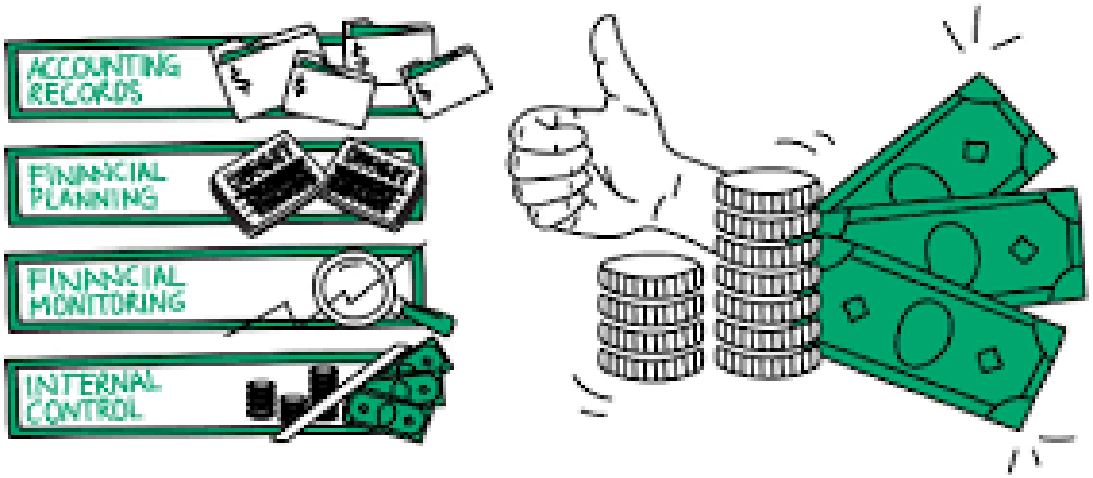
FINANCIAL MANAGEMENT



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Unit -1 Financial Management - Meaning And Scope - Finance Functions – Profit maximization And Wealth Maximization - Sources Of Finance - Short Term - Bank Sources – Longterm –Shares - Debentures, Preferred Stock - Debt.

FINANCIAL MANAGEMENT :-

INTRODUCTION:

Finance is the life blood of a business. Circulation of blood is necessary for maintaining life in human body in the same way, finance is absolutely necessary for the survival and smooth running of a business. Finance is necessary to promote a business, purchase fixed assets, buy raw materials, produce goods and market them. Every business activity requires finance, without finance, the business would come to a halt.

MEANING:

Financial management may be described as making decisions on financial matters, implementing the decisions and review of the implementation. It is the process of managing the finance function.

DEFINITION:

According to Arcer and Ambrosio," Financial management is the application of the planning and control function to the finance function.

OBJECTIVES:

- **PROFIT MAXIMATION** -profit maximation of income or earning of a firm.

1. **NATURAL GOAL**: profit is the aim of any business. Naturally, the goal of financial management should be profit maximation.
2. **MEASURE OF EFFICIENCY**: profit is a measure of efficiency. Higher profits imply. Greater efficiency. Hence, the objective of profit maximisation is quite rational.
3. **INTERNALGENERATION OF FUNDS**: profits lead to internal generation of funds. It helps to finance the growth of the business.
4. **PROTECTION AGAINST RISKS**: profits provide protection against risks. When a company is faced with unfavorable conditions (such as fall in prices, increase in costs and serve competition), accumulated profits serve as cushion to absorb the shocks.
5. **FULFILMENT OF SOCIAL OBLICATION:** Profits are essential for fulfilling social obligations of the business. The goal of profit maximisation helps to maximize social welfare.

- **WEALTH MAXIMISATION**- wealth maximisation, as an objective of financial management, refers to the maximisation of wealth of the shareholders. It involves maximisation of the net present value of an investment.

1. **CLARITY:** wealth maximisation is a clear concept. It represents the net present worth.
2. **TIME VALUE OF MONEY**: It takes into account the time value of money, by discounting the future cash inflows.
3. **RECOGNISES RISK FACTOR**: The risk factor is also recognised. For proposals with a

greater degree of risk, a high discount rate (cost of capital) is used and vice versa.

4. **UNIVERSAL ACCEPTANCE**: The concept of wealth maximisation is universally accepted. It take care of the interests of the shareholders, financial institutions, employees and the society.

FINANCIAL DECISION:

MEANING:

Financial decisions are decisions concerning the financial matters of a firm. To accomplish the goal of wealth maximisation, a finance manager has to take decisions such as the amount of the investment, kinds of assets to be acquired, financing of the investment and distribution of profits.

1. **INVESTMENT DECISION:** Investment decision is the most important financial matters of a concerned with decision the total amount of assets to be held in the firm and their composition.
2. **FINANCING DECISION:** Once the investment decision is made, the financial manager has to decide the source of finance for financing the investment. Debt and equity are two major sources of long-term finance. Use of debt and helps to enhance the earnings of the shareholders. But excessive debt increases the risk. Therefore, the choice must be made in such a way that the capital structure is optimum and the value of the firm is maximized.
3. **DIVIDEND DECISION:** Dividend decision is concerned with deciding the quantum of points to be disturbing to share holder (pay-out). The finance manager has to decide whether the firm should distribute all the point, retain all the profits or distribute a portion and retain the balance. The finance manager should generally aim at an optimum dividend pay-out, which maximizes the value of the firm.

***APPROACHES TO FINANCIAL MANAGEMENT*:**

1. **TRADITIONAL APPROACH:**

The traditional approach was popular during the early stages of evolution of financial management. It was introduction by Thomas Greene (1897) in his book, “corporation finance”. Under the traditional approach, the scope of financial management was limited to the procurement of funds on the most suitable terms. The utilization of funds was not regarded as a function of financial management. The focus was on the financial institution, instruments and practices through which funds were raised.

LIMITATIONS OF TRADITIONAL APPROACH:-

- √ Traditional approach is narrow. It concentrates only on procurement of funds. It completely ignores the important issue of utilisation of funds.
- √ It views financial management only from the point of view of suppliers of capital. It is called outsider looking in approach.
- √ The traditional approach also neglects internal decision making and day to day financial problems of a firm.
- √ The traditional approach considers only the procurement of long-term funds. It does not pay any attention to working capital finance and management.
- √ The traditional approach fails to deal with the financing mix. It gives no consideration to the relationship between financing mix and cost.

2. MODERN APPROACH:

The new approach views financial management in a border sense. The scope is not limited to the procurement of the funds, it includes efficient utilisation as well.

The effective utilisation of funds involves a comparison of the returns from potential uses and the cost of alternatives sources of funds, with a view to achieve the financial goals. Hence, the modern approach covers financial planning, raising of funds, evaluation of investment proposals, allocation of funds, financial control etc.

The modern approach covers three broad decision areas namely, investment decision, financing decision and dividend decision. It considers working capital management and day-to-day financial problems.

FUNCTIONS OS FINANCIAL MANAGEMENT:-

1. **ESTIMATING FINANCIAL NEEDS:** An important function of the finance manager is to provide adequate and timely finance. Finance may be needed for different purposes. A firm may need money for purchase of fixed assets or investment in current assets. Therefore, it is necessary to estimate the fixed as well as working capital requirements in advance.
2. **IDENTIFICATION OF SOURCES OF FUNDS**: In order to meet varied financial needs, financial management has to identify the various sources of finance. The source of long-term as well as short-term finance, their costs and other terms have to be ascertained.
3. **DEVELOPING AN OPTIMUM CAPITAL STRUCTURE:** Capital structure decision is very important. It involves deciding the proportion of debt and equity as the sources of finance. Use debt helps to increase the earnings of shareholders. But excessive debt increases the risk and reduces the market value of shares.

4. **CAPITAL BUDGETING:** Capital expenditure decisions relate to effective utilisation of capital. They commit funds in long-terms assets and influence the firm wealth determine its and affect its risk. Hence, these decisions are crucial.
5. **WORKING CAPITAL MANAGEMENT:** Working capital refers to the funds required for financing the day-to-day operation. The firm should have sufficient liquidity to meet its current obligations. The function of financial management is to ensure adequacy of working capital. Working capital management includes cash management, receivables management, and inventory management.
6. **DIVIDEND POLICY:** An important function of financial management is to formulate the dividend policy of the company. Shareholders may prefer high dividends. But retention of profits strengthens the internal generation of funds. For firms with profitable opportunities, retention is ideal.
7. **MERGERS AND ACQUISITIONS (M&A):** Acquisition refers to the purchase of a business. Mergers is a process by which one company is merged into the other. Mergers and acquisitions are rare or episodic events in the life of a company. But, they are of great importance from the point of view of financial management. These events involve commitment of huge funds for long periods and influence the prospects and profitability significantly.
8. **FINANCIAL ANALYSIS**: Analysis of financial performance is an integral part of financial management. It helps in the assessment of strengths and weaknesses of the company in respect of liquidity, solvency, profitability, operating efficiency etc. It is also useful in analysing the capital structure, its effect capital structure, its effect on earnings of shareholders, and the dividend behaviour of a company. “Financial analysis is very useful in financial planning and control”.
9. **COST VOLUME PROFIT ANALYSIS:** Cost, volume and profit are closely related. In fact, profit depends on the efficient management of cost which in turn, depends on the volume of output. Analysis of the relationship is known as cost-volume-profit analysis. It divides the cost into fixed and variable.
10. **FINANCIAL CONTROL:** Financial control is the control function of financial management. Its object is to ensure that the performance is according to plans. Financial control involves application of control device such as return on investment, budgetary control, break – even analysis, ratio analysis etc.

FINANCE FUNCTION:-

MEANING:

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All functions of the business- purchase, production, marketing, research and development – requires finance. Without money, these activities will come to a halt. Hence, finance function is the most important of all functions. The need for finance is continuous.

