UNIT-1

Financial management – Introduction, Objectives, Functions -Changing role of finance managers. Indian Financial System: Financial market, instruments, institutions & services.

Time value of money–Basic concepts – Future value & present value of single cash flow & Annuity, Capital recovery & loan amortization. Case Study on Loan amortization.

Meaning of Finance

Finance is provision of money at the time when required.

Management, creation and study of money and investments

Financial services – concerned with the design & delivery of advice & financial products to individuals & institutions .

Financial Management refers to that part of the management activity which is concerned with the planning & controlling of firm's financial resources.

Financial managers actively manage the financial affairs of any type of business, namely financial and non financial, private and public, large and small, profit-seeking and not-for-profit.

They perform such varied tasks as budgeting, financial forecasting, cash management, credit administration, investment analysis, funds management and so on.

Definition

In the words of Weston & Brigham " FM is an area of financial decision making harmonizing individual motives & enterprise goals"

According to J. L. Massie, "FM is the operational activity of a business that is responsible for obtaining & effectively utilizing the funds necessary for efficient operations"

Evolution of FM

FM emerged as a distinct field in 20th century. Its evolution may be divided into 3 phases

- **The traditional Phase** – Concentration on the formation, issuance, expansion , merger, reorganization & liquidation in the life cycle of company: Mainly descriptive & institutional: Outsiders point of view was dominant.
- **The transitional phase** – Focus on day to day activities of company – working capital Management.

Evolution of FM

- **The modern phase** – Rational matching of funds to their uses to maximize the wealth to shareholders - More analytical & quantitative

  Financial decisions in a firm:

  Investment Decisions: Capital budgeting & Working capital management

  Financing decision: Capital Structure

  Dividend Decision

Investment Decisions

Capital Budgeting:

The first and perhaps the most important decision that any firm has to make is to define the businesses that it wants to be. This is referred to as strategic planning and it has a significant bearing on how capital is allocated in the firm.

Once the managers of a firm choose the business or businesses they want to be in, they have to develop a plan to invest in buildings, machineries, equipments, research and development, godowns, showrooms, distribution network, information Infrastructure, brands and other long-lived assets. This is the capital budgeting process.

Investment Decision

Working Capital Management:

Also referred to as short term financial management, refers to the day to day financial activities that deal with current assets and current liabilities.

The key issues are: What is the optimal level of inventory for the operations of the firm? Should the firm grant credit to its customers and if so, on what terms? How much cash should the firm carry on hand? Where should the firm invest its temporary cash surpluses? What sources of short-term finance are appropriate for the firm?

Financing Decision

Capital Structure:

Once a firm has decided on the investment projects it wants to undertake, it has to figure out ways and means of financing them.

The key issues in capital structure decision are: what is the optimal debt-equity ratio for the firm? Which specific instruments of equity and debt finance should the firm access? When should the firm raise finances? At what price should the firm offer its securities?

Capital structure and dividend decisions should be guided by considerations of cost and flexibility, in the main.

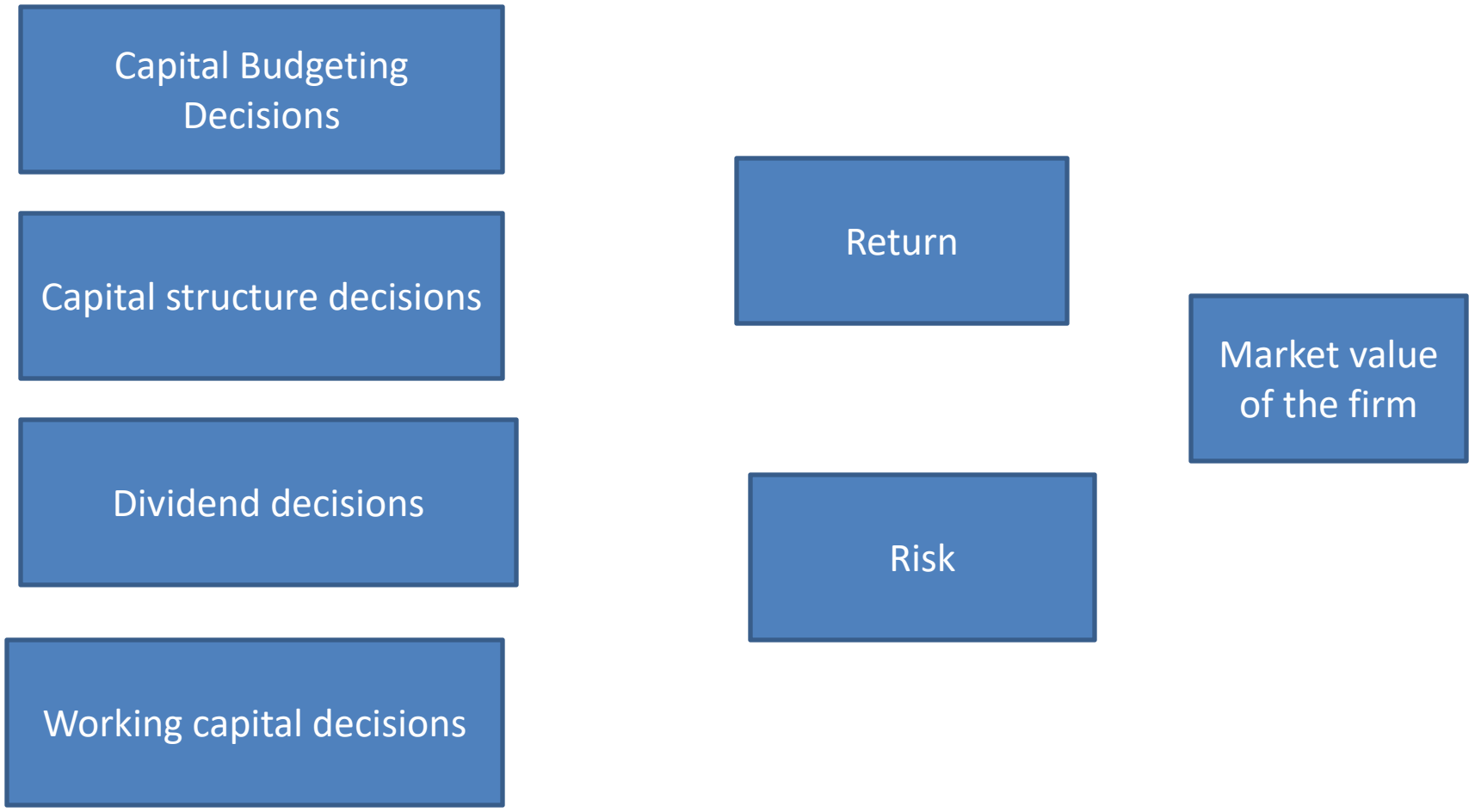
Dividend Decision

The decision of deciding the portion of distributable profits to be retained by the management for future contingencies & the remaining portion to be distributed as dividend.

Risk Return Tradeoff

1.What is the expected return?

2. What is the risk exposure?



SCOPE/ FUNCTION of FM

- Estimating Financial requirements
- Deciding Capital structure
- Selecting a Source of finance
- Selecting a Pattern of investment
- Proper Cash management
- Implementing Financial controls
- Proper use of Surpluses

Interface of FM with other functional areas

- Purchase Function
- Production Function
- Distribution Function
- Accounting Function
- Personnel Function
- Research & Development Function

Objectives of FM

The objective provide a framework for optimum financial decision. It is used in the sense of a goal/decision criteria for the 3 financial decision involved in FM.

Firms in practice state their vision, mission and values in broad terms and are also concerned about technology, leadership, productivity, market standing image, profitability, financial resources, employees satisfaction and so on.

Objective 1- Profit maximization

Meaning

Profit is the main function of every economic activity. A business being an economic institution must earn profit to cover its costs and provide funds for growth.

Profit maximization implies that a firm either produces maximum output for a given amount of input, or uses minimum input for producing a given output. The logic of profit maximization is efficiency.

Features of Profit Maximization:

- It is also called cash per share maximization.
- Ultimate aim of the business concern is earning profit.
- Profit is the parameter of measuring the efficiency of the business concern.
- It helps to reduce the risk of the business.

Advantages of Profit Maximization

- Profits is the test of economic efficiency.
- Efficient allocation of funds.
- Social welfare.
- Internal resources for expansion.
- Reduction in risk and uncertainty.
- More competitive.
- Desire for controls.
- Basis of decision-making.

Limitations of Profit Maximization

Time value of money

- It does not make an explicit distinction between returns received in different time periods.
- It gives no consideration to the time value of money, and it values benefits received in different periods of time as the same.

Limitations of Profit Maximization

Uncertainty of returns

- The streams of benefits may possess different degree of certainty .
- Two firms may have same total expected earnings, but if the earnings of one firm fluctuate considerably as compared to the other, it will be more risky.
- The owners of the firm would prefer smaller but surer profits to a potentially larger but less certain streams of benefits.

Limitations of Profit Maximization

- Ambiguity- vague.
- Timing and value of money- ignored.
- Change in organization structure.
- Social welfare may be ignored.
- Ignores financing and dividend aspects.

Wealth Maximization

Meaning

Shareholders wealth maximization means maximizing the net present value to shareholders. A financial action that has a positive NPV creates wealth for shareholders and, therefore is desirable or otherwise negative NPV erodes wealth of shareholders.

This is also known as **value maximisation or net present worth maximization**.

Using Ezra Solomon's definition, the NPV can be calculated as shown below:

$$W = V - C$$

where W= NPV

V= Gross present worth

C= Investment (equity capital) required to acquire the asset or to purchase the course of action

Advantages of Wealth Maximization

- Serves the interests of the owners as well as other stakeholders.
- Long- run survival
- Takes care of the questions of the timing and risk of the expected benefits.
- Appropriate.
- Unambiguous measure.

Limitations

- Not descriptive(prescriptive)
- Not socially desirable
- Stockholders Vs Stakeholders
- Agency problem

Changing Role of Finance Managers

Reflecting the emerging economic and financial environment in the post liberalization era, the role/job of financial managers in India has become more important, complex and demanding. The key challenges are in the areas specified below. (a)financial structure (b) foreign exchange management (c) treasury operations (d) investor communication (e) management control and (f) investment planning. The role of a financial manager can be categorised as the following

Main functions

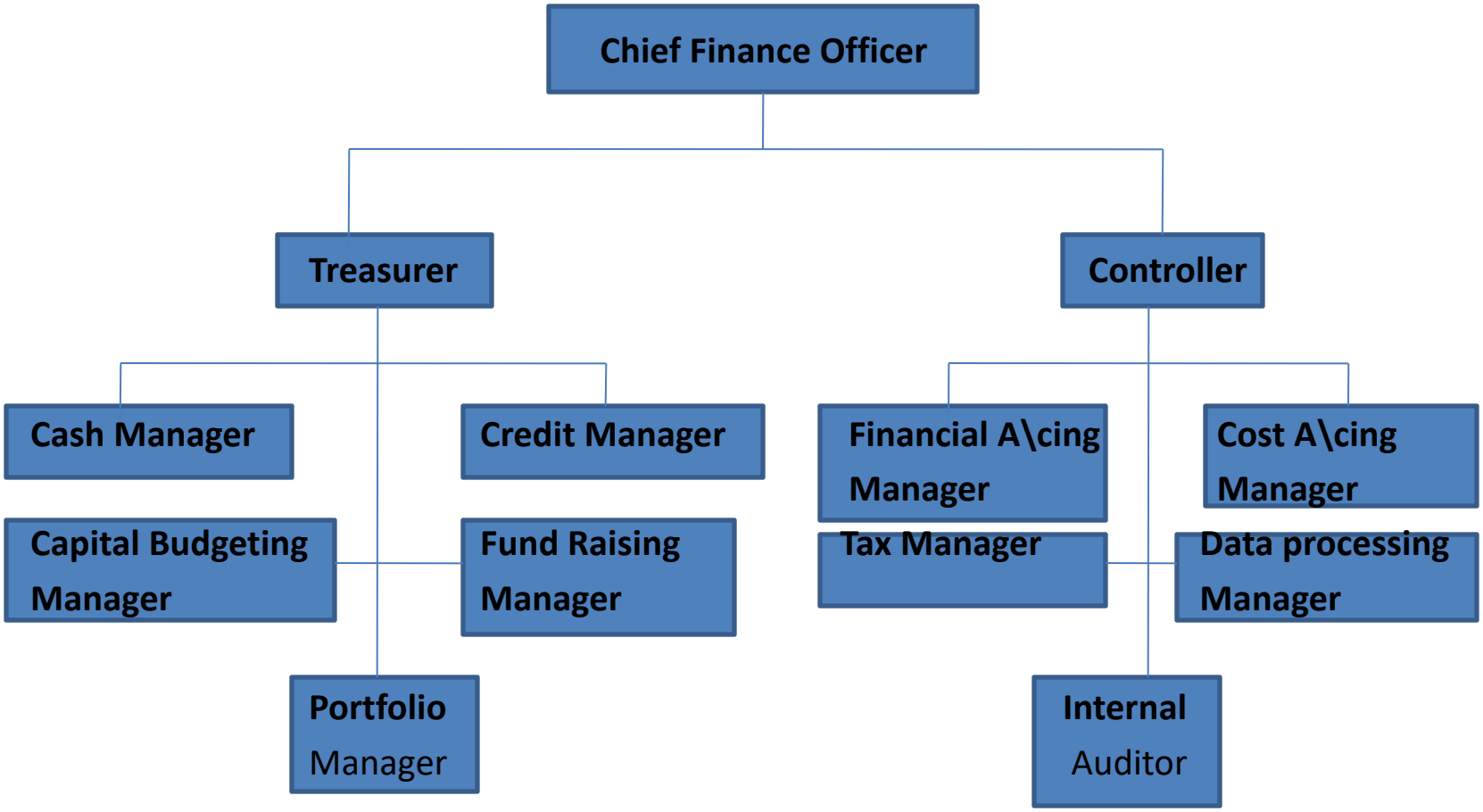
- Financial forecasting and planning
- Acquisition of funds
- Investment of funds
- Helping in valuation decisions
- Maintain proper liquidity

They perform the role of a controller and treasurer

Changing Role of Finance Managers

Treasurer	Controller
Provision of capital	Accounting
Relations with banks & financial institutions	Preparation of financial reports
Cash management	Reporting & interpreting
Receivables Management	Planning & control
Protect funds & securities	Internal audit
Investor relations	Tax administration
Audit	Economic appraisal & reporting to government

Organization of Finance Function



Agency Problem

Meaning:

In companies, particularly large public limited companies, owners typically are not active managers. Instead, they entrust this responsibility to professional managers who may have little or no equity stake in the firm.

Reasons for separation of ownership and management:

- Most enterprises require large sums of capital to achieve economies of scale. It is impractical for any owners to participate actively in management.
- Professional managers are more qualified in managing the business
- Permits unrestricted change in owners through share transfers without affecting the operations of the firm.
- Given economic uncertainties, investors would like to hold a diversified portfolio of securities.

Indian Financial System(IFS)

The IFS is characterized by the presence of an integrated, organised & regulated financial markets and institutions that meet the short term & long term financial needs of both the household & corporate sector.

