity finance via public means—such as selling stocks on the open market—you will need to formally declare your business to be a public corporation. Though your business structure is something that can (and likely should) be changed in the future, there is no doubt that the preexisting structure will have a major impact on your short-term financing decisions.

6. Future Repayment Terms

While many business loans are simple, flat loans with a fixed interest rate, there are many loans with repayment terms that are notably more complicated. For example, some loans will not require any repayment for several years down the loan. When this is the case, you will need to calculate both the average total interest rate *as well* as the time value of money. If you are hoping to borrow from a single venture capitalist or angel investor, they may be able to dictate additional terms that are not found in traditional bank loans. Sometimes, these investors will offer a complex mix of debt and equity financing for new businesses.

7. Access to Equity Markets

If you do hope to finance your business via equity, it will be crucial that you have access to people who are *actually interested* in buying. Contrary to what some entrepreneurs initially assume, there isn’t a readily available “counsel” of venture capitalists, ready to give fund new businesses without scrutiny. If you do hope to finance via equity, you will need to significantly develop your business plan, meet with a wide range of individuals, and also be willing to make compromises. For some business owners, the time it takes to do this is justified by the lack of debt that only equity financing can provide. For others, traditional lending is a more appealing option.

Conclusion

With equity financing, you lose some control over your business, but you are able to continue operating without debt. With debt financing, you will increase your future liabilities, but the future of your business will remain in your hands. As you can see, both decisions have clear appeals and trade-offs. Many business owners also use a mixed financing model that is better tailored to their specific needs. Regardless, be sure to remember these seven factors before making any permanent decisions.

**10. Discuss the role of an underwriter in managing an IPO.**

IPO underwriters are financial specialists who work closely with the issuing body to determine the initial offering price of the securities, buy the securities from the issuer, and sell the securities to investors via the underwriter's distribution network

**11. Why is a stock exchange an important institution of the capital market**

The capital market is a market which deals in long-term loans. It supplies industry with fixed and working capital and finances medium-term and long-term borrowings of the central, state and local governments. The capital market deals in ordinary stock are shares and debentures of corporations, and bonds and securities of governments.

The funds which flow into the capital market come from individuals who have savings to invest, the merchant banks, the commercial banks and non-bank financial intermediaries, such as insurance companies, finance houses, unit trusts, investment trusts, venture capital, leasing finance, mutual funds, building societies, etc.

Further, there are the issuing houses which do not provide capital but underwrite the shares and debentures of companies and help in selling their new issues of shares and debentures. The demand for funds comes from joint stock companies for working and fixed capital assets and inventories and from local, state and central governments, improvement trusts, port trusts, etc. to finance a variety of expenditures and assets.

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. In fact, the capital market is related to the supply and demand for new capital, and the stock exchange facilitates such transactions.

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Thus the capital market comprises the complex of institutions and mechanisms through which medium-term funds and long­-term funds are pooled and made available to individuals, business and governments. It also encompasses the process by which securities already outstanding are transferred.

Importance or Functions of Capital Market:

The capital market plays an important role immobilizing saving and channel is in them into productive investments for the development of commerce and industry. As such, the capital market helps in capital formation and economic growth of the country.below is the importance of capital market.

The capital market acts as an important link between savers and investors. The savers are lenders of funds while investors are borrowers of funds. The savers who do not spend all their income are called. “Surplus units” and the borrowers are known as “deficit units”. The capital market is the transmission mechanism between surplus units and deficit units. It is a conduit through which surplus units lend their surplus funds to deficit units.

Funds flow into the capital market from individuals and financial intermediaries which are absorbed by commerce, industry and government. It thus facilitates the movement of stream of capital to be used more productively and profitability to increases the national income.