AIM OF FINANCE FUNCTION:

1. **PROCUREMENT OF FUNDS:** The main aim of the finance function is the provision of adequate finance to meet the requirements of the business. Finance must be provided in time at a reasonable cost.
2. **EFFICIENT UTILISATION OF FUND:** Efficient utilisation of funds is the fundamental requirement for the success of the finance function. The firm must generate a return higher than the cost of funds. So as to magnify the earnings of the shareholders.
3. **INCREASING PROFITABILITY:** Finance function should aim at increasing the profitability of the business. All financial decisions influence the profits. Hence, decision making should always be guided by profitability criterion.
4. **MAXIMISING FIRM'S VALUE:** Finance function plays a key role in maximizing the firm's value. To a considerable extent, value of the firm depends on its profitability.

ORGANISATION OF THE FINANCE FUNCTION:

THE FINANCE MANAGER:

MEANING:

The finance manager is also known as vice-president (finance) or director (finance). He is member of the top management and reports directly to the managing director or general manager. As chief financial officer, the finance functions. He is closely

associated with formulation of policies and making decisions for the firm.

TREASURES AND CONTROLLER:

The treasures and controller work under the guidance and supervision of the finance manager.

FUNCTION OF TREASURER:

1. **PROVISION OF FINANCE**: The major responsibility of the treasurer is to provide adequate and timely finance. He has to forecast the short-term and l0ng-term financial needs and arrange for meeting those needs by issues of securities, arrangements with banks etc.
2. **INVESTOR RELATION**: Investor relations include:

   Creating and maintaining a market for the securities of the firm,

   Maintaining cordial relations with the investor,

   Rendering efficient service to investors-shareholders, debenture holders etc.
3. **RECEIVABLES MANAGEMENT**: It is concerned with granting of credit and collection of dues from debtors in time.
4. **CASH MANAGEMENT**: It is crucial function. The treasure has to maintain optimum cash balance to meet the payment obligations without difficulty.
5. **INVESTMENT**: In order to ensure efficient utilisation, the finance manager has to arrange for investment of surplus cash. Monitoring of the investment and realization of the investments-as and when required- are also his function.
6. **INSURANCE**: It is concerned with arrangements for adequate insurance coverage wherever required.

FUNCTIONS OF CONTROLLER:

1. **PLANNING AND CONTROL:** It includes planning and administration of control programmes such as budgeting, reporting, system, profit planning etc.
2. **REPORTING AND INTERPRETATION:** Timely information is required for decision making and control. The function of the controller is to establish a sound financial reporting system to meet the informational requirement.
3. **TAX ADMINISTRATION:** Tax administration relates to compliance with various tax laws, payment of taxes, filing of returns, tax planning etc.

4. **REPORTING TO GOVERNMENT:** The controller is responsible for providing information required by the government on various financial matters.
5. **PROTECTION OF ASSETS:** The controller has to design and implement appropriate system like internal control and internal audit for the protection of the firm's assets.
6. **ECONOMIC APPRAISAL:** The controller appraises the macro economic environment. He advises the management regarding the outlook of the economy, effect of economic and social forces on the business.

SOURCES OF FINANCE:

MEANING:

A company needs finance to meet different purposes. Finance may be needed for acquiring fixed assets or for meeting day-to-day expenses. Acquiring of fixed assets involves commitments of funds for a long-time. On the other hand, finance for meeting day-to-day expenses is required only for a short duration.

Important sources of long-term finance:

Equity shares
Preference shares
Debentures or bonds
Term loans
Retained earnings

EQUITY SHARES:

MEANING:

Equity shares are the most common source of finance. They are also known as ordinary shares and represent the owner capital in the company. The holders of equity shares are the real owners of the company.

FEATURES OF EQUITY SHARES:

1. **PERMENENT CAPITAL:** There is no maturity for equity share capital. The share capital, (except in the case of buy-back) is generally repaid to the shareholders only at the time of liquidation, after meeting all other claims. Thus, equity shares provide permanent capital to the company.
2. **RIGHT TO DIVIDEND:** The equity shareholders are paid dividends are paid dividends out of profit earned by the company. Sometimes, the board may decide not to pay any dividend, even if there are profits. If there are no profits, dividend will not be paid.
3. **CONTROL:** Equity shareholders are the real owners of the company. Each equity shares carries one vote and the equity shareholders take part in the management of the company are electing the directors.

4. **LIMITED LIABILITY:** This is a very important feature of equity shares, liability of shareholders is limited to the issue price of shares. The shareholder has paid the amount in full. Then, he cannot be asked to pay any amount towards the losses of the company.
5. **PRE-EMPTIVE RIGHT:** When a company issues additional shares, the existing shareholders have a right to purchase new shares in the same proportion of their current holding. These shares are called right shares.

MERITS OF EQUITY SHARES:

1. **PERMANENT CAPITAL:** Equity shares are not redeemable. Hence, it is a permanent capital available for use throughout the life time of the company.
2. **BORROWING STRENGTH:** Equity shares capital represents the owner funds. It provides the base for borrowing capability.
3. **FLEXIBILITY IN PAYMENT OF DIVIDEND**: A company is not legally obliged to pay dividend. During tough times, the company may cut or skip dividend. Even during good times, the company may not hike the dividend and conserve resources for further growth.

LIMITATION OR DEMERITS:

1. **HIGHER COST:** Dividend are not allowed as a deduction in the computation of income tax. The company has to pay tax on dividend distributed. Flotation costs are also high. Hence, equity shares have a higher cost for the company.
2. **HIGH RISK:** From the point of view of investors, ordinary shares are more risky due to uncertainty of dividends and capital.
3. **NO BENEFITS OF LEVERAGE:** The company cannot take advantage of financial leverage or trading on equity shares only.
4. **DILUTION OF EARNINGS**: If the profits of a company do not increase after the issues of additional shares, the earnings per share declines.
5. **DILUTION OF OWNERSHIP:** If the existing shareholders are not able to subscribe to the new shares, their ownership gets diluted.

PREFERENCE SHARES:

MEANING:

Preference share enjoy two preferences. Firstly, dividend on these shares is to be prior to any dividend on the equity shares. Secondary, preference shares are to be redeemed before any. Payment is made to the equity shareholders at the time of liquidation.

FEATURES OF PREFERENCE SHARES:

1. **MATURITY:** Preference shares may be redeemable or irredeemable. Redeemable preference shares are repaid after the stipulated period. Irredeemable or perpetual preference shares are repaid only at the time of liquidation.
2. **FIXED DIVIDEND:** The preference shares carry a fixed rate of dividend, say 7 percent or 9 percent. The dividend is payable only if the company earns profits. However, in the case of cumulative preference shares, the shareholders are entitled to arrears of dividend.
3. **CONTROL:** Generally preference shares holders do not have voting rights. They do not have any say in the management of the company.
4. **CLAIM ON ASSETS:** At the time of liquidation, preference shares have a preference in the repayment of capital. Their claim is to be settled before making any payment to equity shareholders. But they are not entitled to any surplus.
5. **HYBRID SECURITY:** Preference shares have features of equity as well as debt. Hence, it is a hybrid security.

MERITS OF PREFERNCE SHARES:

1. **ADVANTAGE OF LEVERAGE:** Use of preference share capital helps to increase the earnings of shareholders. If the company earns a rate which is higher than the rate of preference dividend, the shareholders are benefited.
2. **PERMANENT CAPITAL:** Irredeemable preference shares can be used as a source of permanent capital.
3. **FLEXIBILITY:** Payment of dividend on preference shares can be postponed. This feature dives some financial flexibility to the management.
4. **REPAYMENT OF CAPITAL:** Redeemable preference shares can be repaid, if the company has surplus funds.
5. **BORROWING STRENGTH:** Preference shares capital is generally regarded as part of a company's net worth. It enhances the credit worthiness and borrowing capacity of the company.
6. **NO DILUTION OF CONTROL:** Preference shares have no voting rights. There is no dilution of control.
7. **NO MORTGAGE OF ASSETS:** Assets are not mortgaged in favor of preference shareholders. Hence, the company can use the assets as security for issue of debentures etc.

LIMITATIONS OR DEMERITS:

1. **CLARITY:** The preference shareholders expect a higher rate of dividend compared to the interest rate on debentures. Hence, preference share capital is a costly source of finance.

2. **COMMITMENT TO PAY DIVIDEND:** There is no obligation to pay preference dividend. But non-payment adversely affects the creditworthiness and image of the company. They equity dividend also cannot be paid.
3. **PARMANENT BURDEN:** In the case of cumulative preference shares, even arrears of dividend have to paid. They are a permanent.

TYPES OF PREFERNCE SHARES:

1. **REDEEMABLE PREFERNCE SHARES:** These are preference shares which are redeemable after the stipulated period, as per the terms and conditions of issue.
2. **IRREDEEMABLE PREFERNCE SHARES:** Irredeemable preference shares are shares which cannot be redeemed during the life time of the company. Redemption takes places only at the time of liquidation of the company.
3. **CUMULATIVE PREFERNCE SHARES:** Cumulative preference shares have the right to receive unpaid dividend or arrears of dividends. The unpaid dividends accumulate till the company is in a position to pay the arrears.
4. **NON-CUMULATIVE PREFERNCE SHARES:** These shares have no right to receive the unpaid dividend. Dividend is paid only if there are sufficient profits. The shareholders cannot claims arrears of dividends.
5. **PARTICIPATING PREFERNCE SHARES:** The holders of participating preference shares get a fixed rate of dividend. In addition, they have a right to participate in the surplus profits.
6. **NON-PARTICIPATING PREFERNCE SHARES:** The holders of non-participating preference shares get a fixed rate of dividend. In addition, they have no right to participate in the surplus profits.
7. **CONVERTIBLE PREFERNCE SHARES:** These shares are convertible into equity shares after a specified period, say 6 months or 12 months. Convertible preference shares may be partly convertible or fully convertible.
8. **NON-CONVERTIBLE PREFERNCE SHARES:** The preference shares which cannot be converted into equity shares are called non-convertible preference shares.

DEBENTURES OR BONDS:

MEANING:

Debentures or bonds are financial securities issued by companies to raise long-term loans from the public. They are generally redeemable after the stipulated periods. Debentures carry a fixed rate of interest which is payable periodically.