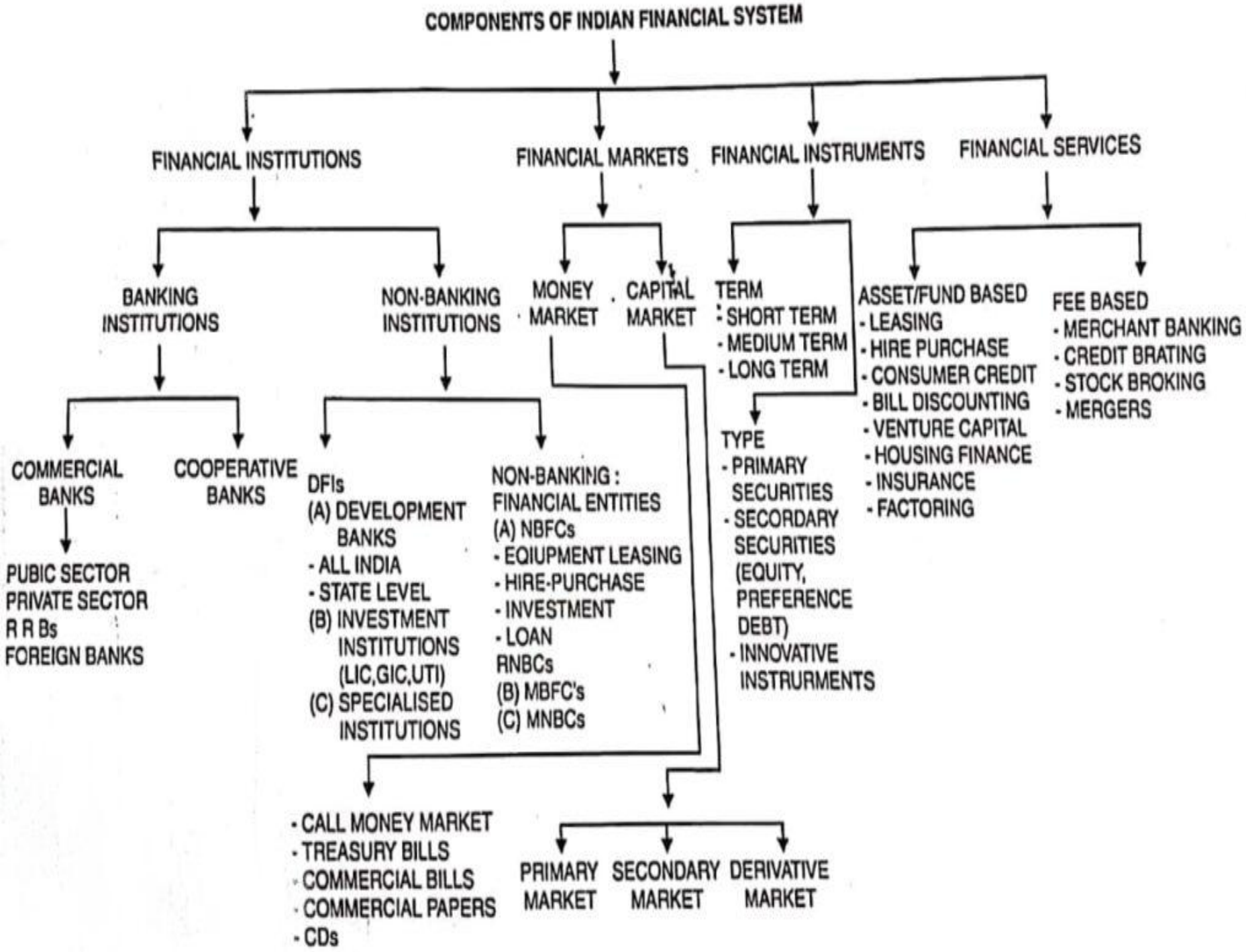
IFS consists of four major elements :

- Financial Institutions
- Financial Markets
- Financial Instruments
- Financial Services

The two major controlling authorities are:

Reserve Bank of India(RBI)

Securities & Exchange Board of India(SEBI)


COMPONENTS OF INDIAN FINANCIAL SYSTEM
FINANCIAL INSTITUTIONS
FINANCIAL MARKETS
FINANCIAL INSTRUMENTS
FINANCIAL SERVICES
BANKING INSTITUTIONS
NON-BANKING INSTITUTIONS
MONEY MARKET
CAPITAL MARKET
TERM
- SHORT TERM
- MEDIUM TERM
- LONG TERM
ASSET/FUND BASED
- LEASING
- HIRE PURCHASE
- CONSUMER CREDIT
- BILL DISCOUNTING
- VENTURE CAPITAL
- HOUSING FINANCE
- INSURANCE
- FACTORING
FEE BASED
- MERCHANT BANKING
- CREDIT BRATING
- STOCK BROKING
- MERGERS
COMMERCIAL BANKS
COOPERATIVE BANKS
PUBIC SECTOR
PRIVATE SECTOR
R R Bs
FOREIGN BANKS
DFIs
(A) DEVELOPMENT BANKS
- ALL INDIA
- STATE LEVEL
(B) INVESTMENT INSTITUTIONS (LIC,GIC,UTI)
(C) SPECIALISED INSTITUTIONS
NON-BANKING : FINANCIAL ENTITIES
(A) NBFCs
- EQIUPMENT LEASING
- HIRE-PURCHASE
- INVESTMENT
- LOAN
RNBCs
(B) MBFC's
(C) MNBCs
TYPE
- PRIMARY SECURITIES
- SECORDARY SECURITIES (EQUITY, PREFERENCE DEBT)
- INNOVATIVE INSTRURMENTS
- CALL MONEY MARKET
- TREASURY BILLS
- COMMERCIAL BILLS
- COMMERCIAL PAPERS
- CDs
PRIMARY MARKET
SECONDARY MARKET
DERIVATIVE MARKET

What is Time Value?

- We say that money has a time value because that money can be invested with the expectation of earning a positive rate of return
- In other words, "a money received today is worth more than a money to be received tomorrow"
- That is because today's money can be invested so that we have more than one money tomorrow

The Terminology of Time Value

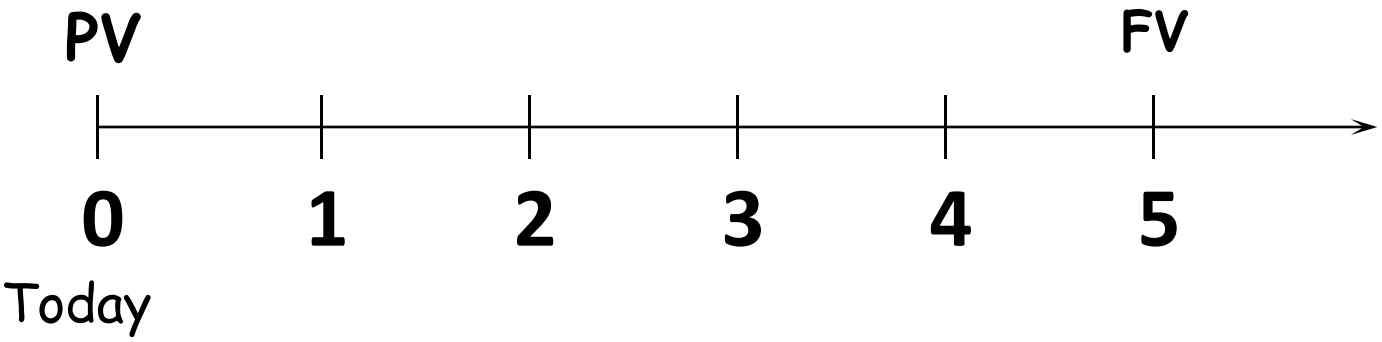
- **Present Value** – An amount of money today, or the current value of a future cash flow
- **Future Value** – An amount of money at some future time period
- **Period** – A length of time (often a year, but can be a month, week, day, hour, etc.)
- **Interest Rate** – The compensation paid to a lender (or saver) for the use of funds expressed as a percentage for a period (normally

Abbreviations

- PV – Present value
- FV – Future value
- Pmt – Per period payment amount
- N – Either the total number of cash flows or the number of a specific period
- i – The interest rate per period

Timelines

- A timeline is a graphical device used to clarify the timing of the cash flows for an investment
- Each tick represents one time period

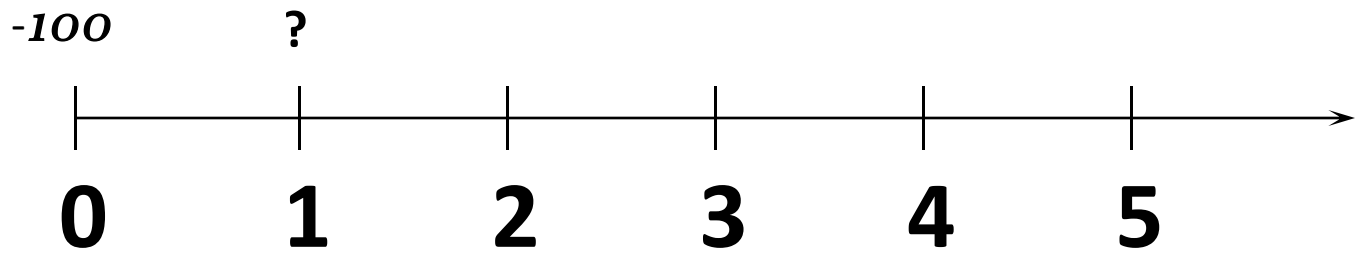


Future value

- **Future value** is the value of an asset at a specific date. It measures the nominal future sum of money that a given sum of money is "worth" at a specified time in the future assuming a certain interest rate, or more generally, rate of return [ROR].

Calculating the Future Value

- Suppose that you have an extra Rs 100 today that you wish to invest for one year. If you can earn 10% per year on your investment, how much will you have in one year?



$$FV_1 = 100(1 + 0.10) = 110$$

Generalizing the Future Value

- Recognizing the pattern that is developing, we can generalize the future value calculations as follows:

$$FV_N = PV(1 + i)^N$$

- If you extended the investment for a third year, you would have:

$$FV_3 = 100(1 + 0.10)^3 = 133.10$$

Compound Interest

- Note from the example that the future value is increasing at an increasing rate
- In other words, the amount of **interest** earned each year is increasing
  - Year 1: Rs10
  - Year 2: Rs11
  - Year 3: Rs12.10
- The reason for the increase is that each year you are earning interest on the interest that was earned in previous years in addition to the interest on the original principle amount

Calculating the Present Value

$$PV = \frac{FV_N}{(1+i)^N}$$

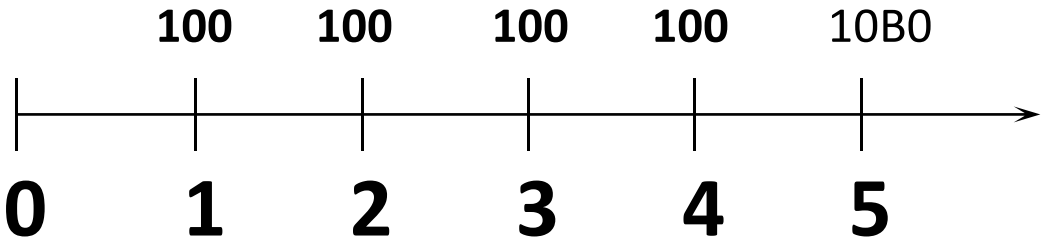
Present Value: An Example

- Suppose that your **five**-year old daughter has just announced her desire to attend college. After some research, you determine that you will need about **Rs 100,000** on her **18**th birthday to pay for four years of college. If you can earn **8%** per year on your investments, how much do you need to invest today to achieve your goal?

$$PV = \frac{100,000}{(1.08)^{13}} = \$36,769.79$$

Annuities

- An annuity is a series of nominally equal payments equally spaced in time
- Annuities are very common:
  - Rent
  - Mortgage payments
  - Car payment
  - Pension income
- The timeline shows an example of a 5-year, Rs100 annuity



The Principle of Value Additivity

- How do we find the value (PV or FV) of an annuity?
- First, you must understand the principle of value additively:
  - The value of any stream of cash flows is equal to the sum of the values of the components
- In other words, if we can move the cash flows to the same time period we can simply add them all together to get the total value

Present Value of an Annuity

- We can use the principle of value additivity to find the present value of an annuity, by simply summing the present values of each of the components:

$$PV_A = \sum_{t=1}^{N} \frac{Pmt_t}{(1+i)^t} = \frac{Pmt_1}{(1+i)^1} + \frac{Pmt_2}{(1+i)^2} + \cdots + \frac{Pmt_N}{(1+i)^N}$$

Present Value of an Annuity (cont.)

- We can use this equation to find the present value of annuity as follows:

$$PV_A = Pmt\left[\frac{1 - \frac{1}{(1.10)^5}}{0.10}\right] = 379.08$$

- This equation works for all regular annuities, regardless of the number of payments

The Future Value of an Annuity

- We can also use the principle of value additivity to find the future value of an annuity, by simply summing the future values of each of the components:

$$FV_A = \sum_{t=1}^{N} Pmt_t(1+i)^{N-t} = Pmt_1(1+i)^{N-1} + Pmt_2(1+i)^{N-2} + \cdots + Pmt_N$$

Present Value of an Annuity Due

- We can find the present value of an annuity due in the same way as we did for a regular annuity, with one exception
- Note from the timeline that, if we ignore the first cash flow, the annuity due looks just like a four-period regular annuity
- Therefore, we can value an annuity due with:

$$PV_{AD} = Pmt\left[\frac{1-\frac{1}{(1+i)^{(N-1)}}}{i}\right] + Pmt$$

Future Value of an Annuity Due

- To calculate the FV of an annuity due, we can treat it as regular annuity, and then take it one more period forward:

$$FV_{AD} = Pmt\left[\frac{(1+i)^{N}-1}{i}\right](1+i)$$

The Terminology of Time Value

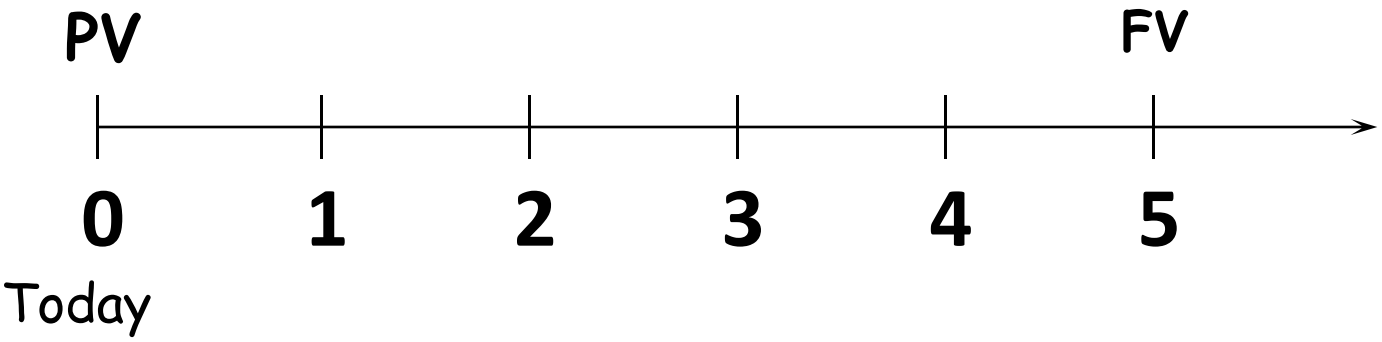
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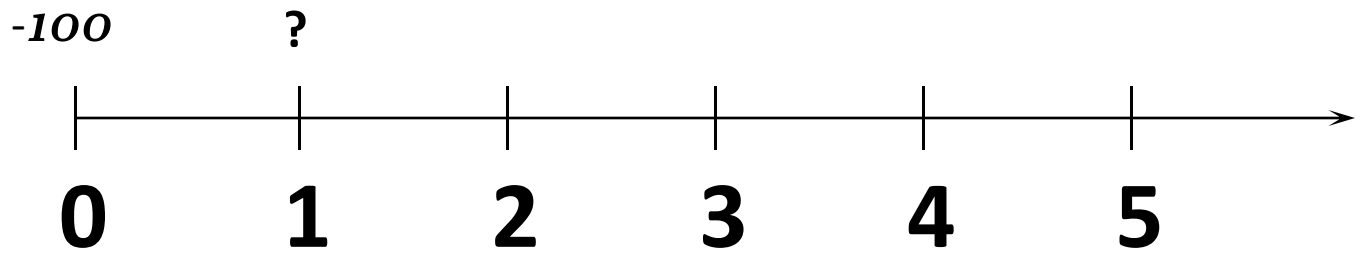