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FEATURES OF DEBENTURES:

1. **MATURITY:** Debentures are to be repaid after the stipulated period, say 5 years or 7 years.
2. **FIXED RATE OF INTEREST:** Debentures carry a fixed rate of interest. Such interest is payable periodically, as per the terms of issue.
3. **PREFERNCE IN PAYMENT:** In the event of liquidation, debentures holders are to be paid before preference shares holders and equity shares holders.
4. CHARGE ON ASSETS: Debentures are generally secured. The debentures holders may have a specific change on the assets or a floating charge on all the assets of the company.
5. **TAX DEDUCTIBILITY OF INTEREST:** Debenture in a loan raised by the company. Interest on debentures is an expenses. It is allowed as a deduction in the computation of income tax.
6. **CONTROL:** Debentures holders are lenders of money to the company. They do not have any voting right or any control over the management of the company.

TYPES OF DEBENTURES:

1. **REDEEMABLE DEBENTURES:** These debentures are to be paid after the fixed periods as per the terms of issue.
2. **IRREDEEMABLE DEBENTURES:** These debentures are not repaid during the life time of the company. They are generally repaid at the time of winding up. However, the company may reserve the right to repay after giving due notice to the debentures holders.
3. **UNSECURED DEBENTURES**: They are also known as simple or naked debentures. The debenture holders are not given any security. The debentures do not carry any changes on the assets of the company.
4. **SECURED DEBENTURES:** Secured debentures are also known as mortgage debentures. They are secured by a mortgage or charge on the assets of the company. In case of default in payment, the debenture holders an sell the assets and recover their dues.
5. **CONVERTIBLE DEBENTURES:** These debentures are convertible into equity shares on a future date as per the terms of issues. If only a part of the debentures is convertible into shares, debentures are called partly convertible debentures.
6. **NON – CONVERTIBLE DEBENTURES**: The debentures which are not convertible into shares are known as non-convertible debentures (NCDs).
7. **BEARER DEBENTURES:** These debentures are easily transferable. There is no formal procedure for transfer and delivery of the certificates to the

purchaser is enough. That is, the debentures certificates are handed over to the buyer and he is recognised as the debentures holder.

8. **REGISTERED DEBENTURES:** Unlike bearer debentures, these debentures can be transferred only through adoption of a formal procedure. The seller and buyer have to sign the transfer deed which contains particulars of the debentures which are sold / bought.

ADVANTAGES OF DEBENTURES:

1. **LONG – TERM FUNDS:** Debentures can be issued for long periods say 7 years or 10 years. Thus, provide long – term finance.
2. **LESS COSTLY:** The rate of interest on debentures is usually less than the rate of dividend on equity shares. In addition, debenture interest is allowed as a deduction in the computation of income tax. Hence, debentures financing involves as comparatively lower cost.
3. **NO DILUTION OF CONTROL:** Debentures holders are not owners. They have no voting rights. Hence, there is no threat of dilution of control or ownership.
4. **TRADING ON EQITY:** A company may issues debentures and raise funds at a lower cost. By earning a higher rate on these funds, the earning of shareholders is improved. Thus, debentures provide the benefits of trading on equity or financial leverage.
5. **FIXED RATE OF INTEREST:** Interest rate on debentures is fixed. Even if a firm earns huge profits, interest payment is limited to the agreed rate.

LIMITATIONS:

1. **LEGAL OBLIGATION:** A company which issues debentures is under legal obligation to pay the interest and repay the principal. Default in payment of interest or principal will lead to legal problems. It may even force the company into liquidation.
2. **INCREASE IS FINANCIAL RISK:** Debentures involve fixed financial commitment. Even if there are no profits, interest has to be paid. The degree of risk is very high for firms which do not have stable sales and profits. It also leads to higher cost of equity capital especially when huge amounts are raised through debentures.
3. **REDEMPTION PRESSURE:** Debentures must be repaid on maturity. It involves huge outflow of cash. If redemption is not planned in advance, it will adversely affect the liquidity position of the company.
4. **FALL IN EARNING OF SHAREHOLDERS:** If the company is not able to earn a return which is higher than or equal to the rate of interest on debentures, the earnings of shareholders will decline.

5. **RESTRICTIVE CONDITIONS:** The debenture holders may impose restrictions on further borrowing and use the assets as security for further loans. These conditions may affect the operational freedom and flexibility of the company.

TERM LOANS:

MEANING:

Terms loans are borrowing from banks and financial institutions. They are an important source of long-term funds. In India, term loans are provided by financial institutions and banks for financing large expansion, modernization and diversification projects. Therefore, this method of financing is popularly known as project financing.

FEATURES OF TERM LOANS:

1. **MATURITY:** Bank and financial institutions are the major providers of term loans. Banks grant loans for a period of 3 to 5 years. Financial institutions grant loans for longer periods like 6 to10 years. The period of the loan varies depending on the projects, resources of promoters etc.
2. **DIRECT CONTACT:** A term loans is a direct transaction between the bank (or financial institution) and the borrower. The terms and conditions such as interest, duration, conversion, moratorium on interest are decide through negotiation between the parties. There are no underwriting or issue expenses.
3. **RESTRICTION:** While sanctioning term loans, financial institution impose many restrictive conditions on the borrowers.
4. **SECURITY:** Term loans are always secured. The assets acquired by the company out of term loan funds serve as the basic or primary security. In addition to the basic security, term loans are generally secured by the company's present and future assets. This is called collateral security or secondary security.
5. **REPAYMENT SCHEDULE:** A repayment schedule is drawn based on mutual agreement. Normally interest alone is payable during the grace period. The loan is amortised over the agreed period and repayment is made in installments.
6. **CONVERSION CLAUSES:** If the company is successful and the shares quoted at a high price, financial institutions may find it advantageous to convert the loan into equity shares. Hence, they reserve an option to convert a part of the term into equity shares at a price favorable to them.

ADVANTAGES:

1. **LESS COSTLY:** There are no issue expenses or underwriting costs. Interest on loan is allowed as a deduction in computing income tax. Therefore, cost of term loan is comparatively low.
2. **EASY REPAYMENT:** Repayment schedule is decided in advance. Repayment of principal and

interest are made in installments, out of cash generated from operations. The burden of repayment is spread over many years.

3. **FINANCIAL DISCIPLINE:** The repayment schedule inculcates a sense of financial discipline which is absolutely necessary for success in business.
4. **FLEXIBILITY:** Term loan is sanctioned on the basis of a formal agreement between the borrower and lending institutions. The loan amount, tenure of loans, terms of repayment etc. are finalized, taking into account the needs and resources of the borrower.
5. **NO DILUTION OF CONTROL:** Lending institutions do not have voting rights. Hence, there is no dilution of management control.

RETAINED EARNING:

MEANING:

Retained earnings are undistributed profits used to finance the requirements of the business. Often, companies do not distribute all the earnings or profits to shareholders. They retain a part or all the earning (in some special cases or in the initial years) for financing expansion, diversification etc. such earnings are called retained earnings.

ADVANTAGE:

1. **EXCELLENT SOURCE:** Retained earnings do not impose any payment obligation. The company does not have to pay interest or dividend on retained earnings. Therefore, retained earnings are ideally suited for financing expansion and mondernisation schemes.
2. **FACILITATES GROWTH:** For firms which have opportunities to earn attractive rates of profit, retention of earnings in very advantageous. Sales and profits will also increase. The growth on the strength of its internal accruals.
3. **ABILITY TO ABSORB SHOCKS**: A company which ploughs back profits can build up huge reserves. As a result, it is in a position to withstand shocks such as competitive pressures and decline in sales and profits.
4. **STRONG FINANCIAL POSITION:** The retention of profits helps to build up huge reserves, which in turn, leads to substantial increase in shareholders fund in the business. As a result, the company's financial position as well as borrowing strength improves.
5. **STABLE DIVIDENDS:** The retention of profits helps to smoothen the adverse effects of fluctuations in the fortunes of the company. Hence, the company would be in a position to declare stable dividends.
6. **REDUCES EXTERNAL DEPENDENCE:** The ploughing back of profits enables the company to improve its financial resources. Therefore, a

company which uses retained earnings can reduce its dependence on external source of finance.

7. **IMPROVES EARNING CAPACITY**: The retention of profits increases the shareholder's funds. It strengthens the financial position. There is no outflow of funds towards interest or dividends. As a consequence, the earning capacity of the company improves.
8. **NO DILUTION OF CONTROL:** The requirement of funds is met by ploughing back of profits. There is no new issue of shares. There is no threat of dilution of control over management.
9. **INCREASE IN VALUE OF SHARES:** Retention of profits increases the shareholder's funds. As the number of shares remains the same, the intrinsic value (or book value) increases. This may have a favorable impact on the market price of shares.

LIMITATIONS:

1. **DISSATISFACTION OF SHAREHOLDERS:** Shareholder who prefers current income may not favor the policy of ploughing back. If the company goes on accumulating profits year after year, (without distribution on shareholders) it may lead to discontent and frustration among the shareholders.
2. **INEFFICIENT UTILISATION OF FUNDS:** Many companies consider retained earnings as a low cost source. They may invest the funds in projects where the return is low. Such investment hurt the shareholders.

DISTINCTION BETWEEN SHARES AND DEBENTURE:-

1. STATUS:

In case of shares a shareholders is a part of the owner of the company.

BUT

In case of debenture holder is a creditor of a company.

2. VOTING:

In case of share a shareholder can vote on different matters related to the company.

BUT

In case of debenture holder may vote on any matter relating to his rights.

3. MANAGEMENT:

In case of shareholder become a director and participates in the management of a company. He can vote in electing the directors.

BUT

In case of debenture holders cannot participate in a company's management.

4. RETURN:

In case of share a shareholder may receive dividend if the board of directors recommend such dividend.

BUT

In case of debenture holders receive interest at periodical intervals.

5. SECURITY:

In case of shareholders have no security.

BUT

In case of debenture holders are given the company's assets as security.

6. REPAYMENT:

In case of share except redeemable preference shares, all other shares are repayable only at the time of liquidation of a company.

BUT

In case of debenture are repayable as per terms of issue except irredeemable debentures.

7. TAX ADVANTAGES:

In case of share dividend on share is an appropriation out profits.