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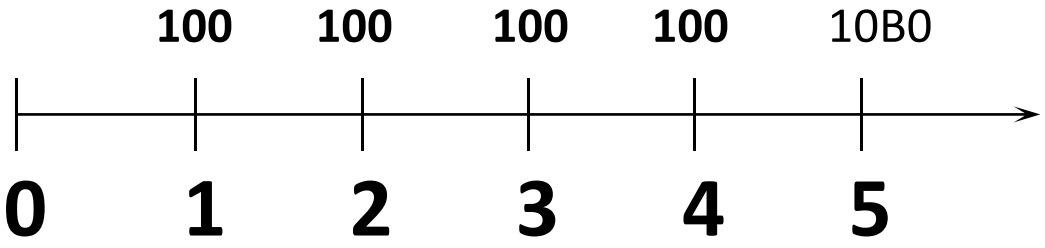
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Effective annual interest rate

Effective Annual Interest Rate

The actual rate of interest earned (paid) after adjusting the *nominal rate* for factors such as the number of compounding periods per year.

$$(1 + [\, i / m \,])^m - 1$$

Amortization

- Amortization is an accounting technique used to periodically lower the book value of a loan or an intangible asset over a set period of time. Concerning a loan, amortization focuses on spreading out loan payments over time. When applied to an asset, amortization is similar to depreciation.

Steps to amortizing a loan

1. Calculate the payment per period.
2. Determine the interest in Period t.

   (Loan balance at t-1) x (i% / m)
3. Compute principal payment in Period t.

   (Payment - interest from Step 2)
4. Determine ending balance in Period t.

   (Balance - principal payment from Step 3)
5. Start again at Step 2 and repeat.

Amortizing a loan expense

Julie Miller is borrowing $10,000 at a compound annual interest rate of 12%. Amortize the loan if annual payments are made for 5 years.

Step 1: Payment

PV_0 = R (PVIFA $_{i\%,n}$)

$10,000 = R (PVIFA $_{12\%,5}$)

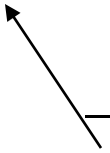
$10,000 = R (3.605)

R = $10,000 / 3.605

R = $2,774

Amortizing a loan expense

End of Year	Payment	Interest	Principal	Ending Balance
0	---	---	---	$10,000
1	$2,774	$1,200	$1,574	8,426
2	2,774	1,011	1,763	6,663
3	2,774	800	1,974	4,689
4	2,774	563	2,211	2,478
5	2,775	297	2,478	0
	$13,871	$3,871	$10,000	



[Last Payment Slightly Higher Due to Rounding]

Usefulness of amortization

1. Determine Interest Expense – Interest expenses may reduce taxable income of the firm.

2. Calculate Debt Outstanding – The quantity of outstanding debt may be used in financing the day-to-day activities of the firm.

UNIT 2

- **Sources of Financing -** Shares, Debentures, Term loans, Lease financing, Hybrid financing, Venture capital investing, Warrants. Angel investing, Private equity, Warrants and convertibles.
- **Dividend Decisions** - Dividend policy – Factors affecting the dividend policy - dividend policies- stable dividend, stable payout.

MEANING OF SHARES :

The capital of a company is divided into units of a fixed value or amount. Those units are called shares. In other words, a share is a fractional part of the capital of a company. In short, share means share in the capital of a company. The Companies Act, 1956 defines a share as “a share in the capital of the company.”

CLASSES OF SHARES:

A company issues different types of shares in order to satisfy the requirements of different classes of investors and to collect more capital. The shares of a company are, generally, of two types

They are:

- Equity Shares (formerly known as Ordinary shares)
- Preference Shares/ Hybrids

EQUITY SHARES

- Equity is the term commonly used to describe the ordinary share capital of a business.
- Equity shares are those which do not carry any special or preferential rights in the payment of annual dividend and repayment of capital.
- Equity capital represents ownership capital, as share holders collectively own the company. They enjoy the reward and bear the risk.

Features of equity shares are

- They don't have no preferential right
- Equity shares are risk bearing shares
- Equity share holders enjoys voting right
- Equity capital is the permanent capital for the company
- Equity shares are easily transferable
- Eligible to receive Bonus shares & Right shares- preemptive rights

Advantages of company: The advantages of issuing equity shares may be summarized as below:

- **Long-term and Permanent Capital:** It is a good source of long-term finance. A company is not required to pay-back the equity capital during its life-time and so, it is a permanent sources of capital.
- **No Fixed Burden:** Unlike preference shares, equity shares have no fixed burden on the company's resources, because the dividend on these shares are subject to availability of profits and the intention of the board of directors.

Advantages to Investors: Investors or equity shareholders may enjoy the following advantages:

- **More Income:** Equity shareholders are the **residual claimants** of the profits after meeting all the fixed commitments. The company may add to the profits by trading on equity. Thus equity capital may get dividend at high in boom period.
- **Right to Participate in the Control and Management:** Equity shareholders have voting rights and elect competent persons as directors to control and manage the affairs of the company.

Disadvantages of equity shares to the company

- **I. Dilution in control:** Each sale of equity shares dilutes the voting power of the existing equity shareholders and extends the voting or controlling power to the new shareholders. Equity shares are transferable and may bring about centralization of power in few hands. Certain groups of equity shareholders may manipulate control and management of company by controlling the majority holdings which may be detrimental to the interest of the company.

  II. Trading on equity not possible: If equity shares alone are issued, the company cannot trade on equity.

Disadvantages to investors: Equity shares have the following disadvantages to the investors:

Uncertain and Irregular Income: The dividend on equity shares is subject to availability of profits and intention of the Board of Directors and hence the income is quite irregular and uncertain. They may get no dividend even three are sufficient profits. **Capital loss During Depression Period:** During recession or depression periods, the profits of the company come down and consequently the rate of dividend also comes down. Due to low rate of dividend and certain other factors the market value of equity shares goes down resulting in a capital loss to the investors.

- **Credit worthiness:** Issuance of equity share capital creates no change on the assets of the company. A company can raise further finance on the security of its fixed assets.
- **Risk Capital:** Equity capital is said to be the risk capital. A company can trade on equity in bad periods on the risk of equity capital.
- **Dividend Policy:** A company may follow an elastic and rational dividend policy and may create huge reserves for its developmental programmes.

- **Capital profits:** The market value of equity shares fluctuates directly with the profits of the company and their real value based on the net worth of the assets of the company. *An appreciation in the net worth of the company's assets will increase the market value of equity shares. It brings capital appreciation in their investments.*
- **An Attraction of Persons having Limited Income:** Equity shares are mostly of lower denomination and persons of limited recourses can purchase these shares.

- **Over-capitalization:** Excessive issue of equity shares may result in over-capitalization. Dividend per share is low in that condition which adversely affects the psychology of the investors. It is difficult to cure.
- **No flexibility in capital structure:** Equity shares cannot be paid back during the lifetime of the company. This characteristic creates inflexibility in capital structure of the company.
- **High cost:** It costs more to finance with equity shares than with other securities as the selling costs and underwriting commission are paid at a higher rate on the issue of these shares.
- **Speculation:** Equity shares of good companies are subject to hectic speculation in the stock market. Their prices fluctuate frequently which are not in the interest of the company.

- **Loss on Liquidation:** In case, the company goes into liquidation, equity shareholders are the worst sufferers. They are paid in the last only if any surplus is available after every other claim including the claim of preference shareholders is settled. It is evident from the advantages and disadvantages of equity share capital discussed above that the issue of equity share capital is a must for a company, yet it should not solely depend on it. In order to make its capital structure flexible, it should raise funds from other sources also.

- **Preference** shares typically carry a right that gives the holder preferential treatment when annual dividends are distributed to shareholders. Shares in this category receive a fixed dividend, which means that a shareholder would not benefit from an increase in the business' profits. However, usually they have rights to their dividend ahead of ordinary shareholders if the business is in trouble. Also, where a business is wound up, they are likely to be repaid the par or nominal value of shares ahead of ordinary shareholders.

Preference shares

Preference capital

It is a hybrid form of financing – it partakes some characteristics of equity and some attributes of debentures

Features

- Preference dividend is payable only out of distributable profits
- It is not obligatory payment
- It is not a tax-deductable payments
- Dividend rate is fixed
- Redeemable in nature
- Do not enjoy the right to vote

Preference shares are of many They are:

- Cumulative Preference Shares
- Non-Cumulative Preference Shares
- Participating Preference Shares
- Non-participating Preference Shares
- Redeemable Preference Shares
- Irredeemable preference Shares
- convertible preference Shares
- Non- convertible preference Shares

Advantages of preference shares to company

1. It is a long term source of finance to the company.
2. By issuing preference shares the company can trade on equity and provides higher rate of returns to equity shareholders.
3. The issues of preference shares will not bring about a charge in the management as the preference shareholders do not have the voting rights.
4. Preference shares can be redeemed whenever the company has surplus funds.
5. Payment of dividend is not compulsory the company can declare the dividends only when it has earned profits.

Limitations of preference shares of the company:

1. The cost of preference shares is high as the rate of dividends paid on preference shares is higher than the rate of interest paid on debentures.
2. Cumulative preference shares are a burden for the company earns the profit.
3. The payment of dividends becomes an obligation for the company to maintain its reputation.
4. The preference dividends paid is not considered as business expenditure and it’s not exempted from tax.
5. Redemptions of preference share may reduce the amount of dividends payable to the equity share holders as a reserve has to be maintained for redemptions.

Advantages of the preference share to the investors

1. Usually the rate of dividends received by the preference shareholders is higher than the rate of interest received by debentures holders.
2. They have the preference to receive the dividends over shareholders.
3. They have a preference for receiving the capitals over equity shareholders at the time of repayment of capital or on maturity, whichever is earlier.
4. Preference shareholders can vote on the matter directly affecting their interest as well as on all resolutions, if the dividends are due on theirs shares/remaining unpaid

Limitations of preference shares to the investors:

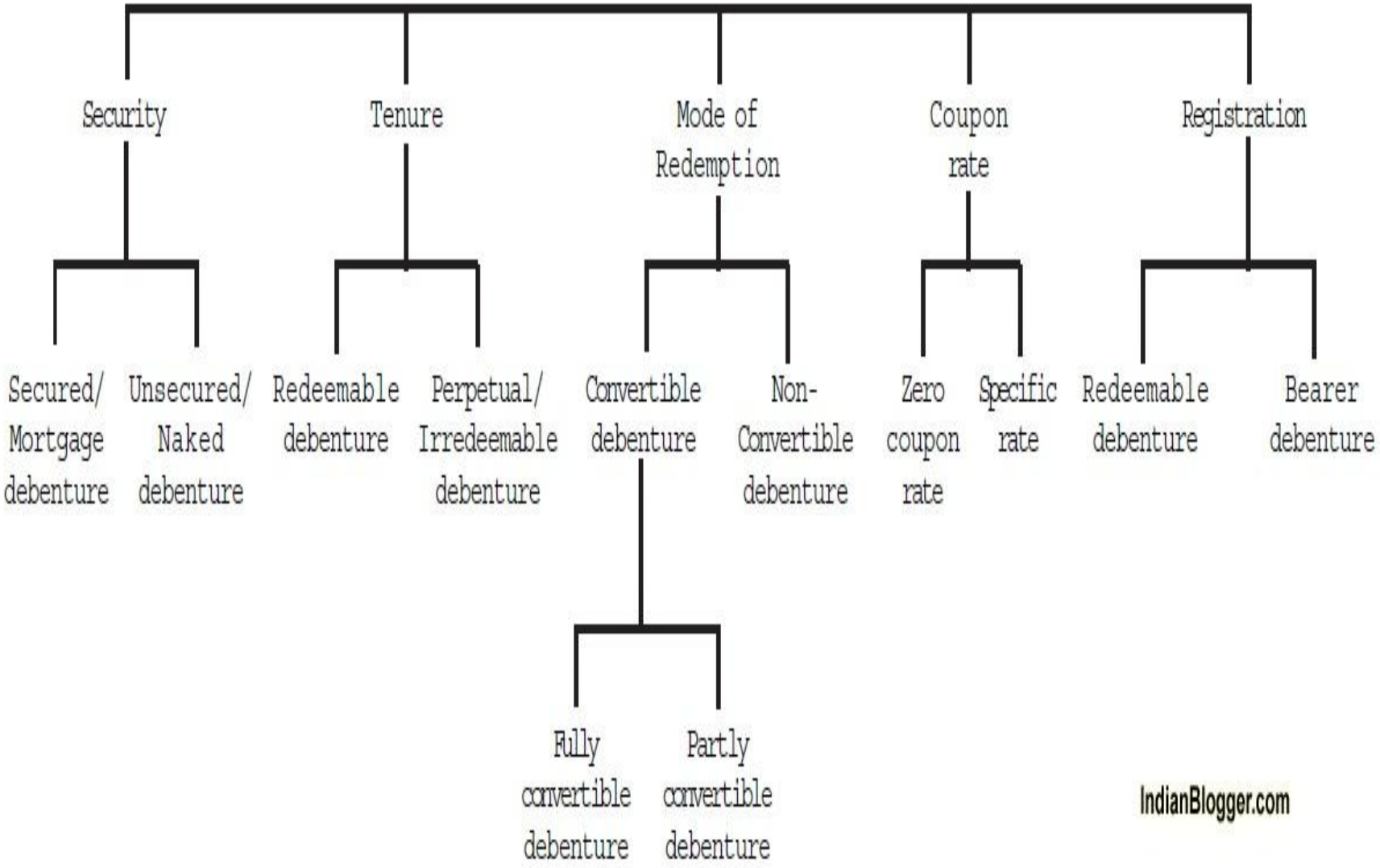
1. Preference share are not assured of the regular payment of dividends as payment of dividend is not compulsory.
2. Preference shareholders will not receive the dividends until the company earns the profits.
3. As preference shareholders do not have the voting rights, they cannot participate in the day to day activities of the management.
4. The rate of dividends received by preference shareholders are lesser when compared to the rate of dividends received by the equity shareholders.