BUT

In case of debenture interest is a charge against and thus reduces the company's income tax.

DEBENTURE STOCK:

Fully paid debentures may be converted into debenture stock.

Financial management

Unit-2

Cost of capital – Concept, Importance – Classification – Calculation of Cost of Debt, cost of Equity and Cost of Perference Shares - Cost of Retained Earnings – Weighted Average Cost of Capital.

Cost of capital

Meaning:

For financing its operations, a firm can rise longtermfundsthrough a combination of (1) debt, (2) preference sharecapital,and (3) equity share capital. The firm has to servicethesefunds
by paying interest, preference dividend and equitydividendrespectively. The payment made by the firmconstitutesthecost of obtaining/utilising the source of finance.

Definition:

Milton H. Spencer: Cost of capital is the minimumrateof returnwhich a firm requires as a condition for undertakinganinvestment.

Components of cost of capital:

1- *Return at zero risk:* This includes the projectedrateofreturn on investment when the project does not involveany business or financial risks.
2- *Premium for business risk:* The cost of capital includespremium for business risk. Business risk referstothechanges in operating profit on account of changeinsales.The project involving higher risk than the averageriskcanbe financed at a higher rate of return than thenormal rate.
3- *Premium for financial risk:* The cost of capital includespremium for financial risk arising on account of higher debtcontent in capital structure, requiring higher operatingprofit to cover periodic payment of interest andrepaymentof principal amount on maturity.

Importance of cost of capital:

1- *Capital budgeting decision:* Cost of capital is usedasa“measuring rod”

for evaluating investment proposals. Thefirm, naturally, will choose the project whichgivesasatisfactory return on investment which wouldbeinnocase less than the cost of capital incurred for itsfinancing.Methods of capital budgeting, cost of capital isthekeyfactor in deciding the project out of variousproposalspending before the management.

2- *Designing the capital structure:* The cost of capital issignificance in designing the firm`s capital structure. Thecost of capital is influenced by the changesincapital structure. A capable financial executive alwayskeepsaneye on capital market fluctuations and tries toachievethesound and economical structure for the firm.
3- *Deciding about the methods of financing:* Acapablefinancial executive must have knowledgeof thefluctuations in the capital market fromtime toanalysetherate of interest on loans and normal dividendratesinthemarket from time to time. Whenever firmrequiresadditional finance, he may have a better choiceof thesource of finance which bears the minimumcost of capital.
4- *Preference of top management:* The cost of capital canbeused to evaluate the financial performanceof thetopexecutives. Evaluation of the financial performancewill involve a comparison of actual profitability of theprojectsundertaken with the projected overall cost of capital andan appraisal of the actual costs incurred inraisingtherequired funds.
5- *Other areas of decisions making:* The concept of cost ofcapital is also used in many other areas of decisionmaking, such as leasing, bond refunding dividendpolicydecisions, working capital management policies, etc.

Factors determining the cost of capital:

1- *General economic condition:* General economicconditionsdetermine the demand and supply of capital withintheeconomy as well as the level of expected inflation. Thiseconomic variable is reflected in the risk less rateof return.This rate represents the rate of return onrisk-freeinvestment such as the interest rate onshort termgovernment securities.
2- *Market conditions:* When investors increase their requiredrate of

return, the cost of capital rises simultaneously. Ifthe security is not readily marketable, whentheinvestorwants to sell or even if a continuous demandfor thesecurity exists but the price varies significantly, aninvestorwill require a relatively high rate of return.

3- *Operating and financing decisions:* Results fromdecisionsmade within the firm. Risk resulting fromthesedecisionsisgenerally divided into two types: businessriskandfinancial risk. Business risk is the variability inreturnsonassets and is affected by the firm`s investment decisions.Financial risk is the increased variability inreturnstoequity shareholders as a result of financingwithdebt orpreferred stock.

4- *Amount of financing:* The last factor determiningthefirm`scost of funds is the level of financing that thefirmrequires.As the financing requirements of the firmbecomelarger,the overall cost of capital increases for several reasons.For instance, as more securities are issued, additional flotation cost or the cost incurred by the firmfor issuingsecurities, will affect the percentage cost of thefundstothe firm.

Types of cost of capital:

1- *Historical cost and future cost:* Historical cost referstothecost which has already been incurred in order tofinanceaparticular project. It is useful for projectingfuturecost.

Future cost is a expected cost of funds financingaparticular project. It is applied for taking financial decision.2- *Explicit cost and implicit cost:* The explicit cost isthediscount rate that equates the present valueof cashinflows that are incremental to the taking of thefinancingopportunity with the present value of its incremental cashoutflows. It is the internal rate of return of thecashflowsoffinancing opportunity.

Implicit costs is alsoknownas opportunity cost. It is a rate of return associatedwiththebest investment opportunity for the firmandit isshareholders that will be foregone if theproject isaccepted. The cost of retained earnings is anopportunitycost because a shareholder is deprived of theopportunityto invest the retained earnings elsewhere.

3- *Specific cost and Composite cost:* It refers tothecost ofeach component

of capital viz., Equity sharecapital,Preference share capital, Debt etc... It is particularlyuseful where the profitability of the project is evaluatedonthebasis of specific source of funds taken for financingthesaid project.

The composite cost refers to thecombinedcost of equity capital, preference capital, debt etc…It isalso known as weighted average cost of thecapital oroverall cost of capital. This cost is used for evaluatingcapital structure decisions.

4- *Average cost and Marginal cost*: Averagecost istheweighted average cost of each componentsof fundsinvested by the firm for a particular project i.e., percentageor proportionate cost of each element in total investment.

Marginal cost is the cost of obtaininganother rupee of new capital. Generally, a firmraisesacertainamount of fund for fixed capital investment. But marginal cost reveals the cost of additional amount of capital whichisraised by a firm for current or fixed capital investment.

Computation of cost of capital:

1- ***Cost of debt***: Cost of debt may be defined asthereturnexpected by the potential investors of debt securitiesof afirm. It measures the current cost of the firmof borrowingfunds to finance the projects.

➢ Cost of irredeemable debt:

a.) Cost of debt before tax(Kdb)

Kdb= Interest/Net proceeds (NP)

b.)Cost of debt after tax (Kda)

(Kda)= Interest-Tax savings/Net proceeds

➢ Cost of Redeemable Debt:

a.) Cost of debt before tax (Kdb)

Kdb = Annual cost before tax / Averagevalueof debt

2- ***Cost of Preference Share Capital***:

Dividendpaidtothepreference shareholders is the cost of preferencesharecapital.

➢ Cost of irredeemable preference share capital: (kp)= Annual preference dividend/net proceeds(NP)

➢ Cost of redeemable preference share capital: Cost of RPS = Annual cost/ Average valueof RPS3- ***Cost of equity capital***: computation of cost of equityisquite complex. Some people argue that the equitycapital iscost free as the firm is not legally bound to pay dividendtoequity shareholder.

➢ Dividend yield (or) dividend price method: Cost equity (ke) = D1/NP (or) (ke) = D1/MP➢ Dividend price plus growth method: Cost of equity (ke) = D1/NP+G (or) (ke) =D1/MP+G➢ Earning/price method:

Cost of equity (ke) = EPS/NP (or) (ke) = EPS/MP➢ Realised yield method :

I. The shareholder except the realisedyieldof thepast in future as well

II. The firm remains in the same risk class. III. The market price of the shares does not changesignificantly.

➢ Cost of equity under CAPM:

Ke = Rf + β(Rm –Rf)

4- ***Cost of retained earnings***:

Cost of retained earnings (kr) = ke(1-t)(1-b) 5- ***Weighted average cost of capital(WACC***): After having ascertained the cost of each componentsofcapital as explained above, the average or compositecostof all the sources of capital is to be determined. Thenit iscalled weighted average cost of capital.

Financial management

Unit-3

Leverage analysis:

Meaning of leverage:

Leverage means the fixed commitment of the organization. The fixed commitment of the organization can be classified into two different categories viz fixed cost of operation and fixed cost of servicing. The fixed cost of operation is pertaining to the investment decision and the fixed cost of servicing with reference to the financing decision.

Definition of leverage:

According to Ezra Solomon, “Leverage is the ratio of net returns on shareholders equity and the net rate of return on capitalisation”.

Characteristics of leverage:

1. Leverage, as a business term, refers to debt or to the borrowing of funds to finance the purchase of inventory, equipment and other company assets.
2. Business owners can use either debt or equity to finance or buy the company’s assets. Using debt, or leverage, increases the company’s risk the bankruptcy. It also increases the company’s returns; specifically its return on equity.
3. With debt financing, regardless if whether the interest charges are from a loan or line of credit, the interest payments are tax deductible.
4. In addition, by making timely payments a company will establish a positive payment history and business credit rating.
5. Investor in a business prefer the business to use debt financing but only up to a point. Beyond a certain point, investors get

nervous about too much debt financing as it drives up the company's default risk.

Types of leverage:

- Operating leverage
- Financial leverage
- Combined leverage

A) Operating leverage:

Meaning:

The leverage associated with investment activities is called as operating leverage. Operating leverage refers to the use of fixed operating costs such as depreciation, insurance of assets, repairs and maintenance, property taxes etc. in the operation of a firm.

Definition:

Operation leverage may be defined as the "firm's ability to use fixed operating cost to magnify effects of charges in sales on its earnings before interest and taxes."

Characteristics:

- Operating leverages occurs when a firm incurs fixed costs which are to be recovered out of sales revenue irrespective of the volume of business in a period. In a firm having fixed costs in the total cost structure, a given change in sales will result in a disproportionate change in the operating profit or EBIT of the firm.
- If there is no cost in the total cost structure, then the firm will not have an operating leverage. In that case, the operating profit or EBIT varies in direct proportion to the changes in sales volume.
- Operating leverage is associated with operating risk or business risk. The higher the fixed operating costs, the higher the firm's operating leverage and its operating risk. Operating risk is the degree of uncertainty that the

firm has faced in meeting its fixed operating cost where there is variability of EBIT.