MEANING OF DEBENTURE

The word ‘debenture’ has been derived from a Latin word ‘debere’ which means to borrow.

Debenture is a written instrument acknowledging a debt under the common seal of the company. It contains a contract for repayment of principal after a specified period or at intervals or at the option of the company and for payment of interest at a fixed rate payable.

Types of Debenture/Bond



OTHERS

- First/ Second Debentures
- SPN- Secured Premium notes
- Callable bonds
- DDB’s
- Adjustable rate bonds
- Inflation adjustable bonds

Advantages of debentures to the company

1. Debentures are an important source of long term finance for a company.
2. Debentures are relatively cheaper, as the interest payable on the debentures is less than the rate of dividend offered on shares.
3. Only a fixed rate of interest is payable on debentures.
4. The interest payable on debentures is an expense that can be charged to profits for the purpose of income tax.
5. A company can easily raise funds through debentures even during depression when capital market sentiment is low.

Advantages to the debenture holder

1. De*b*enture holders can get interest regularly, whether the company earns profit or not.
2. Debenture holders can get a fixed & stable income on their investments.
3. Debentures are attractive to investors because of definite maturity period.
4. Debenture holders have priority over shareholders as regards the repayment of funds on the liquidation of the company.
5. Debenture are comparatively safer investments for debenture holders, as the debenture holders have either a specific charge or a floating charge on the assets of the company.

Disadvantages to the company

1. Debentures can be issued only by public ltd companies.
2. The cost involved in the issue of debentures is fairly heavy.
3. In the case of debentures, interest has to be paid whether the company earns profit or not.
4. Debentures do not suit companies which have fluctuating earnings.
5. The cost of raising finance through debentures is high because of heavy stamp duty.
6. Debentures are required to be paid on their maturity dates, whether there are profits or not. This imposes a serious burden on the company.

Disadvantages of debentures to debenture holder

1. Debenture holders do not enjoy any voting rights, & so, they do not have any controlling power or the management of the company.
2. The debenture holders get only a fixed rate of interest, however huge the profits of the company may be.
3. As the debenture holders are only the creditors, & not the owners of the company, they do not have any rights to share in the surplus profits & in the surplus assets of the company.
4. The market prices of debentures change with the changes in the rates of interest.

Shares v/s Debentures

- Issue on Discount: Both shares and debentures can be issued at a discount.

- Security : Shares are not secured by any charge whereas the debentures are generally secured and carry a fixed or floating charge over the assets of the company.

- Convertibility: Shares cannot be converted into debentures where as debentures can be converted into shares

Investing in Debentures

Debentures are often viewed as a mixture of having a shareholding and a fixed interest loan. They usually rank higher than shares in terms of the order they receive their distribution, but below fixed interest loans.

Debenture holders are normally entitled to a return equivalent to a fixed percentage of their initial investment and this is usually an annual payment.

The specific arrangement would determine the individual features applicable to a particular debenture. One attribute which might exist could provide holders with an accumulation option whereby, the amounts owing are built up and paid at a later date should the company fall short of cash in a particular year.

Debentures might be secured on the assets of a company either through a fixed charge (paired with a specific asset) or a floating guarantee over the general assets of the business.

The security inherent in **debentures** makes them a “safer” investment than **shares**. Should the company perform very well, the amounts attributable to holders of **debentures** would not increase in line with any gains, they would only be entitled to their previously agreed return.

On some occasions, an option might exist to convert fixed return **debentures in to shares** at a pre-arranged conversion rate. The term given to such an arrangement is **convertible debentures**.

ISSUE OF DEBENTURES

By issuing debentures means issue of a certificate by the Co. under its seal which is an acknowledgment of debt taken by the company.

Issue of Debenture takes various forms which are as under :

1. Debentures issued for cash

2. Debentures issued for consideration other than cash

3. Debentures issued as collateral security.

Further, debentures may be issued
(i) at par, (ii) at premium, and (iii) at discount

DEBENTURES IN INDIA

The following types of Debentures are available in India

1. Non Convertible Débentures (NCD):

These instruments retain the debt character and can not be converted in to equity shares

2. Partly Convertible Debentures (PCD):

A part of these instruments are converted into Equity shares in the future at notice of the issuer.

The issuer decides the ratio for conversion. This is normally decided at the time of subscription.

3. Fully convertible Debentures (FCD)

These are fully convertible into Equity shares at the issuer's notice. The ratio of conversion is decided by the issuer. Upon conversion the investors enjoy the same status as ordinary shareholders of the company.

4. Optionally Convertible Debentures (OCD)

The investor has the option to either convert these debentures into shares at price decided by the issuer/agreed upon at the time of issue

ISSUE OF DEBENTURES FOR CONSIDERATION OTHER THAN CASH

When a company purchases some assets and issues debentures as a payment for the purchase, to the vendors it is known as issue of debentures for consideration other than cash. Debentures can be issued to vendors at par, at premium and at discount.

ISSUE OF DEBENTURES AS COLLATERAL SECURITY

Collateral security means security given in addition to the principal security. It is a subsidiary or secondary security. Whenever a company takes loan from bank or any financial institution it may issue its debentures as secondary security which is in addition to the principal security. Such an issue of debentures is known as 'issue of debentures as collateral security'. The lender will have a right over such debentures only when company fails to pay the loan amount and the principal security is exhausted. In case the need to exercise this right does not arise debentures will be returned back to the company. No interest is paid on the debentures issued as collateral security because company pays interest on Loan borrowed.

REGISTERED

NUMBER
RM 8330



REGISTERED

$ 1,000

LOUISVILLE AND NASHVILLE RAILROAD COMPANY

COLLATERAL TRUST OF 1968 7¾% BOND, DUE 1993

Louisville and Nashville Railroad Company, a corporation organized and existing under the laws of the Commonwealth of Kentucky (hereinafter called the "Company"), for value received, hereby promises to pay to

*1000*RM 8330 -LOUISVILLE & NASHVILLE RR CO

54748336 F001932
-00009999-

or registered assigns, the principal sum of

ONE THOUSAND DOLLARS,

SEE REVERSE FOR CERTAIN DEFINITIONS

CUSIP 546608 RJ 1

on January 1, 1993 and to pay interest thereon semiannually on June 1 and December 1 in the case of Bonds not issued upon the first day of June or December, as the case may be, with preceding the date hereof to which interest has been paid unless the date hereof is a June 1 or December 1 to which such interest has been paid or duly provided for, in which case from such date, at the rate of seven and three-quarters per centum (7¾%) per annum, until the principal hereof is paid or duly provided for. Interest hereon shall be payable at the office or agency of the Company in the Borough of Manhattan, The City of New York, in such coin or currency of the United States of America as at the time of payment is legal tender for public and private debts. Reference is hereby made to the further provisions of this Bond set forth on the reverse hereof and such further provisions shall for all purposes have the same effect as though fully set forth at this place.

This Bond shall not be valid or become obligatory for any purpose unless and until the certificate of authentication hereon shall have been executed by the Trustee under the Indenture.

IN WITNESS WHEREOF, Louisville and Nashville Railroad Company has caused this Bond to be executed on its behalf by the manual or facsimile signature of its President or one of its Vice Presidents and by its Treasurer or one of its Assistant Treasurers, attested by the manual or facsimile signature of its Secretary or one of its Assistant Secretaries, and has caused a facsimile of its corporate seal to be imprinted hereon.

Louisville and Nashville Railroad Company

By C. R. Yates
VICE PRESIDENT

Attest: [illegible]
SECRETARY

DATED: JAN 12 1981

TRUSTEE'S CERTIFICATE OF AUTHENTICATION

This is one of the Bonds described in the within-mentioned Indenture.

CITIBANK, N.A.

By [illegible]
AUTHORIZED OFFICER

R 16133

REGISTERED

RU

REGISTERED



McDONALD'S CORPORATION

10½% NOTE DUE SEPTEMBER 30, 1990

CUSIP 580135 AZ 4

McDonald's Corporation, a corporation organized and existing under the laws of the State of Delaware (hereinafter called the "Company", which term includes any successor corporation under the Indenture hereinafter referred to), for value received, hereby promises to pay to

a registered assignee, the principal sum of

DOLLARS

on September 30, 1990 and to pay interest thereon to the Registered Holder hereof from the date of this note, or from the most recent Interest Payment Date to which interest has been paid or duly provided for, semi-annually on March 31 and September 30 in each year, commencing September 30, 1980, at the rate of 10½% per annum until the principal hereof is paid or made available for payment, and (to the extent that the payment of such interest shall be legally enforceable) at the same rate per annum on any overdue principal and premium and on any overdue installment of interest (computed on the basis of a 360-day year consisting of twelve 30-day months), payable in like money on each Interest Payment Date to the person in whose name this note is registered at the close of business on the Regular Record Date for such interest installment, except that interest payable at Maturity will be paid to the person to whom principal is paid. The principal of, premium, if any, and interest on this note are payable at the office or agency of the Company maintained for that purpose in the City of Philadelphia, Pennsylvania, in such coin or currency of the United States of America as at the time of payment is legal tender for the payment of public and private debts, or at the option of the Company, interest on overdue installments of interest may be paid by mailing a check to the address of the Person entitled thereto as it appears in the Security Register. Reference is hereby made to the further provisions of this Note set forth on the reverse hereof, which further provisions shall for all purposes have the same effect as if set forth at this place.

Unless the certificate of authentication hereon has been executed by the Trustee referred to on the reverse hereof or by an Authenticating Agent, as provided in the Indenture hereinafter referred to, this Note shall not be entitled to any benefit under the Indenture or be valid or obligatory for any purpose.

IN WITNESS WHEREOF, McDONALD'S CORPORATION has caused this Note to be signed in its corporate name by its Chairman of the Board or its President or one of its Vice Presidents manually or in facsimile and a facsimile of its corporate seal to be imprinted hereon and attested by the manual or facsimile signature of its Secretary or one of its Assistant Secretaries.

DATED:

McDonald's Corporation

TRUSTEE'S CERTIFICATE OF AUTHENTICATION

This is one of the Debt Securities of the series designated herein provided for in the within-mentioned Indenture.

FIDELITY BANK, NATIONAL ASSOCIATION,
as Trustee

By

Authorized Officer

SPECIMEN

McDONALD'S CORPORATION
CORPORATE
SEAL
DELAWARE

Attest:

Donald P. Hornby
Secretary

By

Jack M. Greenberg
Executive Vice President
and Chief Financial Officer

TERM LOANS

Definition

The raising of funds by means of share capital, debentures, public deposits and internal financing, firms may also raise term loans for meeting their medium-term and long-term financial needs.

The main advantage of a term loan is that it is for a fixed period and is to be paid back out of the cash generations from the operation.

Major Source of Term Loans

- Specialized Financial Institutions or Development Banks
- Commercial Banks

Specialized Financial Institutions

These specialized financial institutions are also called Development Banks because they provide not only finance but also help in promotion for new enterprises.

These institutions have to play a very significant role in the industrial development of our country for the following reasons:

- Absence of organized capital markets
- Lack of entrepreneurial talent
- Low capital formation
- Shyness of capital
- Inadequacy of financial facilities to meet huge requirements of funds and
- Planned economic development to achieve the socio economic objectives.

Some of the important financial institutions are:-

Industrial finance corporation of India(IFCI)

- The main objective of the corporation has been to provide medium and long term credit to industrial concerns in India.
- Since July 1, 1993 this corporation has been converted into company and it has got its registration under companies Act, 1956.
- Only Government of India, RBI, Scheduled Banks, Insurance Companies and Co-operative Societies.

Functions:

Financial Assistance

Promotional Assistance

Industrial Credit and Investment Corporation of India(ICICI)

- Its equity capital is owned by public sector institutions like banks, LIC and GIC etc.
- It provide term loans in India and foreign currencies, underwrites issues of shares and debentures, makes direct subscription to these issues and guarantees payment of credit made by others.

Functions:

- Assisting in the creation, expantion and modernnisation of such enterprises.
- Encouraging and promoting private ownership
- Expansion of investment market
- Making fund available for re-investment.
- To extend guarantee for deferred payments.

State Financial corporations(SFCs)

The State Finance corporation Act was passed by the Government of India in 1951 with a view to provide financial assistance to small and medium scale industries which were beyond the scope of IFCI

A State Government is empowered to establish a financial corporation to operate within the state. Its capital structure has been left to be determined by State Government within the limits of Rs.50 lakh to Rs.5 crores, 25% of the capital can be subscribed by the public and the rest by the SG, the RBI, insurance companies and other institutional investors.

Functions:

- Granting of loans or advances to industrial concerns repayable within a period not exceeding 20 yrs

- Subscribing to the debentures of industrial concerns repayable within a period not exceeding 20 yrs

- Guaranteeing loans raised by industrial concerns repayable within 20 yrs

- Guaranteeing deferred payments due from any industrial concern in connection with purchase of capital goods in India.

State Industrial Development Corporations(SIDC'S)

Many of these corporations are registered under Companies Act and two have been set up under the statutes of legislative bodies. These corporations are wholly owned by state governments.

SIDCs perform the following functions:

- Grant of financial assistance
- Provisions of industrial sheds or plots.
- Promotion and management of industrial concerns.
- providing risk capital to entrepreneur by way of equity participation and seed capital assistance.

Industrial Development Bank of India(IDBI)

- The ownership of IDBI has since been transferred to Central Government from February 16, 1976.

- The main object of establishing IDBI was to set up an apex institution to co-ordinate the activities of other financial institutions and to act as a reservoir on which the other financial institutions can draw.

- It provides direct financial assistance to industrial assistance to industrial units also to bridge the gap between supply and demand of medium and long term finance.

Functions:

- To provide refinance to financial institutions granting medium and long-term loans to industry.

- To provide refinance to scheduled banks or co-operative banks.

- To provide refinance for export credits granted by banks and financial institutions

- To provide technical and administrative assistance for promotion management or growth of industry.

Industrial Reconstruction Bank of India(IRBI)

- It was established on March 20, 1985 under Indian Industrial Reconstruction Bank Act.

- The basic aim of establishing IRBI was to revive sick and closed industrial units and to act as prime loan and reconstruction agency.

- It has been rechristened as Industrial Investment Bank of India Ltd. With effect from March 27, 1997.

- It has an autonomous development finance institution like IFCI, ICICI and IDBI.

Unit Trust of India (UTI)

- It was established on February 1, 1964 under the Unit Trust of India Act, 1963 with the following objectives:
- To stimulate and pool the savings of the middle and low income groups.
- To sell units among as many investors as possible.
- To invest the money raised from the sale of units and its own capital in corporate and industrial securities.
- To pay dividend to the unit holders.

UTI is now allowed to grant term loans, rediscount bills, undertake equipment leasing and bill purchase financing, provide housing and construction finance, provide merchant banking and set up overseas funds. It mobilises saving fund from public by selling its units in various schemes. The mobilised sources are invested by the Trust in shares and debentures of various well established companies.

Small Industries Development Bank of India (SIDBI)

- The main objective of SIDBI has been to work as a principal financial institution for the promotion, financing and development of industries in the small scale sector.