- It arises when there is volatility in earnings of a firm due to changes in demand, supply, economic environment, business conditions etc. The larger the magnitude of operating leverage, the larger is the volume of sales required to cover all fixed costs.
- When a firm has fixed operating costs an increase in sales volume results in a more than proportionate increase in EBIT. Similarly, a decrease in the level of sales has an exactly opposite effect.

Importance of operating leverage:

1. It gives an idea about the impact of changes in sales on the operating income of the firm.
2. High degree of operating leverage magnifies the effect on EBIT for a small change in the sales volume.
3. High degree of operating leverage indicates increase in operating profit or EBIT.
4. High operating leverage results from the existence of a higher amount of fixed costs in the total cost structure of a firm which makes the margin of safety low.
5. High operating leverage indicates higher amount of sales required to reach break-even point.
6. Higher fixed operating cost in the total cost structure of a firm promotes higher operating leverage and its operating risk.
7. A lower operating leverage gives enough cushion to the firm by providing a high margin of safety against variation in sales.
8. Proper analysis of operating leverage of a firm is useful to the finance manager.

B) Financial leverage:

Meaning:

A leverage activity with financing activities is called financial leverage. Financial leverage is primarily concerned with the financial activities which involve raising of funds from the sources for which a firm has to bear fixed charges such as interest expenses, loan fees etc. These sources include long-term debt (i.e., debentures, bonds etc.) and preference share capital.

Definition:

According to Gitman financial leverage is "the ability of a firm to use fixed financial charges to magnify the effects of changes in EBIT on firm's earnings per share".

Characteristics:

- Favourable or positive financial leverage occurs when a firm earns more on the assets investment purchased with the funds, than the fixed cost their use.
- Unfavourable or negative leverage occurs when the firm does not earn as the funds cost.
- Thus shareholder gain where the firm earns a higher rate of return and pays a lower rate of return to the supplier of long-term funds.
- The difference between the earnings from the assets and the fixed cost on the use of funds goes to the equity shareholders. Financial leverage is also, therefore, called as 'trading on equity'.
- Financial leverage is associated with financial risk. Financial risk refers to risk of the firm not being able to cover its fixed financial costs due to variation in EBIT. With the increase in financial charges, the firms is also

required to raise the level of EBIT necessary to meet financial charges.

Importance:

1. It increases earning per share (EPS) as well as financial risk.
2. A high financial leverage indicates existence of high financial fixed costs and high financial risk.
3. It help to bring balance between financial risk and return in the capital structure.
4. It shows the excess on return on investment over the fixed cost on the use of the funds.
5. It is an important tool in the hands of the finance manager while determining the amount of debt in the capital structure of the firm.

C) <u>Combined leverage:</u>

Meaning:

Combined leverage is the combination of operating leverage and financial leverage. Combined leverage is a leverage which refers to high profits due to fixed costs. It includes fixed operating expenses with fixed financial expenses. It is also called as composite leverage or total leverage.

Characteristics:

- Operating leverage shows the operating risk and is measured by the percentage change in EBIT due to percentage change in sales.
- The financial leverage shows the financial risk and is measured by the percentage change in EPS due to percentage change in EBIT.
- Both operating and financial leverage are closely concerned with ascertaining the firm's ability to cover fixed costs or fixed rate of interest obligation.

- If it combines then the result is total leverage and the risk associated with combined leverage is known as total risk.
- It measures the effect of a percentage change in sales on percentage change in EPS.

Importance:

1. It includes the effect that changes in sales will have on EPS.
2. It shows the combined effect of operating leverage and financial leverage.
3. A combination of high operating leverage and a high financial leverage is very risky situation because the combined effect of the two leverages is a multiple of these two leverages.
4. A combination of high operating leverage and a low financial leverage indicates that the management should be careful as the high involved in the former is balanced by the later.
5. A combination of low operating and low financial leverage indicates that the firm losses profitable opportunities.

Dividend:

Meaning:

The term dividend refers to that portion of profit (after tax) which is distributed among the owners/shareholders of the company.

Definition:

According to the Institute of chartered accountants of India, dividend is "a distribution over the time to shareholders.

Dividend policy:

Meaning:

Dividend policy means the practice that management follows in making dividend payout decisions, or in other words, the size and pattern of cash distribution over the time to shareholder.

Definition:

According to Moyer Guigan "Dividend policy determines the ultimate distribution of the firm's earnings between retention (that is reinvestment) and cash dividend payments of shareholders".

Types of dividend:

1. **Cash dividend**:
   Companies mostly pay dividends in cash. A company should have enough cash in its bank account when cash dividends are declared. If it does not have enough bank balance, arrangement should be made to borrow funds. The cash account and the reserve account of a company will be reduced when the cash dividend is paid.
2. **Bonus shares or stock- dividend**:
   An issue of bonus share is the distribution of shares free of cost the existing shareholders, In India, Bonus shares are issued in addition to the cash dividend and not in lieu of cash dividend. Hence, companies in India may supplement cash dividend by bonus issues.
3. **Special dividend**:
   In special circumstances company declares special dividends. Generally, company declares special dividend in case of abnormal profits.
4. **Extra- dividend**:
   An extra dividend is an additional non-recurring dividend paid over and above the regular dividends by the company, companies with fluctuating earnings payout additional

dividends when their earnings warrant it, rather than fighting to keep a higher quantity of regular dividends.

5. **Annual dividend**:
   When annually company declares and pay dividend is defined as annual dividend.

6. **Interim dividend:**
   During the year any time company declares a dividend, it is defined as interim dividend.
7. **Regular cash dividend**:
   Regular cash dividend are those the company exacts to maintain every year. They may be paid quarterly, monthly, semiannually or annually.
8. **Scrip dividend**:
   These are promises to make the payment of dividend at a future date: Instead of paying the dividend now, the firm elects to pay it at some later date. The 'scrip' issued to stockholders is merely a special form of promissory note or notes payable.
9. **Liquidating dividend:**
   These dividends are those which reduce paid- in capital. It is a pro-rata distribution of cash or property to stock holders as part of the dissolution of a business.
10. **Property dividend**:
    These dividends are payable in assets of the corporation other than cash. For example, a firm may distribute samples of its own product or shares in another company it owns to its stockholders.

Types of dividend policy:

1. **Stable dividend policy**:
   According to this policy, the percentage of earnings paid out of dividends remains constant. The dividends will fluctuate with the earnings of the company.

2. **Low regular dividend plus extra dividend policy**:
   As per this policy, a low, regular dividend is maintained and when times are good an extra dividend is paid. Extra dividend is the additional dividend optionally paid by the firm if earnings are higher than normal in a given period.
3. **Residual dividend policy**:
   Under this policy, dividends are paid out of earnings not needed to finance new acceptable capital projects. The dividends will fluctuate depending on investment opportunities available to the company.
4. **Multiple dividend increase policy**:
   Some firms follow the policy of very frequent and small dividends increases. The objective is to give shareholders an illusion on movement and growth.
5. **Erratic dividend policy**:
   Dividends are paid erratically when the management feels it will not strain the resources of the firms. Interests of the shareholders are not taken care of while making the dividend decision.
6. **Uniform cash dividend plus bonus policy**:
   Under this policy, the minimum rate of dividend per share is paid in cash plus bonus shares are issued out of accumulated reserves.

CAPITAL STRUCTURE

CAPITAL STRUCTURE – AN INTRODUCTION:

General public often hear corporate officers, professional investors and investment analysis discuss a company's capital structure. They may not know what a capital structure is or why should even concern with something that sounds so technical but rest assured that the concept is extremely important because it can influence not only the return, a company earns for its shareholders but whether or not a firm survives in a recession or depression.

CAPITAL STRUCTURE – WHAT IT IS? AND WHY IT MATTERS?

The term capital structure refers to the percentage of capital (money) at work in a business by type. Broadly speaking, there are two form of capital: equity capital and dept capital. Each type of capital has its own benefits and drawbacks and a substantial park of wise corporate stewardship and management is attempting to find the perfect capital structure in terms of risk/ reward payoff for shareholders.

This is true for big corporate companies and for small business owners trying to determine how much of their start-up money should come from a bank loan without endangering the business.

CAPITAL STRUCTURE –MEANING:

The capital structure is how a firm finances its overall operation and growth by using different sources of funds. Debt comes in the form of bond issues or long-term notes payable, while equity is classified as common stock, preferred stock or retained earnings. Short-term dept such as working capital requirements is also considered to be part of the capital structure.

Capital structure is essentially concerned with how the firm decides to divide its cash flows into two broad components, a fixed component that is earmarked to meet the obligations toward dept capital and a residual component that belongs to equity shareholders.

CAPITAL STRUCTURE – DEFINITION:

According to Gere Stenberg, 'capital structure of a company refers to the composition or make up of its capitalization and it includes all long-term capital resources viz., loans, reserves, shares and bonds'.

Keown defined capital structure as, 'balancing the array of funds sources in a proper manner, i.e. in relative magnitude or in proportions.

CONCEPT OF CAPITAL STRUCTURE:

The relative proportion of various sources of funds used in business is termed as financial structure. Capital structure is a part of the financial structure and refers to the proportion of the various long term sources of financing. It is concerned with making the array of the sources of the funds in a proper manner, which is in relative magnitude and proportion.

The capital structure of a company is made up of debt and equity securities that comprise a firm's financing of its assets. It is the permanent financing of a firm represented by long-term debt, preferred stock and net worth. So, it relates to the arrangement of the capital and excludes short-term borrowings. It denotes some degree of permanency as it excludes short-term sources of financing.

Again, each component of capital structure has a different cost to the firm. In case of companies, It is financed from various sources. In proprietary concerns, usually, the capital employed, is

wholly contributed by its owners. In this context, capital refers to the total of funds supplied by both-owners and long-term creditors.

The question arises: what should be the appropriate proportion between owned and debt capital? It depends on the financial policy of individual firms. In one company dept capital may be nil while in another such capital may even be greater than the owned capital. The proportion between the two, usually expressed in terms of a ratio, denotes the capital structure of a company.