- It is also expected to co-ordinate the functions of various financial institutions, such as, State Financial Corporations, State Small Industries Development Corporations, Scheduled Banks and State Co-operative Banks, etc engaged in financing, promotion and development of small scale industries.

Commercial Banks

It concentrates on providing short-term financial assistance to industrial sector. The industrial sector required huge funds for long-term financing. The financial institution could not cope with this demand. The commercial banks came into the picture for filling the gap between demand and supply of long term requirements. The banks started giving term loans to meet long-term needs of the industry. This bank are assisting industrial units by granting term-loans, subscribing to shares and debentures of corporate units and underwriting securities issued of these companies.

LEASE

- A lease is an agreement between two parties, the "lessor" and the "lessee". The lessor owns a capital asset, but allows the lessee to use it. The lessee makes payments under the terms of the lease to the lessor, for a specified period of time.
- Leasing is a form of rental. Leased assets may include:-

1.Plant and machinery

2.Cars and commercial vehicles

3.Computers and office equipment.

There are two basic forms of lease: 1.Operating leases and 2. Finance leases.

OPERATING LEASES

Operating leases are rental agreements between the lessor and the lessee whereby:

a) the lessor supplies the equipment to the lessee

b) the lessor is responsible for servicing and maintaining the leased equipment

c) the period of the lease is fairly short, less than the economic life of the asset, so that at the end of the lease agreement, the lessor can either

i) lease the equipment to someone else, and obtain a good rent for it, or
ii) sell the equipment secondhand.

FINANCE LEASES

Finance leases are lease agreements between the user of the leased asset (the lessee) and a provider of finance (the lessor) for most, or all, of the asset's expected useful life.

CHARACTERISTICS:

- A tenancy for years greater than 1 year must be in writing.
- The term of the lease may be fixed, periodic or of indefinite duration.
- If it is for a specified period of time, the term ends automatically when the period expires, and no notice needs to be given.

- The term's duration may be conditional, in which case it lasts until some specified event occurs, such as the death of a specified individual.
- A periodic tenancy is one which is renewed automatically, usually on a monthly or weekly basis.
- A tenancy at will lasts only as long as the parties wish it to.
- In lease the lessee obtains some ownership rights over the asset involved in the transaction, resulting in the recording of the asset as company property on its general ledger.

Leasing Companies

Manufacturing companies can secure long-term funds from leasing companies. For this purpose a lease agreement is made whereby plant, machinery and fixed assets may be purchased by the leasing company and allowed to be used by the manufacturing concern for a specified period on payment of an annual rental. At the end of the period the manufacturing company may have the option of purchasing the asset at a reduced price.

ADVANTAGES

- Leasing offers fixed rate financing; you pay at the same rate each month.
- Leasing is inflation friendly. As the costs go up over five years, you still pay the same rate as when you began the lease, therefore making your dollar stretch farther.
- There is less upfront cash outlay; you do not need to make large cash payments for the purchase of needed equipment.

- Leasing better utilizes equipment; you lease and pay for equipment only for the time you need it (until the end of the lease).
- There is typically an option to buy equipment at end of the term of the lease.
- You can keep upgrading; as new equipment becomes available you can upgrade to the latest models each time your lease ends.
- It is easier to obtain lease financing than loans from commercial lenders (in most cases).
- It offers potential tax benefits depending on how the lease is structured.

DISADVANTAGES

- Leasing is a preferred means of financing for many businesses. However, it is not for every business. The type of industry and type of equipment required also need to be considered. Tax implications also need to be compared between leasing and purchasing equipment outright.

- You have an obligation to continue making payments. Typically, leases may not be terminated before the original term is completed. The renter is responsible for paying off the lease. This can create a major financial problem for the owner of a business experiencing a downturn.

- You have no equity until you decide to purchase the equipment at the end of the lease term, at which point the equipment may have depreciated significantly.
- Although you are not the owner, you are still responsible for maintaining the equipment as specified by the terms of the lease.

Regulating Public Deposits

According to Companies Act and the Companies(Acceptance of Deposit) Rules,1975 , the following amounts are not included in the expression‘ deposits':-

✓Any amount received from the Central Government or a State Government, local authority, foreign Government, any foreign citizen or authority or any other source whose repayment is guaranteed by the Central Government or a State Government

✓Any amount received as a loan from any banking company, State Bank of India or its subsidiaries,a nationalised bank or co-operative bank

✓Any amount received as a loan from any of the notified financial institutions

- ✓Any amount received from an employee of the company by way of security deposit
- ✓Any amount received by way of security or as an advance from any purchasing ,selling or other agents in the course of or for the purposes of the business of the company
- ✓Any amount received in trust or any amount in transit
- ✓Any amount received from directors of the company or from its shareholders by a private company
- ✓Any amount of unsecured loans brought in by the promoters in pursuance of stipulations of financial institutions or loans provided by the promoters themselves and/or by their relatives but not by their friends and business associates

Under the Companies Act and the rules framed there under, the invitation and acceptance of deposits by companies is subjected to the following conditions:-

✓Companies are not permitted to raise unlimited amounts of fund through public deposits. The aggregate of all outstanding deposits cannot exceed certain prescribed percentage of the paid up capital and free reserves of the company.

✓Invitations of deposits by a company can be made only by means of an advertisement specifying the financial position. A company which has defaulted in repayment of deposit or interest thereon is prohibited from inviting deposits.

- ✓The depositors shall fill the application form supplied by the company. The company in return issues a deposit receipt which is an acknowledgement of debt by the company. The terms and conditions of the deposit are printed on the back of the receipt. The company shall maintain a register of deposits containing the prescribed particulars and file returns of deposits duly certified by their auditor with a Registrar on or before 30th June of every year.
- ✓The interest to be allowed on such deposits by the company must be in accordance with the rate fixed by the Government. The rate of interest on deposits also varies depending upon the period of deposit and the reputation of the company

SHORT TERM FINANCING AND INVESTMENTS

Meaning:

Short-term financing means availability of funds for a period of one year or less than that period. The basic purpose of this is to meet working capital requirements of corporate sector.

- **Types of short term financing:**
- Trade credit.
- Bank borrowing.

- **Trade credit :**refers to credit received by a customer from supplier of goods in normal course of business.
- Trade credit is mostly an informal arrangement and granted on open account basis.
- Trade credit depends on nature of business and no lengthy negotiation is necessary to obtain normal trade credit period.
- Ex. Bills of exchange.

- **<u>Advantages:</u>**

1. Easy availability: on this trade credit, many small firms survive. Even new shops gets trade credit after a couple of transactions.
2. Flexibility: if business expands, more purchases are made and with higher purchases more credit is given.
3. Informality: no legal documents are involved.

- **Accrued expenses:**
- Accrued expenses represent a liability for services already received and yet to be paid.
- In case of salaries and wages, employees render their services and then they are paid at end of month . So even they provide short term finance.
- Other ex: Electricity and telephone bill, water bill, corporate tax .
- **Deferred income**: It refers to funds received in advance for services to be rendered in future.
- Ex: advance paid to contractors and manufacturers, Turnkey projects.

- **Factoring :**

It is an institution which offers credit against receivables and provides services relating to management of debts arising from credit sales.

- **Limitations:**

1. High cost of factoring compared to other short term finance.
2. Firms availing factoring services are viewed as weak.

- Bank finance for working capital
- **Cash credit**: Bank considers firm's sales and production plans to sanction a particular working capital limit. These cash credit limits are against security of current assets such as stocks and book-debts.

- **Overdraft :** Banks sanction regular overdraft limits normally against security of fixed deposit receipts, life insurance policy etc. This is only for current account holders and when cheques received are in excess of balance in current account.

- **Purchase or discounting of bills**: Banks often experience difficulty to check and control diversion of funds i.e. utilisation for purposes other than sanctioned. In this context, this form of finance is ideal as banks can control better in respect of utilisation as well as monitoring the end use of funds.

- **Letter of credit :**

The purpose of letter of credit is that payment is assured to supplier of goods or services by bank. In other words, creditworthiness of borrower is substituted by creditworthiness of bank.

It is a non-fund based limit.

- **Working capital loan:**

Working capital loan is normally sanctioned by banks for adhoc or temporary requirements of customers, not earlier forseen. Once repayment is made loan account would be closed.

- **Commercial paper:** It is an unsecured instrument issued in the form a promissory note. They are issued by the highly rated corporate firms to diversify their sources of short-term financing.

- It is an ideal route to raise funds as well as investing excess short-term funds.

- Innovative Instruments:
- Venture Capital
- Seed Capital
- Bridge Finance
- Warrants
- Private Equity
- Convertibles
- Leasing, HP, Installment

Dividend policy & Decisions

- The term dividend refers to the divisible profits of a company distributed among its share holder in the proportion of their share holdings.
- Decision about the proportion of dividend and proportion of retained earnings is called Dividend decision.

Forms of dividend

- ***Cash dividend*** : kind of dividend paid in cash out of current profits through cheques or dividend warrants.

- Types of cash dividend are:
  - A. Interim dividend
  - B. final dividend
- ***Bond dividend*** : dividend given in the form of a bond which promises to pay the dividend declared to the share holder at a future specified date with interest.

- ***Script dividend*** : dividend in the form scripts or promissory notes.

- ***Option dividend*** : dividend payable at the option of share holder either in cash or in shares.
- ***Property dividend*** : dividend in the form of any property or asset other than cash.
- ***Stock dividend/share dividend/bonus shares*** **:** dividend is given to the share holder by the issue of shares which are known as bonus shares.

A prosperous company which has followed conservative dividend policy must have accumulated very large reserves of undistributed profits, which are in excess & have been invested in the form of assets. Such company may think of converting the excess reserves into capital by issue of shares either partly paid on fully paid share in proportion of their share holding.

Sources of funds to issue bonus shares

- Accumulated profits and profits of current year
- General reserve
- Dividend equalization reserve, insurance funds,
- Capital reserve
- Capital redemption reserve

➢ Effects of issues of bonus shares

➢ Distribution of bonus shares

➢ Conditions for the issue of bonus shares

- ***Stock split or share split*** refers to the increase in the number of outstanding equity share achieved through reduction in the par value per share.

  share of higher value to share of smaller value

- ***Reverse split or reverse stock split*** reduce the number of shares by increasing the par value of share

smaller value to share of higher value

Dividend Policy

What is It?

- ***Dividend Policy*** refers to the explicit or implicit decision of the Board of Directors regarding the amount of residual earnings (past or present) that should be distributed to the shareholders of the corporation.

  This decision is considered a financing decision because the profits of the corporation are an important source of financing available to the firm.

Determinants of dividend policy

- ***External factors:***
- General state of economy.
- State of capital market.
- Legal restrictions.
- Contractual restrictions.
- Tax policy of government and tax position of share holders.
- Inflation.
- Cost differential between external equity and retained earnings.

- ***Internal factors***
- Dividend payout ratio
- Access to capital market
- Dilution of control
- Stability of dividend
- Rate of return on alternative investment opportunities
- Nature of earnings
- Liquidity position of the company
- Shareholder preferences

Types of dividend policy

- Regular dividend policy
- Irregular dividend policy
- Stable dividend policy no dividend policy
- Constant dividend share
- Constant pay out ratio
- Stable rupee dividend + extra dividend

Module-3-COC & CS

Cost of Capital – Calculation of Specific costs, Determination of Weighted average cost of capital (WACC).

Capital structure decisions–EBIT–EPS Analysis, Point of Indifference, Financial Break-even Point, **Leverages**-Types and Measurement**.**

Case study on WACC & planning the capital structure.

Cost of Capital

- It is the minimum rate of return expected by its investors.
- It is the cost of obtaining funds by a company.
- According to Soloman Ezra" COC is the minimum required rate of earnings or the cut off rate of capital expenditures".
- According to James. C. Van Horne" a cut off rate for the allocation of capital to investments of projects. It is the rate of return on a project that will leave unchanged the market price of the stock".

Nutshell of the definitions

- COC is not a cost as such – rate of return.
- Minimum rate of return expected by investors.
- COC is symbolically expressed as

  Ko=Rf+b+f

  K= COC

  Rf=Risk free rate of return

  b= Business risk

  f= Financial risk

Importance/Need for COC

- As an acceptance criteria in capital budgeting
- As a determinant of capital mix in capital structure decisions.
- As a basis for evaluating the financial performance.
- As a basis for taking other financial decisions.

Classification of cost

- Historical cost & Future cost
- Specific cost & composite cost
- Explicit cost & Implicit cost
- Average cost & Marginal cost

Problems in Determination of COC

- Conceptual controversies regarding the relationship between COC & CS.
- Historic cost & future Cost
- Problems in computation of cost of equity
- Problems in computation of cost of retained earnings.
- Problems in assigning weights.

Cost of specific source of capital

- Cost of Debt/Debenture capital

  i) Cost of Perpetual/ Irredeemable debt

  ii) Cost of Redeemable debt.

  Before tax & After tax
- Cost of preference capital – After tax cost
- Cost of Equity capital – After tax cost

  i) Dividend yield method/Dividend price ratio

  ii) Dividend yield plus growth method

  iii) Earning yield method

  iv) Capital asset price method
- Cost of Retained earnings.

Weighted Average COC

WACC is the average cost of various sources of financing. It is also called as Composite, overall & average COC. The WACC is computed by putting weights to the specific COC in proportion of the various sources of funds to the total. The weights are assigned either on book value or on market value

CAPITAL STRUCTURE

- MEANING
- DEFINITION & FORMS
- OPTIMAL CAPITAL STRUCTURE
- BASIC RATIO
- CAPITALIZATION, CAPITAL STRUCTURE AND FINANCIAL STRUCTURE
- FACTORS DETERMINING CAPITAL STRUCTURE

MEANING OF CAPITAL STRUCTURE

In Finance, **capital structure** refers to the way a corporation finances its assets through some combination of equity, debt, or hybrid securities.

A firm's capital structure is then the composition or 'structure' of its liabilities.

For example, a firm that sells $20 billion in equity and $80 billion in debt is said to be 20% equity-financed and 80% debt-financed.

The firm's ratio of debt to total financing, 80% in this example, is referred to as the firm's leverage.

In reality, capital structure may be highly complex and include dozens of sources.

DEFINITION :

*" **CAPITAL STRUCTURE** of a company refers to the composition of its capitalization and it includes all long term capital sources viz, loans, reserves, shares and bonds"*

- Gerestenberg

FORMS OF CAPITAL STRUCTURE

1. Equity shares only
2. Equity and preference shares
3. Equity shares and debentures
4. Equity shares, preference shares and debentures

OPTIMAL CAPITAL STRUCTURE

It is that capital structure or combination of debt & equity that leads to the maximization of the value of the firm and minimize the cost of capital

It is the best optimal structure which implies the most economical and safe ratio between types of securities.

Essentials:

- Minimum cost of capital
- Minimum risk
- Maximum returns
- Maximum control
- Safety
- Simplicity
- Flexible
- Commensurate to legal requirements

BASIC RATIO

Gearing Ratio is the proportion of the capital employed by the firm which is been raised from outside sources of business finance.

- Debt equity ratio must be **1:1**
- Earning interest ratio must be **2:1**
- During depression : one and a half time of interest
- Total debt capital should not be more than net working capital
- Current ratio must be **2:1**
- Liquid ratio must be **1:1**

Debt –Equity ratio analysis

The debt equity ratio affects the firms cost of capital when a debt equity ratio of a firm increases its cost of capital will decline & vice versa.

When a firm depends on high debt combination, makes a high interest payments which reduces the tax payments & saves the erosion of cash flows to equity holders. But always the company should also be prepared to see that at low levels of earnings the interest payment to debts is not affected otherwise it leads to bankruptcy.

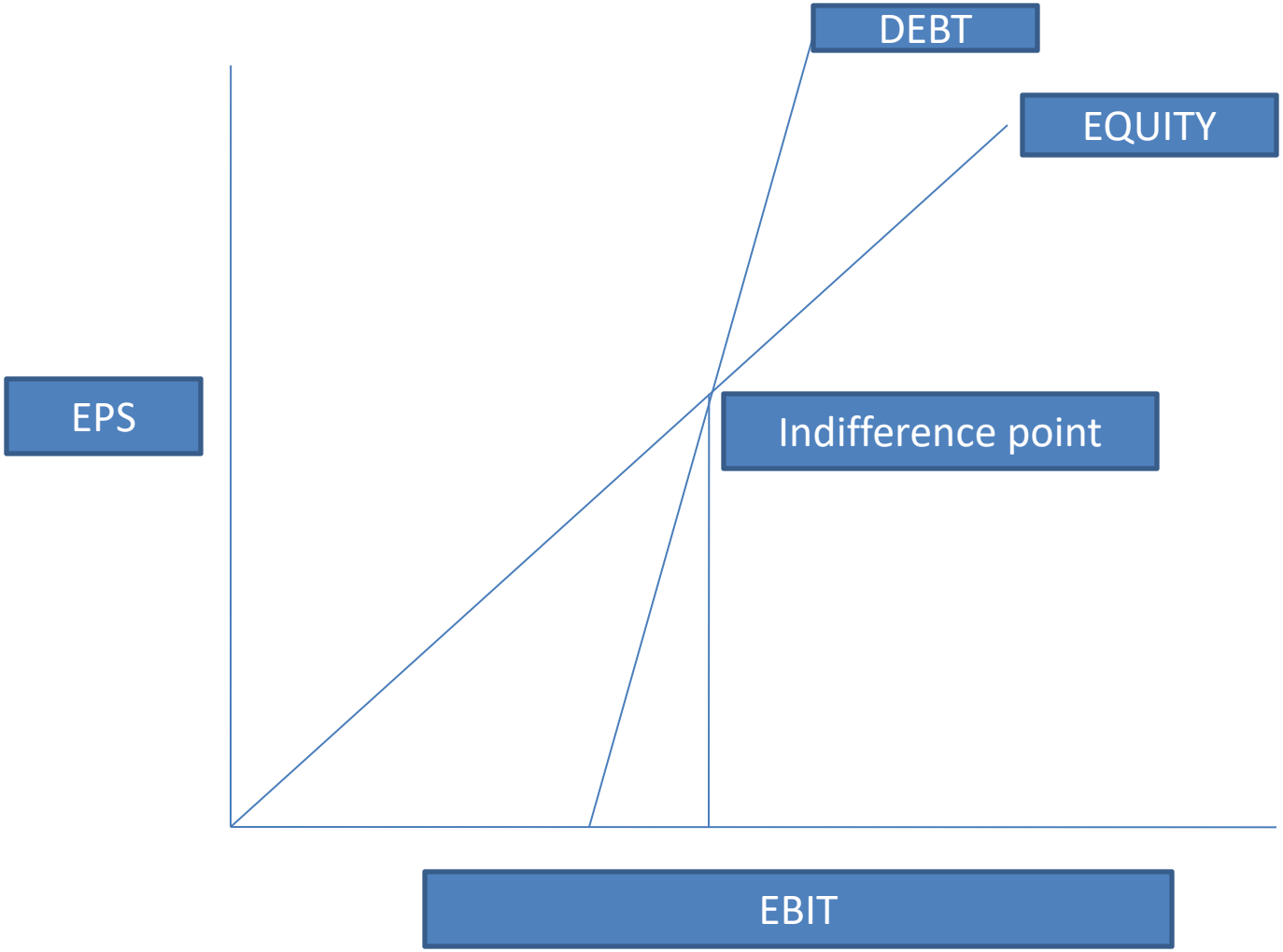
EBIT-EPS analysis

- EPS is a yard stick to evaluate the firms performance for the investors
- The level of EBIT varies from year to year which indicates how successful the firms operations are.
- **Financial Break even point :** It is the minimum level of EBIT needed to satisfy all fixed financial commitments of the company. It denotes the level of EBIT for which the firms EPS just equals zero.

EBIT< FBEP = EPS negative (Equity preferred)

EBIT> FBEP = EPS positive (Debt preferred)

Debt Equity & Indifference point



Financial indifference point

- When two alternative plans do produce the level EBIT where EPS is the same, this situation referred to as ‘Indifference point’.
- In other words it is that level of EBIT where the finance manager would be indifferent to any alternative plan (Equity& Debt Plan) as EPS would be same.
- EBIT> Indifferent Point = EPS is high-debt preferred
- EBIT< Indifference point = EPS low – equity prefereed

CAPITALIZATION, CAPITAL STRUCTURE AND FINANCIAL STRUCTURE

Capitalization is a quantitative aspect of the financial planning of an enterprise, it refers to the total amount of securities issued by a company.

Capital structure refers to kinds of securities and proportion of amounts that make up capitalization.

F**inancial structure** refers to all the financial resources mar shelled by the firm, short term as well as long term, and all forms of debt as well as equity.

Thus financial structure generally is composed of a specific percentage of short term debt , long term debt and shareholders fund.

Features of capital structure

A sound appropriate capital structure should have the following features:

- **Profitability:** The capital structure of the company should be most advantageous, within the constraints. Maximum use of leverage at a minimum cost should be made.
- **Solvency:** The use of excessive debt threatens the solvency of the company. Debt should be used judiciously.
- **Flexibility:** The capital structure should be flexible to meet the changing conditions. It should be possible for the company to provide funds whenever needed to finance its profitable activities.

Factors Determining Capital Structure

- **Trading on Equity-** 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 earnings, equity shareholders are at advantage which means a company should go for a judicious blend of preference shares, equity shares as well as debentures.
- **Degree of control-** In a company, it is the directors who are the elected representatives of equity shareholders. If the company's management policies are such that they want to retain their voting rights, the capital structure consists of debenture holders and loans rather than equity shares.

- **Risk** : the two elements of risk are important for capital structure decisions i.e Business risk & financial risk. Business risk are influenced by demand, price, input costs, fixed costs, business cycles, competition etc. Financial risk arises due to the combination of debt & equity mix in capital structure.
- **Income:** Maximizing the wealth to shareholders depends on the method of financing and its impacts on EPS & ROE. If the levels of EBIT & ROI is low it is better for the company to go for equity capital rather for debt capital.
- Tax considerations: Interest on debt is a deductible expenses for income tax calculations where as dividend is an appropriation of funds.

- **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 plans.
- **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.
- **Capital market condition:** During the depression period, the company's capital structure generally consists of debentures and loans. While in period of booms and inflation, the company's capital should consist of share capital generally equity shares.

- **Period of financing-** When company wants to raise finance for short period, it goes for loans from banks and other institutions; while for long period it goes for issue of shares and debentures.
- **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 shares where equity shareholders demand an extra share in profits.
- **Stability of sales-** An established business which has a growing market and high sales turnover, the company is in position to meet fixed commitments.

- **Sizes of a company-** Small size business firms 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.

LEVERAGE

MEANING:

A general dictionary meaning of the term 'Leverage' refers to "an increased means of accomplishing some purpose." The term leverage refers to the firm's ability to use fixed cost fund to magnify the return to the shareholders. In other words leverage is the employment of fixed assets or funds for which a firms has to meet fixed costs like interest obligation, irrespective of the level of operations.

DEFINITION:

James Horne has defined leverage as "the employment of an asset or sources of funds for which the firms has to pay a fixed cost fixed returns”

TYPES OF LEVERAGE

- There are basically three types of leverages

1. FINANCIAL LEVERAGE:

The use of long term fixed interest bearing debt and preference share capital along with equity share capital called financial leverage or trading on equity. The object here is to get maximum benefit from the use of debt capital in order to give to equity share holders in the form of dividend.

It measures the percentage change in EPS for percentage change in EBIT.

Financial leverage can be calculated as:

$$\text{Financial Leverage} = \frac{\text{EBIT}}{\text{EBT}}$$

$$\text{Degree of Financial leverage} = \frac{\%\text{ change in EPS}}{\%\text{ change in EBIT}}$$

Significance of Financial Leverage:

1. Planning of Capital Structure
2 .Profit planning

Limitation of Financial Leverage/Trading on Equity:

1. Double- edged weapon.
2. Beneficial only to companies having stability of earnings.
3. Increase in risk and rate of interest.
4. Restriction from financial institutions.

OPERATING LEVERAGE:

The Operating leverage occurs when a firm has fixed costs which must be recovered irrespective of sales volume. The fixed cost remaining the same, the percent change in operating revenue will be more than the percentage change in the sales. The occurrence is known as *operating leverage*

It measures the percentage change in EBIT for percentage change in sales.

- ✓ Operating leverage= $\frac{\text{Contribution}}{\text{EBIT}}$

or

- ✓ Operating leverage= $\frac{\text{Contribution}}{\text{Operating profit}}$
- ✓ Degree of operating leverage = $\frac{\%\text{ change in EBIT}}{\%\text{ change in sales}}$

COMPOSITE OR COMBINED OR TOTAL LEVERAGE

Both the financial and operating leverage magnify the revenue of the firm. It shows the relationship b/w a change in sales and corresponding variation in taxable income. It measures the percentage change in EPS for percentage change in sales. Combined leverage may be defined as the effect of both fixed expenses and interest on the level of EPS, changes in EPS and total risk associated with it.

DIFFERENCE B/W OPERATING AND FINANCIAL LEVERAGE

OPERATING LEVERAGE	FINANCIAL LEVERAGE
1.It is related to the investment activity(capital expenditure) 2.The fluctuation in the EBIT can be predicted with the help of operating leverage. 3. Financial manager uses the operating leverage to identify the items of assets sides of the B\S 4 It is used to predict the business risk	1. It is more concerning with financial matters(mixing of debt equity in capital structure) 2. The change of EPS due to D:E mix is predicted by financial leverage 3. The uses financial leverage to make decisions in the liability side of the B/S 4. It is used to analyze the financial risk

E

UNIT 4

Long-Term Investment decisions – Process of Capital Budgeting Investment evaluation techniques – Discounting, Non-discounting and modified techniques. Estimation of cash flows – elements, basic principles and cash flow estimation for new and replacement projects.

Case study on Projecting the Cash flows & replacement projects.

Basic Concept & CB

- INVESTMENT - Employment of fund on a financial product or other item of value with an expectation of favorable future returns
- INVESTMENT DECISION of a firm are generally known as the capital budgeting or capital expenditure decisions.
- CAPITAL EXPENDITURE is the amount used during particular period to acquire or improve long term assets such as property, plant or equipment.
- CAPITAL BUDGETING is the process of determining which potential long term projects/investments are worth undertaking, by comparing their expected cash flows with their internal rate of returns.

Definition & Meaning

- “Capital budgeting is long term planning for making and financing proposed capital outlays” – Charles T Horngren.
- Capital budgeting is defined as” as the firm’s formal process for the acquisition and investment of capital. It involves firms’ decisions to invest its current funds for addition, disposition, modification and replacement of fixed assets”.
- The process through which different projects are evaluated is known as capital budgeting

Nature of Investment Decisions

- The **investment decisions** of a firm are generally known as the **capital budgeting, or capital expenditure decisions.**
- The firm's investment decisions would generally include **expansion**, **acquisition**, **modernisation** and **replacement** of the long-term assets. Sale of a division or business (**divestment**) is also as an investment decision.
- Decisions like the change in the **methods of sales distribution**, or an **advertisement campaign** or a **research and development programme** have long-term implications for the firm's expenditures and benefits, and therefore, they should also be evaluated as investment decisions

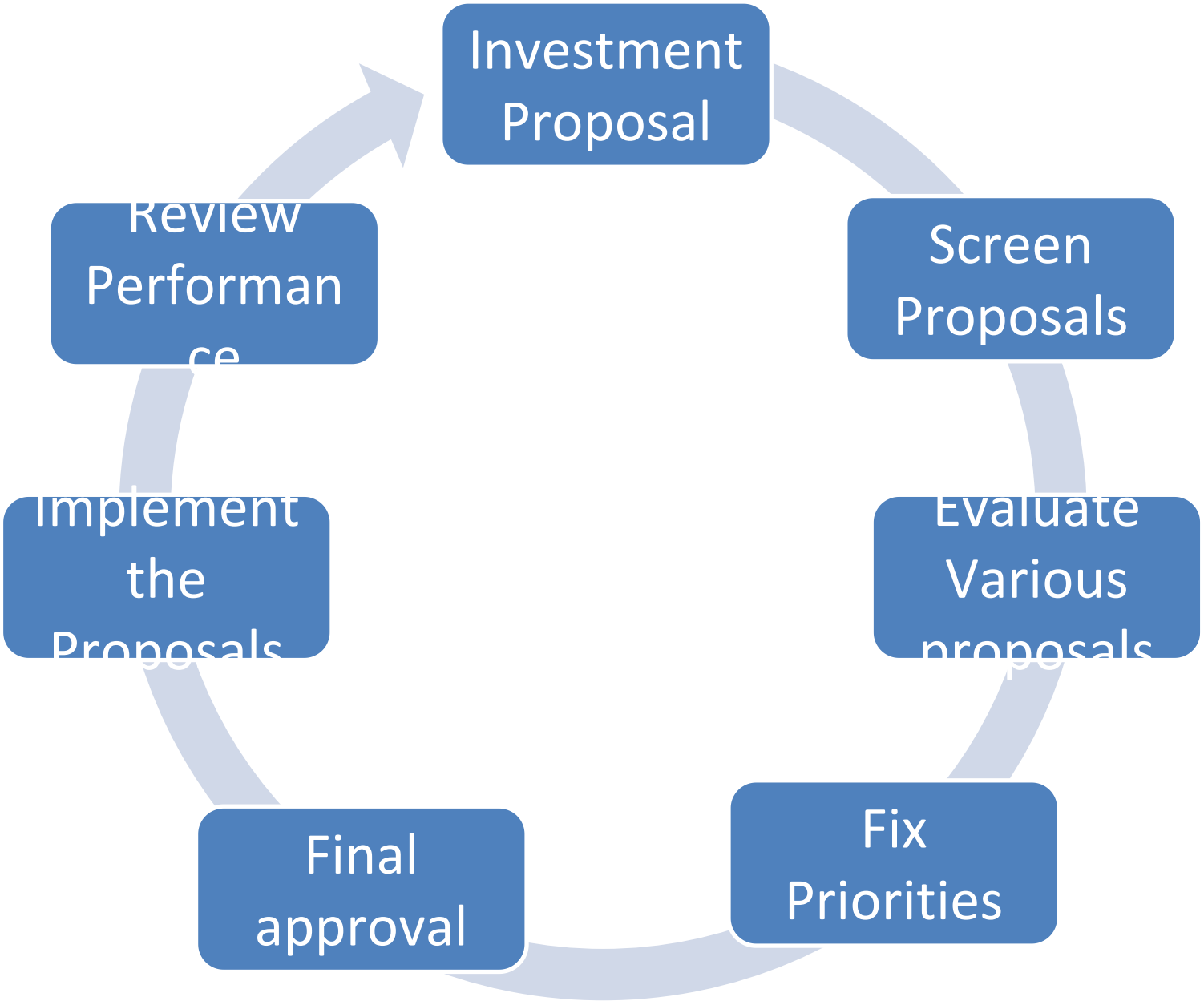
Features of Investment Decisions

- The exchange of current funds for future benefits.
- The funds are invested in long-term assets.
- The future benefits will occur to the firm over a series of years.