IMPORTANCE OF CAPITAL STRUCTURE:

The importance of designing a proper capital structure is explained below:

a) VALUE MAXIMIZATION:

Capital structure maximizes the market value of a firm, i.e. in a firm having a properly designed capital structure the aggregate value of the claims and ownership interests of the shareholders are maximized.

b) COST MINIMIZATION: Capital structure minimizes the firm's cost of capital or cost of financing. By determining a proper mix of fund sources, a firm can keep the overall cost of capital to the lowest.

c) INCREASING IN SHARE PRICE: Capital structure maximizes the company's market price of share by increasing earnings per share of the ordinary shareholders. It also increases dividend receipt of the shareholders.

d) INVESTMENT OPPORTUNITY: Capital structure increases the ability of the company to find new wealth-creating investment opportunities. With proper capital gearing it also increases the confidence of suppliers of debt.

e) GROWTH OF THE OPPORTUNITY: Capital structure increases the country's rate of investment and growth by increasing the firm's opportunity to engage in future wealth- creating investments.

PATTERNS OF CAPITAL STRUCTURE:

There are usually two sources of funds used by a firm: Debt and equity. A new company cannot collect Sufficient funds as per their requirements as it has yet to establish its creditworthiness in the market; consequently, they have to depend only on equity shares, which is the simple type of capital structure; After establishing its creditworthiness in the market, its capital structure gradually becomes complex.

COMPLEX CAPITAL STRUCTURE PATTERN MAY BE OF FOLLOWING FORMS:

a. Equity Shares and Debentures (i.e. long-term debt including Bonds etc.).
b. Equity Shares and Preference Shares.
c. Equity Shares, Preference shares and Debentures (i.e. long-term debt including Bonds etc.).

However, irrespective of the pattern of the capital structure, a firm must try to maximize the earnings per share for the equity shareholders and also the value of the firm.

FACTORS THAT INFLUENCING COMPANY'S CAPITAL-STRUCTURE DECISION ARE:

a. **Trading on Equity:** The word "equity" denotes the ownership of the company. Trading on equity means taking advantage of equity share capital to borrowed funds on reasonable basis. It refers to additional profits that equity shareholders earn because of issuance of debentures and preference shares. It is based on the thought that if the rate of dividend on preference capital and the rate of interest on borrowed capital is lower than the general rate of company's earning, equity shareholders are at advantage which means a company should go for a judicious blend of preference shares, equity shares as well as debentures. Trading on equity becomes more important when expectations of shareholders are high.

b. **Degree of control:** In a company, it is directors who are called elected representative of equity shareholders. These members have got maximum voting rights in a concern as compared to the preference shareholders and debenture holders. Preference shareholders have reasonably less voting rights while debenture holders have no voting rights. If the company's management policies are such that they want to retain their voting rights in their hands, the capital structure consists of debenture holders and loans rather than equity shares.

c. **Flexibility of Financial Plan:** In an enterprise, the capital structure should be such that there is both contractions as well as relaxation in plans. Debentures and loans can be refunded back as the time requires. While equity capital cannot be refunded at any point which provides rigidity to plan. Therefore, in order to make the capital structure possible, the company should go for issue of debentures and other loans.

d. **Choice of Investors:** The Company's policy generally is to have different categories of investors for securities. Therefore a capital structure should give enough choice to all kind of investors to invest. Bold and adventurous investors generally go for equity shares and loans and debentures are generally raised keeping into mind conscious investors.

e. **Capital Market Condition:** In the lifetime of the company, the market price of the shares got an important influence. During the depression period, the company's capital structure generally consists of debentures and loans. While in period of boons and inflation, the company's capital should consist of share capital generally equity shares.

f. **Period of financing:** When company wants to raise finance for short period, it goes from banks and other institutions; while for long period it goes for issue of shares and debentures.

g. **Cost of financing:** In a capital structure, the company has to look to the factor of cost when securities are raised. It is seen that debentures at the time of profit earning of company prove to be a cheaper source of finance as compared to equity shareholders demand an extra share in profits.

h. Stability of sales: An established business which has a growing market and high sales turnover, the company is in position to meet fixed commitments. Interest on debentures has to be paid

regardless of profit. Therefore, when sales are high, thereby the profits are high and company is in better position to meet such fixed commitments like interest on debentures and dividends on preference shares. If company is having unstable sales, then the company is not in position to meet fixed obligations. So, equity capital powers to be safe in such cases.

i. Sizes of a company: Small size business firm's capital structure generally consists of loans from banks and retained profits. While on the other hand, big companies having goodwill, stability and an established profit can easily go for issuance of shares and debentures as well as loans and borrowings from financial institutions. The bigger the size, the wider is total capitalization.

j. Business Risk: Excluding debt, business risk is the basic risk of the company's operations. The greater the business risk, the lower the optimal debt ratio.

k. Company's Tax Exposure: Debt payments are tax deductible. As such, if a company's tax rate is high, using debt as a mean of financing a project is attractive because the tax deductibility of the debt payments protects some income from taxes.

l. Financial Flexibility: This is essentially the firm's ability to raise capital in bad times. It should come as no surprise that companies typically have no problem raising capital when sales are growing and earnings are strong. However, given a company's debt level, the more financial flexibility a company has.

m. Management Style: Management styles range from aggressive to conservative. The more conservative a management's approach is, the less inclined it is to use debt to increase profits. An aggressive management may try to grow the firm quickly, using significant amounts of debt to ramp up the growth of the company's earnings per share (EPS).

n. Growth Rate: Firms that are in the growth stage of their cycle typically finance that growth through debt, borrowing money to grow faster. The conflict that arises with this method is that the revenues of growth firms are typically unstable and unproven. As such a high debt load is usually not appropriate. More stable and mature firms typically need less debt to finance growth as its revenues are stable and proven. These firms also generate cash flow, which can be used to finance projects when they arise.

o. Market condition: Market conditions can have a significant impact on a company's capital-structure condition. Suppose a firm needs to borrow funds for a new plant. If the market is struggling, meaning investors are limiting companies' access to capital because of market concerns, the interest rate to borrow may be higher than a company would want to pay. In that situation, it may be prudent for a company to wait until market conditions return to a more normal state before the company tries to access funds for the plant.

FEATURES OF CAPITAL STRUCTURE:

Capital structure in simple words refers to debt equity ratio of a company. In other words, it refers to the production of debt in the investments of the company. It is important for a company to have an appropriate capital structure; a proper capital structure should have the following features:

a. Flexibility: The consideration of flexibility gives the finance manager the ability to alter the firm's capital structure with a minimum cost and delay, if warranted by the changed environment. It should also be possible for the company to provide funds whenever needed to finance its profitable activities.

b. Profitability: A sound capital structure should permit the maximum use of leverage at a minimum cost so as to provide better profitability and thus maximizing earnings per share.

c. Solvency: Extensive debt threatens the solvency and credit rating of the company. The debt financing should be only to the extent that it can be serviced fully and also be paid back (if required).

d. Conservatism: No company should exceed its debt capacity. As already explained that the interest is to be paid on debt and the principal sum is also to be paid. These payments depend on future cash flows. If future cash flows are not sufficient then the cash insolvency can lead to legal insolvency.

e. Control: The capital structure should not lead to loss of control in the company.

f. Tax advantage: The capital structure should be such that it gives maximum gain to a company. Since interest rate on debt is a tax-deductible expenses company should make use of leverage or debt in order to gain tax advantage.

g. Congruence with the goals of the company: Capital structure should be in congruence with the goals of the company, which implies that if the policy of the company will not take more debt, than capital structure should be framed accordingly and it should have included more equity and less debt.

CAPITALISATIOM, CAPITAL STRUCTURE AND FINANCIAL STRUCTURE:

CAPITALISATON-MEANING:

Capitalisation refers to the amount of long term funds available to a company. Capitalisation refers to the par value of securities i.e., shares and debentures plus any other reserves kept meeting long term and permanent need of a company.

CAPITALISATION STRUCTURE-MEANING:

Capital structure is the permanent financing of the firm represented primarily by long term debt and shareholders' funds but excluding all short-term credit.

FINANCIAL STRUCTURE-MEANING:

Financial structure refers to the composition or make up of the entire liabilities side of the balance sheet of a firm. It shows the way in which the firm's assets are financed. It included long term as well as short-term, sources of finance.

EBIT-EPS ANALYSIS:-

EBIT-EPS ANALYSIS-MEANING:

EBIT-EPS analysis gives a scientific basis for comparison among various financial plans and shows ways to maximum EPS.

EBIT-EPS ANALYSIS-DEFINITION:

EBIT-EPS analysis may be defined as ‘a tool of financial planning that evaluates various alternatives of financing a project under varying levels of EBIT and suggests the best alternative having highest EPS and determines the best profitable level of EBIT.’

CONCEPT OF EBIT-EPS ANALYSIS:

- The EBIT-EPS analysis is the method that studies the leverage i.e., comparing alternative methods of financing at different levels of EBIT.
- Simply put, EBIT-EPS analysis examines the effect of financing leverage on the EPS with varying levels of EBIT or under alternative financial plans.
- It examines the effect of financial leverage on the behaviour of EPS under different financing alternatives and with varying levels of EBIT.
- EBIT-EPS analysis is used for making the choice of the combination and of the various sources. It helps select the alternatives that yield the highest EPS
- A firm can finance its investment from various sources such as borrowed capital. The proportion of various sources may also be different under various financial plans. In every financing plan the firm’s objectives lie in maximizing EPS.

ADVANTAGES OF EBIT-EPS ANALYSIS

a) **Financial Planning:**

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

b) **Comparative Analysis:**

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

c) **Performance Evaluation:**

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

d) **Determining Optimum Mix:**

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

LIMITATIONS OF EBIT-EPS ANALYSIS:-

a. No Consideration for Risk: Leverage increases the level of risk, but this technique ignores the risk factor. When a corporation, on its borrowed capital, earns more than the interest it has to pay on debt,

any financial planning can be accepted irrespective of risk. But in times of poor business the reverse of this situation arises which attracts high degree of risk. This aspect is not dealt in EBIT-EPS analysis.

b. Contradictory Results: It gives a contradictory result where under different alternative financing plans new equity shares are not taken into consideration. Even the comparison becomes difficult if the number of alternatives increase and sometimes it also gives erroneous result under such situation.

c. Over-capitalization: This analysis cannot determine the state of over-capitalisation of a firm. Beyond a certain point, additional capital cannot be employed to produce a return in excess of the payments that must be made for its use. But this aspect is ignored in EBIT-EPS analysis.