Importance/Need of Investment Decisions

- Large Proposals
- Long term Commitment of funds- Risk
- Irreversibility
- Long term effect on profits
- Difficulties of Investment Decisions
- National importance

Capital Budgeting Process



CB Process

- **Identification of investment proposals** – The proposal or idea can originate from top to lower management anywhere at any point of time , it is the responsibility of the department mangers to analyse in the light of corporate strategies.
- **Screen the proposals** – The expenditure planning committee has to screen the submitted proposals keeping the objectives & the policies of the company.

CB Process

- **Evaluation of various proposals –** The proposals have to be evaluated keeping in view the profitability of the projects. The evaluation techniques like discounted & non discounted techniques can be adopted to evaluate but before that the projects have to be classified into:
- Mutually exclusive Proposals
- Independent Proposals
- Contingent or dependent Proposals

CB Process

- **Fixing priorities** – Ranking of the proposals based upon urgency , risk & profitability.
- **Final approval** – after which a capital expenditure budget to be prepared for all the accepted projects & sanctioning of funds.
- **Implementing proposal** – after funds are released the project implementation process begins with Scheduling of the various stages of implementation.
- **Performance review** – This is very important to note whether project is implemented properly or not and any deviations to be corrected.

Types of Investment Decisions

- ***MUTUALLY EXCLUSIVE PROPOSALS –*** It is the acceptance of one such proposals which excludes all other proposals.
- ***INDEPENDENT PROPOSALS –*** They are accept or reject decisions who do not compete with each other , they are independent.
- ***CONTINGENT PROPOSALS –*** They are dependent on other project or the acceptance of one such projects leads to automatic acceptance of the other dependent project.

Investment Evaluation Criteria

- Three steps are involved in the evaluation of an investment:
- Estimation of future & the present cash flows
- Estimation of the required rate of return (the opportunity cost of capital)
- Application of a decision rule for making the choice

Evaluation Criteria

. ***Discounted Cash Flow (DCF) Criteria***

- Net Present Value (NPV)
- Internal Rate of Return (IRR)
- Profitability Index (PI)

Non-discounted Cash Flow Criteria

- Payback Period (PB)
- **Discounted Payback Period (DPB)**
- Accounting Rate of Return (ARR)

ESTIMATION OF PROJECT CASH FLOWS

- Estimation of cash flows- the investment outlays and the cash inflows after the project is commissioned is the most important, but also the most difficult step in capital budgeting. Forecast errors can be quite large, particularly in gigantic, complex projects.
- The role of the finance manager is to coordinate the efforts of various departments and obtain information from them, ensure that the forecasts are based on a set of consistent economic assumptions, keep the exercise focused on relevant variables, and minimize the biases inherent in cash flow forecasting.

Elements of the cash flow stream

- The cash flow stream of a conventional project-a project which involves cash outflows followed by cash inflows- comprises three basic components:

(i) initial investment,

(ii) operating cash inflows, and

(iii) terminal cash inflow.

- The initial investment is the after-tax cash outlay on capital expenditure and net working capital when the project is set up.

Time Horizon for Analysis

- **Physical Life of the Plant:** This refers to the period during which the plant remains in a physically usable condition.
- **Technological Life of the Plant:** New technological developments tend to render existing plants obsolete.
- **Product Market Life of the Plant:** A plant may be physically usable, its technology may not be obsolete, but the market for its products may disappear or shrink and hence its continuance may not be justified.
- **Investment Planning Horizon of the Firm:** The time period for which a firm wishes to look ahead for purposes of investment analysis may be referred to as its investment planning horizon.

Basic principles of cash flow estimation:

1. Separation principle

There are two side of a project, viz., the investment (or asset) side and the financing side and the cash flows associated with these sides should be separated.

Assuming that there are no taxes, the cash flows associated with the investment side of the project, the rate of return on the investment side of the project, the cash flows associated with the financing side of the project, and the cost of capital on the financing side

Basic principles of cash flow estimation:

2. Incremental principle

The cash flow of a project must be measured in incremental terms. To ascertain a project's incremental cash flows you have to look at what happens to the cash flows of the firm with the project and without the project. The difference between the two reflects the incremental cash flows attributable to the project. That is,

- Project cash flow for year t=Cash flow for the firm- Cash flow for the firm **With** the project for year t **Without** the project for year t

In estimating the incremental cash flows of a project, the following guidelines must be borne in mind:

- Ignore Sunk Costs
- Include Opportunity Costs
- Allocation of Overhead Costs
- Estimate Working Capital Properly

Basic principles of cash flow estimation:

3. Post tax principle

Cash flow should be measured on an after-tax basis. Some firms may ignore tax payments and try to compensate this mistake by discounting the pre-tax cash flows at a rate that is higher than the cost of capital of the firm. Since there is no reliable way of adjusting the discount rate, you should always use after tax flows along with after-tax discount rate. Cash flows should be measured after taxes.

4. Consistency principle

Cash flows and the discount rates applied to these cash flows must be consistent with respect to the investor group and inflation.

Estimating project cash flow

- Total cash flows of a project in year t, where t ranges from year 0 to year n.
- =Project operating cash flows for that particular year-change in net working capital-initial investment.
- There is no project operating cash flows for year 0.

ESTIMATING PROJECT OPERATING CASH FLOWS

Particulars	Amount	Amount
Estimated Sales Revenue		xxxxx
Variable Costs	xxx	
Fixed Costs per year	xxx	
Depreciation	xxx	
Total cost		xxxx
Earnings Before Interest and Taxes (EBIT)		xxxx
Less: Tax		Xx
Net Income		xxxx

Contd..,

- Operating Cash Flows = Net Income + Depreciation
- OR
- Operating Cash Flows= EBIT - Taxes + Depreciation



Replacement Projects

- Assume old project is sold today and replaced by the new one.
- Receive inflow from the sale of old project today, but give up any future expected inflows (opportunity cost).
- General form: Increase in net income+ (depreciation on new – depreciation on old)

UNIT -5

Short Term Investment decisions- factors influencing working capital requirements. Working capital financing, Operating cycle and cash cycle. Estimation of working capital requirements of a firm.

Case study on Estimation of working capital.

Working capital- Introduction

- Working capital typically means the firm's holding of current or short-term assets such as cash, receivables, inventory and marketable securities.
- These items are also referred to as circulating capital.
- Corporate executives devote a considerable amount of attention to the management of working capital.

Definition of Working Capital

Working Capital refers to that part of the firm's capital, which is required for financing short-term or current assets such a cash marketable securities, debtors and inventories. Funds thus, invested in current assets keep revolving fast and are constantly converted into cash and this cash flow out again in exchange for other current assets. Working Capital is also known as revolving or circulating capital or short-term capital.

Concept of working capital

Importance of working capital

- Risk and uncertainty involved in managing the cash flows
- Uncertainty in demand and supply of goods, escalation in cost both operating and financing costs.

There are two possible interpretations of working capital concept:

1. Balance sheet concept
2. Operating cycle concept

Balance sheet concept

There are two interpretations of working capital under the balance sheet concept.

a. Excess of current assets over current liabilities

b. Gross or total current assets.

- Excess of current assets over current liabilities are called the net working capital or net current assets.
- Working capital is really that part of long term finance which is locked in and used for supporting current activities.
- The balance sheet definition of working capital is meaningful only as an indication of the firm's current solvency in repaying its creditors.
- When firms speak of shortage of working capital they in fact possibly imply scarcity of cash resources.
- In fund flow analysis an increase in working capital, as conventionally defined, represents employment or application of funds.

Operating cycle concept

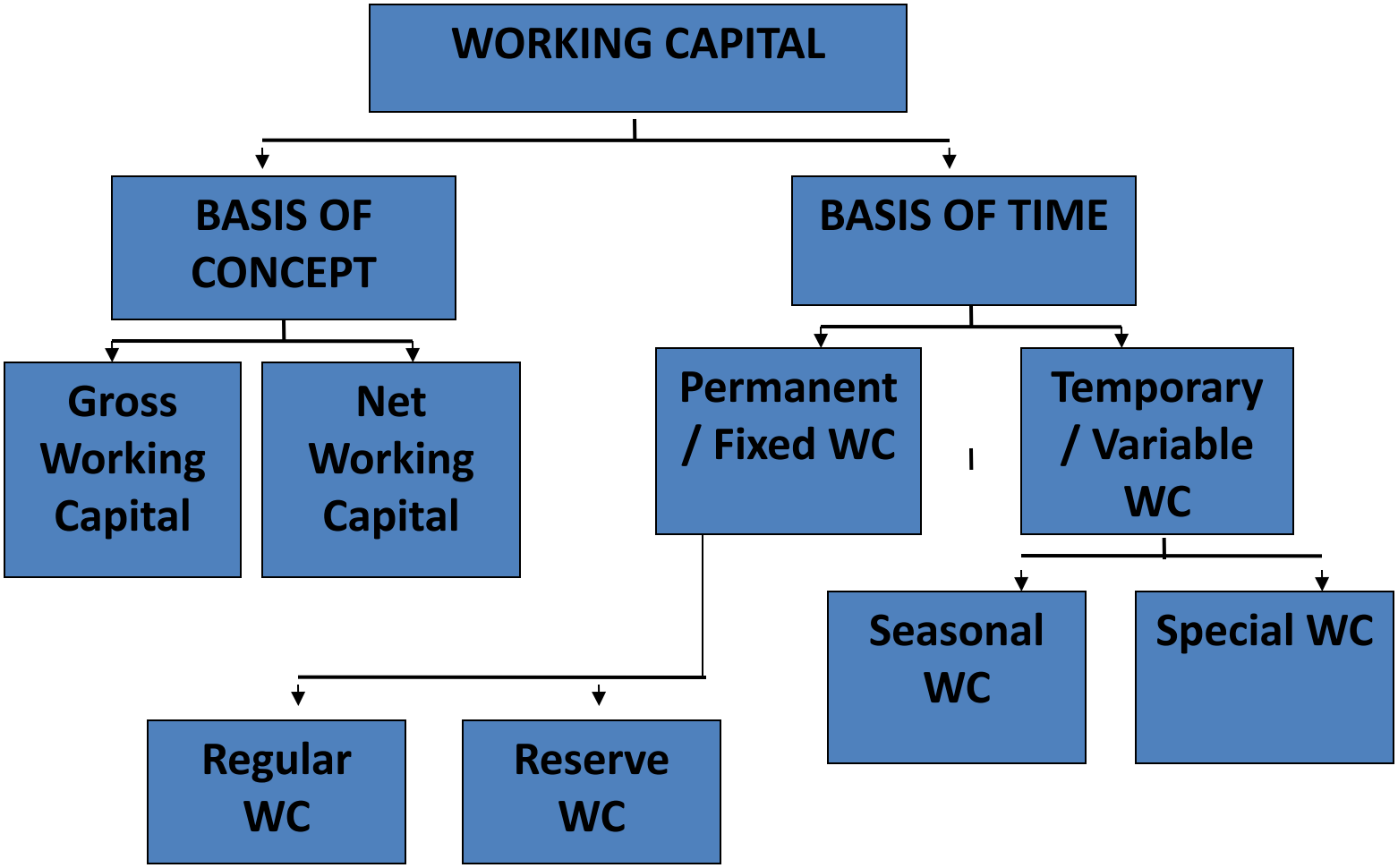
A company's operating cycle typically consists of three primary activities: Purchasing resources: Producing the product and: Distributing (selling) the product.

These activities create funds that are both unsynchronized and uncertain.

Unsynchronized because cash disbursements (for eg, payments for resource purchases) usually take place before cash receipts (for eg. collection of receivables)They are uncertain because future sales and costs, which generate the respective receipts and disbursements, cannot be forecasted with complete accuracy.

Cash conversion cycle **= operating cycle – payables deferral period.**

TYPES OF WORKING CAPITAL

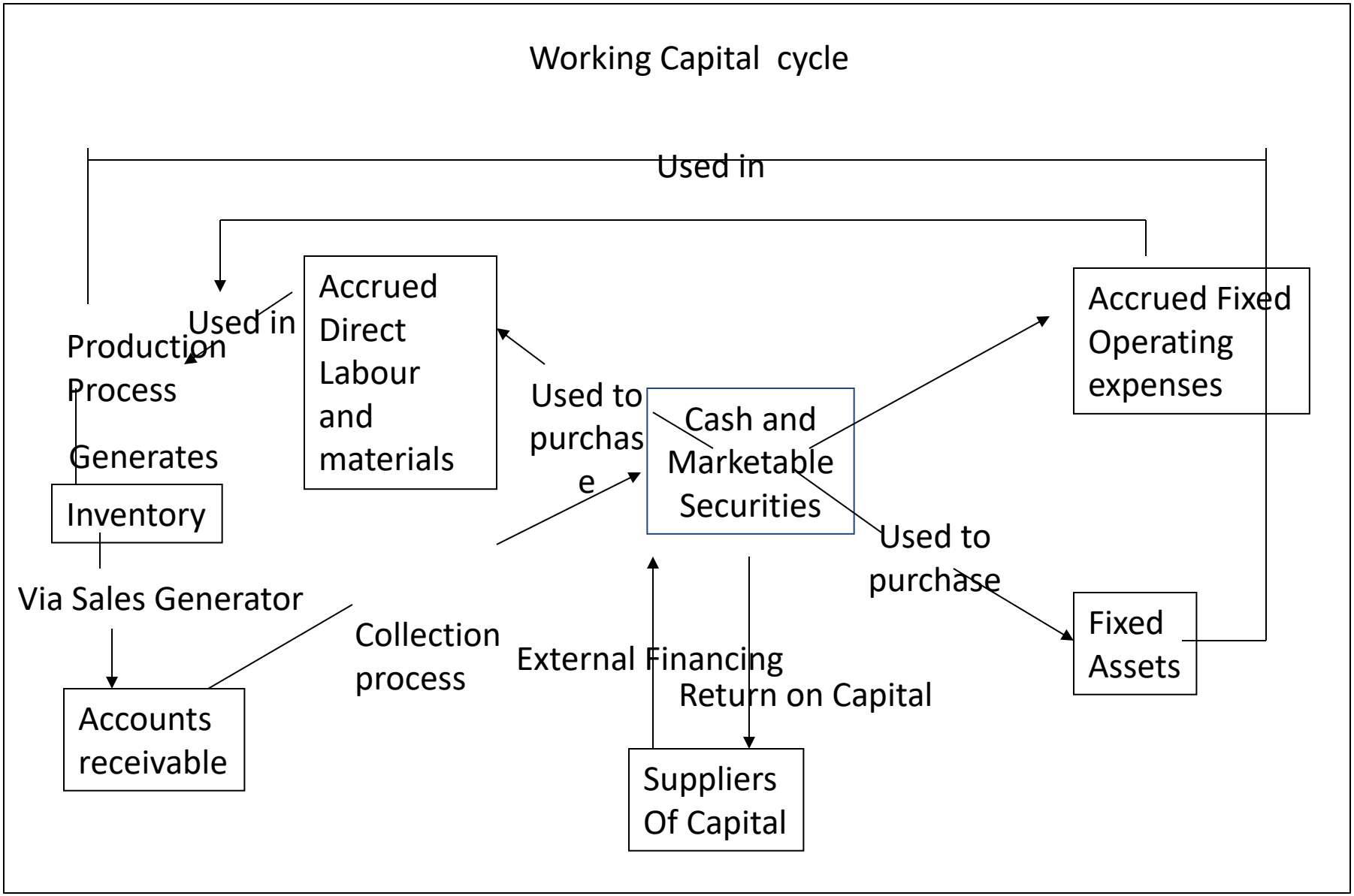


- **Strategies to overcome the problem**

  Manage working capital investment or financing such as

  - Holding additional cash balances beyond expected needs
  - Holding a reserve of short term marketable securities
  - Arrange for availability of additional short-term borrowing capacity
  - One of the ways to address the problem of fixed set-up cost may be to hold inventory.
  - One or combination of the above strategies will target the problem