CAPITAL STRUCTURE THEORIES (OR) APPROACHES:

Capital Structure Theories deals with the question whether change in capital structure influences the value of the firm. These are four approaches to this, viz. net income approach, net operating income approach, traditional approach and M&M approach.

CAPITAL STRUCTURE THOERIES(OR) APPROACHES

A. David Durand Views:
   1. Net Income Approach (NI Approach)
   2. Net Operating Income Approach (NOI Approach)

B. Traditional Approach

C. Modigliani and Miller Approach (MM Approach)

A. DAVID DURAND VIEWS:

The existence of an optimum capital structure is not accepted by all. There exist two extreme views and a middle position. David Durand identified the two extreme views- the Net income approach and net operating approaches.

1. NET INCOME APPROACH (NI APPROACH):

Net income theory was introduced by David Durand. According to this approach, the capital structure decision is relevant to the valuation of the firm. This means that a change in the financial leverage will automatically lead to a corresponding change in the overall cost of capital as well as the total value of the firm. According to NI approach, if the financial leverage increases, the weighted average cost of capital decreases and the value of the firm and the market price of the equity shares increases. Similarly, if the financial leverage decreases, the weighted average cost of capital increases and the value of the firm and the market price of the equity shares decreases.

Under this approach, the cost of debt and the cost of equity are assumed to be independent of the capital structure. The weighted average cost of capital declines and the total value of the firm rise with increased use of average.

ASSUMPTIONS OF NI APPROACH:

- There are no taxes
- The cost of debt is less than the cost of equity
- The use of debt does not change the risk perception of the investors

2. NET OPERATING INCOME APPROACH (NOI APPROACH):

Net Operating Income Approach was also suggested by Durand. This approach is of the opposite view of Net Income Approach. This approach suggests that the capital structure decision of a firm is irrelevant and that any change in the leverage or debt will not result in a change in the total value of the firm as well as the market price of its shares. This approach also says that the overall cost of capital is independent of the degree of leverage.

Under the net operating income (NOI) approach, the cost of equity is assumed to increase linearly with average. As the result, the weighted average cost of capital remains constant and the total of the firm also remains constant as average changed.

Thus, if the NI approach is valid, average is a significant variable and financing decisions have an important effect on the value of the firm. On the other word, if the NOI approach is correct, then the financing decision should not be of greater concern to the financial manager, as it does not matter in the valuation of the firm.

FEATURES OF NOI APPROACH:

- At all degrees of leverage (debt), the overall capitalization rate would remain constant. For a given level of earnings before Interest and Taxes (EBIT), the value of a firm would be equal to EBIT overall capitalization rate.
- The value of equity of a firm can be determined by subtracting the value of debt from the total value of the firm. This can be denoted as follows:
- Value of Equity=Total value of the firm-Value of debt.
- Cost of equity increases with every increase in debt and the weighted average cost of capital (WACC) remain constant. When the debt content in the capital structure increases, it increases the risk of the firm as well as its shareholders. To compensate for the higher risk involved in investing in highly levered company, equity holders naturally expect higher returns which in turn increase the cost of equity capital.

B. TRADITIONAL APPROACH:

The Net Income theory and Net Operating Income theory stand in extreme forms. Traditional approach stands in the midway between these two theories. This traditional theory was advocated by financial exerts Solomon and Fred Weston.

Accordingly to this theory a proper and right combination of debt and equity will always lead to market value enhancement of the firm. This approach accepts that the equity shareholders perceive financial risk and expert premiums for the risks undertaken. This theory also states that after a level of debt in the capital structure, the cost of equity capital increases.

The traditional approach is a compromise between the net income approach and the net operating approach. Accordingly to this view, the value of the firm can be increased or the cost, of capital can be reduced by the judicious mix of debt and equity capital.

The traditional approach very clearly implies that the cost of capital decreases within the reasonable limit of debts and then increase with average. Thus an optimum capital structure exists and

occurs when the cost of capital is minimum or the value of the firm is maximum.

The cost of capital declines with leverage because debt capital is chipper than equity capital within reasonable, or acceptable, limit or debt. The weighted average cost of capital will decrease with the use of debt.

CRITICISM OF TRADITIONAL APPROACH:

- The traditional view is criticised because it implies that totality of risk incurred by all security holders of a firm can be altered by changing the way in which this totality of risk is distributed among the various classes of securities.
- Modigliani and Miller also do not agree with the traditional view. They criticise the assumption that the cost of equity remains unaffected by leverage up to some reasonable limit.

C. MODIGLIANI AND MILLER APPROACH (MM APPROACH):

Modigliani Miller approach, popularly known as the MM approach is similar to the Net operating income approach. The MM approach favors the Net operating income approach and agrees with the fact that the cost of capital is independent of the degree of leverage and at any mix of debt-equity proportions.

The significance of this MM approach is that it provides operational or behavioral justification for constant cost of capital at any degree of leverage. Whereas, the net operating income approach does not provide operational justification for independence of the company's cost of capital.

The Modigliani-Miller Hypothesis is identical with the net operating income approach; Modigliani and Miller (M.M) argue that, in the absence of taxes, a firm's market value and the cost of capital remain invariant to the capital structure changes.

MM theory or approach is fully opposite of traditional approach. This approach says that there is not any relationship between capital structure and cost of capital. There will not affect of increasing debt on cost of capital.

Value of firm and cost of capital is fully affected from investor's expectations may be further affected by large numbers of other factors affected by large numbers of other factors which have been ignored by traditional theorem of capital structure.

BASIC PROPOSITIONS OF MM APPROACH:-

- At any degree of leverage, the company's overall cost of capital (KO) and the firm (V) remains constants. This means that it is independent of the capital structure. The total value can be obtained by capitalizing the operating earnings stream that is expected in future, discounted at an appropriate discount rate suitable for the risk undertaken.
- The cost of capital (Ke) equals the capitalization rate of a pure equity stream and a premium for financial risk. This is equal to the difference between the pure equity capitalization rate and ki times the debt-equity ratio.

- The minimum cut-off rate for the purpose of capital investments is fully independent of the way in which a project is financed.

ASSUMPTIONS OF MM APPROACH:-

- Capital markets are perfect, so the securities are traded in the perfect market situation.
- All investors have the same expectation of the company's net operating income for the purpose of evaluating the value of the firm.
- Within similar operating environments, the business risk is equal among all firms.
- 100% dividend payout ratio.
- An assumption of "no taxes" was the earlier, which has been removed. So, no corporate income taxes exist.
- Firms can be grouped into homogeneous risk classes.
- The expected NOI is a random variable.
- Firm distribute all net earnings to the shareholders.

CRITICISM OF MM APPROACH:-

- The shortcoming of the MM hypothesis lies in the assumption of perfect capital market in which arbitrage is expected to work.
- Due to the existence of imperfections in the capital market/arbitrage will fail to work and will give rise to discrepancy between the market values of levered and unlevered firms.

INDIFFERECE POINT:-

INDIFFERENCE POINT – MEANING:

Indifference points refer to the EBIT level at which the EPS is same for two alternative financial plans.

INDIFFERENT POINT – DEFINITION:

According to J.C.Van Home, 'Indifference point refers to that EBIT level at which EPS remains the same irrespective of debt equity mix".

CONCEPT OF INDIFFERENCE POINT:

- The indifference point, often called as breakeven point, is highly important in financial planning because; at EBIT amounts in excess of the EBIT indifference level, the more heavily levered financing plan will generate a higher EPS.
- On the other hand, at EBIT amount below the EBIT indifference points the financing plan involving less leverage will generate a higher EPS.
- The management is indifferent in choosing any of the alternative financial plans at this level because all the financial plans are equally desirable.
- The indifferent point is the cut-off of level of EBIT below which financial leverage is disadvantageous. Beyond the indifference point level of EBIT the benefit of financial leverage with respect to EPS starts operating.
- The indifference level of EBIT is significant because the financial planner may decide to take the debt advantage if

the expected EBIT crosses this level. Beyond this level of EBIT, the firm will be able to magnify the effect of increase in EBIT on the EPS.

- In other words, financial leverage will be favorable beyond the indifference level of EBIT and will lead to an increase in the EPS .If the expected EBIT is less than the indifferent point then the financial planners will opt for equity for financing projects, because this level, EPS will be more for less levered firm.

COMPUTATION OF INDIFFERENT POINT:-

Indifference point refers to the level of EBIT at which EPS is the same for two different financial plans. So the level of that EBIT can easily be computed.

There are two approaches to calculate indifferent points:

a) Mathematical approach and b) Graphical approach.

a) Mathematical Approach:

Under the mathematical approach, the indifference point may be obtained by solving equations.

b) Graphical Approach:

The indifference point may also be obtained using a graphical approach. Under graphical approach EBIT along the horizontal axis and EPS along the vertical axis.

Unit - 5

FINANCIAL MANAGEMENT

CAPITAL BUDGETING :-

MEANING :-

Capital budgeting is the process of making investment descisions regarding capital expenditures. A capital expenditure is an expenditure incurred for acquiring or improving the fixed assets, the benefits of which are expected to be received beyond one year in future.

- The purchase of fixed assets for expansion of business
- Cost of replacement of fixed assets already in use
- Modernisation of existing machinery
- Research and development projects for reducing cost and improving quality of products and finding new uses of the product

DEFINITION OF CAPITAL BUDGETING :-

Charles T.Horngreen has defined capital budgeting as,"a long- term planning for making and financing proposed capital outlay"

NEED AND IMPORTANCE OF CAPITAL BUDGETING :-

Capital Budgeting decisions are vital to any organisation. Special care should be taken in making these decisions on account of the following reasons:-

1. ***Heavy Investment :-***
   All capital expenditure project involve heavy investment of funds. These funds are raised by the firm from various exteral and internal sources. Hence, it is important for a firm to plan its capital expenditure.
2. ***Permanent Commitment of Funds :-***
   The funds involved in capital expeditures are not only large but also more or less permanently blocked. Therefore, these are long term investment decisions. The longer the time, the greater is the risk involved. Hence, careful planning is essential.
3. ***Long Term Effect on Profitability :-***

Capital budgeting decisions have a long term and significant effect on the profitability of the concern. If properly planned, they can increase the size, scale and volume of sales as well as the growth pothential of the concern.

4. ***Irreversible in Nature :-***

   In most cases, capital budgeting descisions are irreversible. Once the decision for acquiring a permanentasset is taken, it is very difficult to reverse that decision. This is becauseIt is difficult to dispose of these assets without incurring heavy losses.

5. ***Difficult to make Investment Decisions :-***

   The capital investment decisions involve an assessment of future event which in fact is difficult to predict. It is really difficult to estimate future cash flows of an investment.

TYPES OF CAPITAL EXPENDITURE DECISION :-

There are many ways to classify the capital budgeting decisions. One way is to classify them on the basis of firm's existence. Another way is to classify them on the basis of decision situation.

1. **On the basis of firm's existence :-**

   The capital expenditure decisions are taken by both newly incorporated firms as well as by existing firms. The new firms may take decisions relating to selection of a plant to be installed.

a) ***Replacemennt and Modernisation decisions :-***

   The main objective of replacement and modernisation is to improve the operating efficiency and reduce the cost. All types of plant and machinery require replacement either because of the economic life of the machinery is over or because it has become technologically outdated.

b) ***Expansion decisions :-***

   Existing sucessful firms may experience growth in demand for their products which cannot be met by their existing production capacity. In such a case they have to take a decision for increasing their production capacity. Sometimes, a company may also acquire existing firms to expand its business.

c) ***Diversification decisions :-***

In the present world, a firm cannot depend on a single line production activity or single market. In order to reduce the risk a firm has to diversify its product line and operate in several markets.

2. **<u>On basis of decision situation :-</u>**

   The capital budgeting on the basis of decision situation are classified as follows :-

a) Independent investments / Accept or Reject Proposals :-

Accepts or rejects proposal relate to projects which serve different purpose and do not compete with one another. The firm may accept or reject a proposal on the basis of a minimum return required on investment.

b) Contingent investments / Dependent Proposals :-

These are proposals whose acceptance depends upon the acceptance of one or more other proposals. For example, if a company accepts a proposal to set up a factory in remote area, it may have to invest in building roads, houses, hospital, school etc. for employees to attract work force.

c) Mutually Exclusive Investments :-

These are proposals which serve the same purpose and compete with one another. The acceptance of one proposal will automatically reject the other proposal. Eg. There are two mutually exclusive project A and B. If project A is accepted, project B is automatically rejected.

<u>PROCESS / PROCEDURE OF CAPITAL BUDGETING :-</u>

1. ***Identification of investment proposals :-***

   The first step in the capital budgeting process is the conception of a profit making idea. The investment proposal of various types may originate at different levels within a firm, depending on their nature. They may originate from the level of workers to top management level.

2. ***Screening the proposals :-***

   In large organisations, the capital Expediture Planning Committee is established to screen the various proposals received from different department heads. The committee views these proposals from various angles to ensure that these are in accordance with the selection criterion of the firm and they do not lead to departmental imbalances.

3. ***Project Evaluation :-***

   The next step is to evaluate the profitability of various proposals in terms of the cost of capital, the expected returns from alternative investment opportunitites and the life of the asset. The following are some of the techniques used to evaluate the financial aspects of a project.

   - Pay back method
   - Discounted cash flow method and
   - Accounting rate of return method

4. ***Establishing priorities :-***

   After evaluation, the uneconomic or unprofitable proposals should be rejected. But it may not be possible for a firm to invest immediately in all the acceptable proposals due to limitation of funds. Hence, it is necessary to rank the various proposals and to establish priorities after considering urgency, risk and profitability involved therein.

5. ***Final approval :-***

   Proposals finally recommended by the committee are sent to the top management along with the detailed report, both of capital expenditure and of sources of funds to meet them. The financial manager will present several alternative capital expenditure budgets to the top management. It will finally approve the capital budget for the firm.

6. **Implementation :-**

   While implementing the project, it is better to assign responsibilities to project managers for completing the project within the given time frame and cost limit. This is necessary in order to avoid unnecessary delays and cost over runs.

7. ***Performance review :-***

   The last stage in the process of capital budgeting is the evaluation of the performannce of the project. Performance review or post completion audit, is a feed back device, It is a means for comparing actual performance with budgeted data.

FACTOR INFLUENCING CAPITAL EXPENDITURE DECISIONS :-

1. ***Availability of funds :-***

Generally, capital expediture projects require large funds. A project, however profitable, may not be taken for want of funds. So, projects with a lesser profitability may be sometime preferred due to lesser pay back period for want of liquidity.

2. ***Urgency :-***

   Sometime an investment is to be made on the grounds of urgency for the firm's survival or to aviod heavy losses. In such circumstance, proper evaluation of proposal cannot be made through profitability test. Eg. Break down of machinery, fire accident etc.

3. ***Legal compulsion :-***

   When statutory compulsion arises, investment has to made in a project though it may not be profitable one. For example, waste disposal plant have to be installed to satisfy the environmental laws, particulary in industries like leather and chemical.

4. ***Degree of uncertainty or risk :-***

   Profitability is directly related to risk. Normally, higher the profits, greater is the risk or uncertainty. Sometime, a project with lower profitability may be selected due to constant flow of income as compared to another project with an irregular and uncertain flow of income.

5. ***Intangible factors :-***

   Sometime, a capital expenditure has to be made due to certain emotional and intangible factor such as safety and welfare of workers, prestigious project, social welfare, goodwill of the firm etc. though such investments are not be profitable.

6. ***Obsolescence :-***

   If obsolete plant and machinery exist in a firm, their replacement become necessary.

7. ***Research and Development project :-***

   It is necessary for the long-term survival of the bussiness to invest in research and development project through it may not look to be a profitable investment.

8. ***Competitors' activities :-***

   When competitors perform certain activities, they may compel a firm to undertake similar activities to withstand competition.

9. ***Future earnings :-***

   A project may not be profitable today when compared to another one, but it may promise better future earnings. In such cases, it may be preferred to increase earning.

METHOD OF EVALUTING CAPITAL EXPENDITURE PROPOSALS :-

PAY BACK PERIOD METHOD :-

Pay back method is popularly known as pay off, or pay out method. It is defined as the number of years required to recover the initial cash outlay invested in a project.

FORMULA :-

$$\text{Pay back period} = \frac{\text{Initial investment}}{\text{Annual cash inflow}}$$

MERITS PAY BACK PERIOD METHOD :-

1. It is easy to calculate and simple to understand.
2. It is preferred by executives who like quick answers for selection of the proposal.
3. It is useful where the business is suffering from shorage of funds as quick recovery is essential for repayment.

DEMERITS PAY BACK PERIOD METHOD :-

1. It does not take into account the life of the project, depreciation, scrap value, interest factor etc.
2. It completely ignores cash inflows after the pay back period.
3. The profitability of the project is completely ignored.

ACCOUNTING OR AVERAGE RATE OF RETURN METHOD :-

It is known as accounting rate of return because it takes into account, the accounting concept of profit (i.e. profit after depreciation and tax) and not the cash inflows. The project which yields the highest rate of return is selected.

The accounting rate of return may be calculated by any of the following methods.

FORMULA :-

1. $ARR = \frac{\text{Average Annual profit}}{\text{Original investment}} \times 100$ **(or)**

2. $ARR = \frac{\text{Average Annual profit}}{\text{Average investment}} \times 100$

- ***The average investment can be calculated by any of the following method :-***

$$\frac{\text{Original Investment}}{2}$$

(or)

$$\frac{\text{Original Investment} - \text{Scrap value}}{2}$$

MERITS ACCOUNTING OR AVERAGE RATE OF RETURN METHOD :-

1. It is simple to understand and easy to calculate.
2. This method gives due weightage to the profitability of the project.
3. It take into consideration the total earning from the project during its life time.

DEMERITS OF ACCOUNTING OR AVERAGE RATE OF RETURN METHOD :-

1. It uses accounting profits and not the cash inflow in appraising the project.
2. It ignores the time value of money. Profits earned in different periods are valued equally.
3. It considers only the rate of return and not the life of the project.

DISCOUNTED CASH FLOW METHOD :-

The discounted cash flow method is an improvement on the pay back method. It takes into account both the profitability and the time value of money.

They are three types :-

a. **Net Present Value method.**
b. **Excess Present Value index.**
c. **Internal Rate of Return.**

- ***Net Present Value Method (NPV) :-***

  Under this method, present value of cash inflow is calculated at the required rate of return and compared with the original investment. If the present value is higher than the original investment, the project can be selected, otherwise rejected.

- ***Excess Present Value Index :-***

  One of the major disadvantages of the present value method is that it is not easy to rank projects on the basis of net present value when the costs of the projects differ. To compare such projects the present value index is prepared. ***It can be calculated with the help of the following formula.***

  Excess Present Value Index =

$$\frac{\text{Total Present value of cash inflows}}{\text{Total Present value of cash outflows}} \times 100$$

  The higher the profitability index, the more desirable is the investment.

- ***Internal Rate of Return (IRR) :-***

  Internal rate of return is the rate of return at which total present value of future cash inflows is equal to initial investment. The method is used when the amount of investment and cash inflows are known but the rate of return is not known. The rate of return is generally found by trial and error method.

MERITS OF DISCOUNTED CASHFLOW METHOD :-

1. This method considers the entire economic life of the project.
2. It gives due weightage to time factor. That is, time value of money is considered.
3. It facilitates comparison between projects.

DEMERITS OF DISCOUNTED CASHFLOW METHOD :-

1. It involves a great deal of calculations. Hence it is difficult and complicated.
2. It is very difficult to forecast the economic life of any investment exactly.
3. The selection of an appropriate rate of interest is also difficult.