RESOURCE FLOWS FOR A MANUFACTURING FIRM



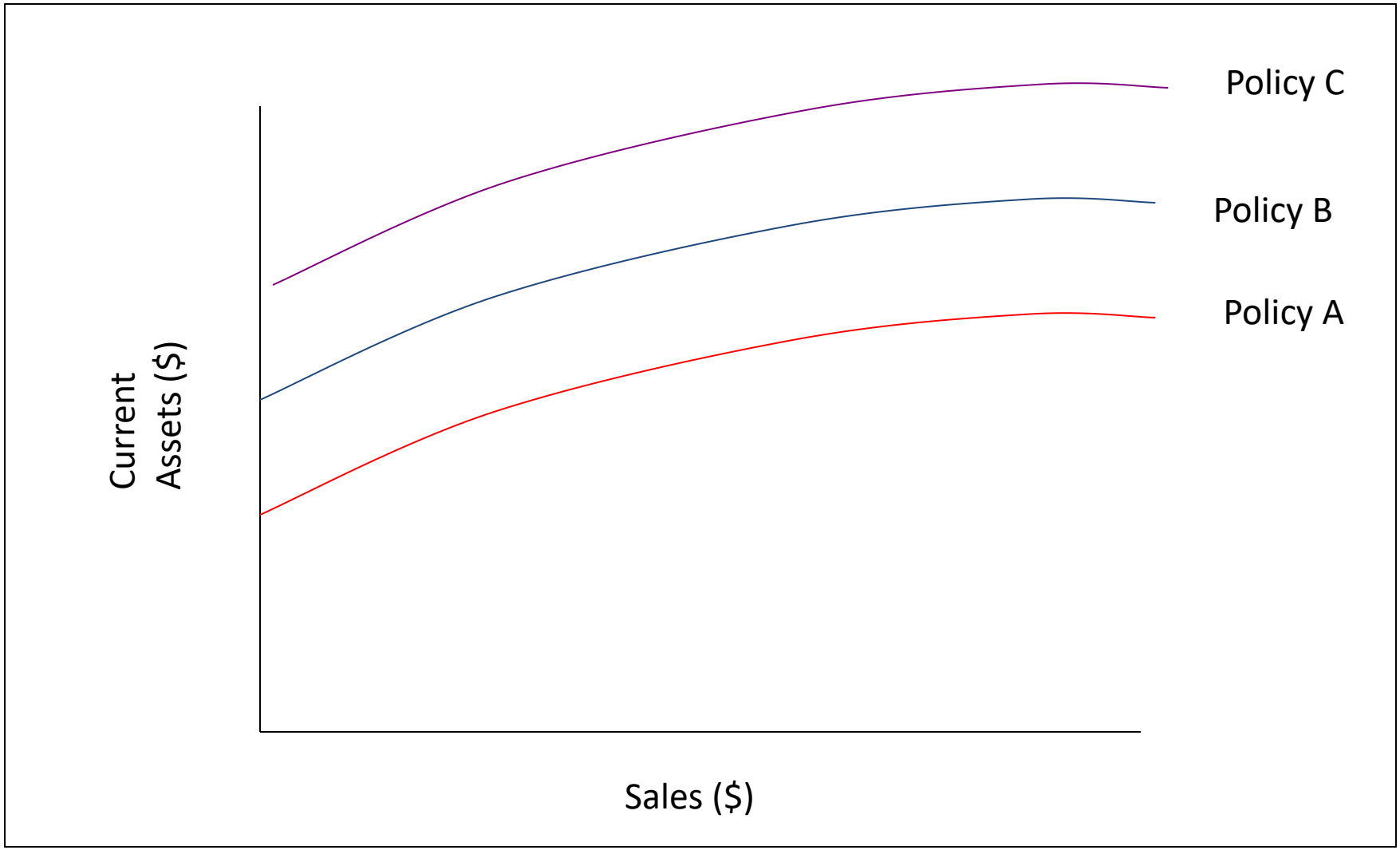
WORKING CAPITAL INVESTMENT

The size and nature of investment in current assets is a function of different factors such as type of products manufactured, the length of operating cycle, the sales level, inventory policies, unexpected demand and unanticipated delays in obtaining new inventories, credit policies and current assets.

Three alternative working capital investment policies

- Policy A represents *Aggressive* Approach
- Policy B represents a *Moderate* Approach
- Policy C represents *Conservative* Approach

Three alternative working capital investment policies



Following are important factors generally influencing the working capital requirements:

1. NATURE AND VOLUME OF THE BUSINESS.
2. PRODUCTION POLICY.
3. LENGTH OF MANUFACTURING PROCESS.
4. SEASONAL VARIATION.
5. RATE OF STOCK TURNOVER.
6. CREDIT POLICY.
7. BUSINESS FLUCTUATIONS.
8. RATE OF GROWTH OF BUSINESS.
9. EARNING CAPACITY.
10. PRICE LEVEL CHANGE.
11. MARKET CONDITIONS.
12. SUPPLY CONDITION .
13. OTHER FACTORS.

Factors influencing the working capital

- **The nature and volume of business** is an important factor in deciding the amount of working capital. For example, the amount of working capital is generally more in trading and in service units as compared to the manufacturing units. On the other hand, public utilities require less working capital. The relation between the volume of business and the requirement of working capital is more direct and clear. The bigger the size of the units, the more will be the requirement of working capital.
- **The production policy** of business is also an important determinant of working capital requirement. If demand for the product is regular and constant, this policy helps in reducing working capital requirement to the lowest possible level. But if demand for the product is seasonal, this policy raises the level of inventory during off season and thereby increases the working capital requirement.

Factors influencing the working capital

- The time that elapses from the purchase and use of raw materials to the production of finished goods is called **manufacturing cycle**. The longer the period a manufacturing cycle takes, the larger is the amount of working capital required, because the funds get locked up in production process for a longer period of time.
- Firms which have marketed seasonally in their operations usually have highly fluctuating working capital requirements. In Industries, they have to buy raw material in bulk during the season to ensure uninterrupted flow & process them during the entire year. A huge amount is thus, blocked in the form of material inventory during such season, which gives rise to more W.C. requirement. During the busy season, a firm requires large W.C. than in the slack season.

Factors influencing the working capital

- There is a high degree of inverse co-relationship between the Quantum of working capital & the speed with which the sales are effected. A firm having a high rate of stock turnover will need lower amount of W.C. as compared to firm having a low rate of turnover.
- In the present-day circumstances, almost all units have to sell goods on credit. The **nature of credit policy** is an important consideration in deciding the amount of working capital requirement. Larger the volume of credit sales, the greater will be the requirement of working capital. Also, the longer the period the collection of payment takes, the greater will be the requirement of working capital.

Factors influencing the working capital

- **Business fluctuations** are of two types: seasonal fluctuations which arise out of seasonal changes in demand for the product. If demand for the product is seasonal, production will have to be increased during the season, and it will have to be reduced during the off-season. Correspondingly, there will be fluctuations in the requirement of working capital.
- Cyclical fluctuations which occur due to ups and downs of economic activities in the country as a whole. The cyclical fluctuations are made up of periods of prosperity and depression. The sales and prices increase during prosperity necessitating more working capital in the form of inventories and book-debts.
- It is difficult to determine the relationship between the growth in the volume of business & growth in W.C. of a business, it may be concluded that for normal rate of expansion in the volume of the business, we may have retained profit to provide for more W.C. but in fast growing concern, we shall require larger amount of working capital.

Factors influencing the working capital

- The **dividend policy** of a concern also influence the req. of its W.C. A firm can maintain a steady high rate of cash dividend irrespective of its generation of profit need more W.C. than the firm that retains larger parts of its profit & doesn't pay so high rate of cash dividend.
- **Change in price level** also affect the W.C. req. The rising price will require the firm to maintain larger amount of W.C. as more funds will be required to maintain the same current assets. The effect of rising price may be different for different firms. Some firms may be affected most while some others may not be affected at all by the rising in prices.

Factors influencing the working capital

- **The degree of competition** prevailing in the market-place has an important bearing on working capital needs. When competition is intense, a larger inventory of finished goods is required to promptly serve customers who may not be inclined to wait because other manufacturers are ready to meet their needs.
- If the market is strong and competition is weak, a firm can manage with smaller inventory of finished goods, because customers can be supplied with some delay.
- **The time taken by a supplier of raw materials, good** etc. after placing an order, also determines the working capital if goods are received as soon as or in a short period after placing an order, then the purchaser will not like to maintain a high level of inventory of that goods. Otherwise, large inventories should be kept

Factors influencing the working capital Certain other factor such as operating efficiency, management ability, import policy, asset structure, importance of labor , banking facilities etc.. Also influence the requirements of working capital.

SOURCES OF WC

- Accruals
- Trade credit
- Working capital advance by commercial banks
- Regulations of bank finance
- Public deposits
- Inter corporate deposits
- Short-term loans from financial institutions
- Right debentures for working capital
- Commercial paper
- Factoring

EXCESS OR INADEQUATE WORKING CAPITAL

Every business concern should have adequate working capital to run its business operations. It should have neither redundant or excess working capital nor inadequate or shortage of working capital.

Both excess as well as shortage of working capital situations are bad for any business. However, out of the two, inadequacy or shortage of working capital is more dangerous from the point of view of the firm.

Disadvantages of Redundant or Excess Working Capital

Idle funds, Poor ROI, Unnecessary Purchasing & Accumulation of Inventories over required level, Excessive debtors and defective credit policy, higher incidence of B/D, Overall inefficiency in the organization, Credit worthiness suffers due to low rate of return on investments, the market value of shares may fall.

Disadvantages or Dangers of Inadequate or Short Working Capital

Can’t pay off its short-term liabilities in time.

Economies of scale are not possible.

Difficult for the firm to exploit favorable market situations

Day-to-day liquidity worsens

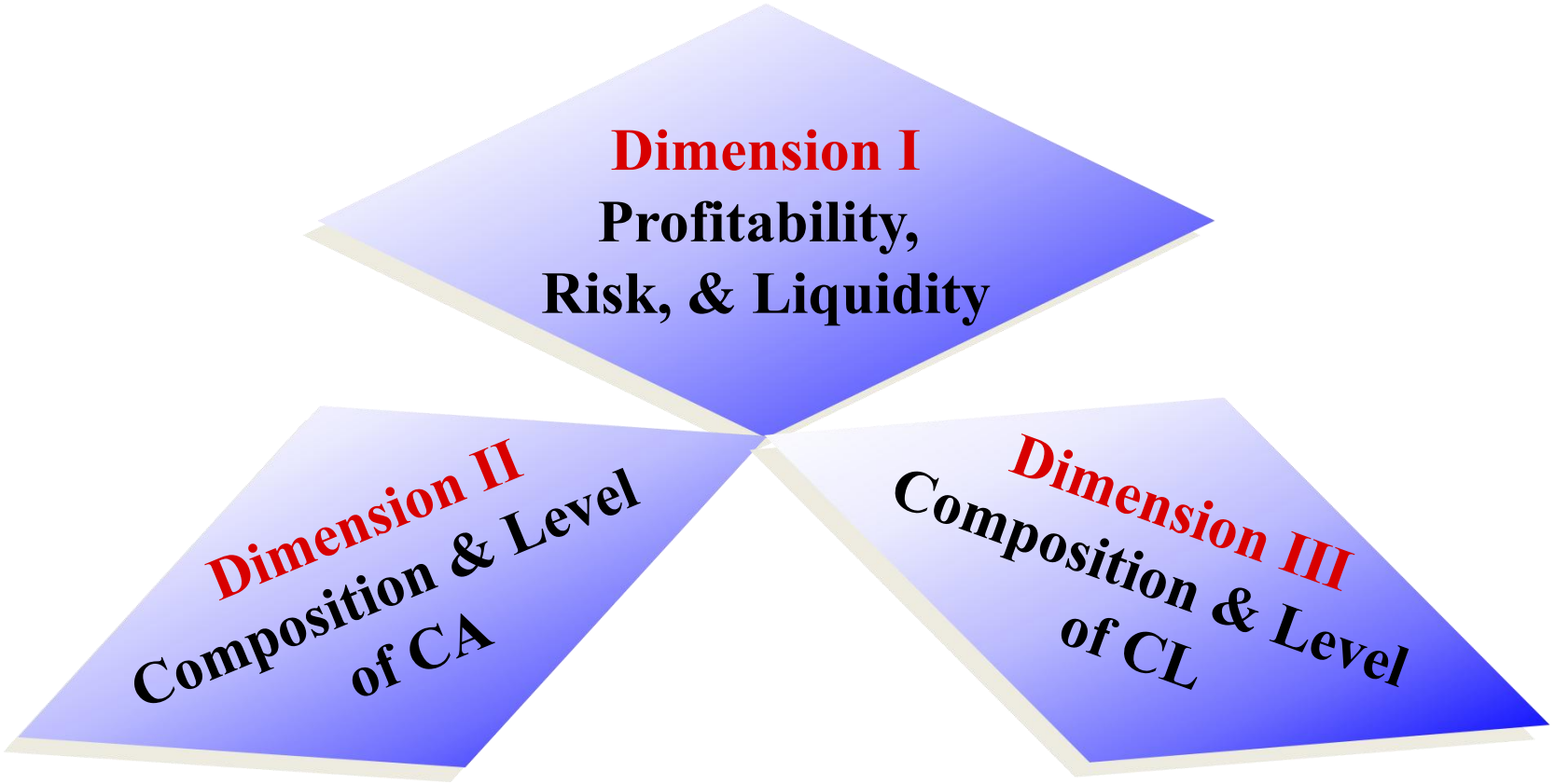
Improper utilization of the fixed assets and ROA/ROI falls sharply.

MANAGEMENT OF WORKING CAPITAL (WCM)

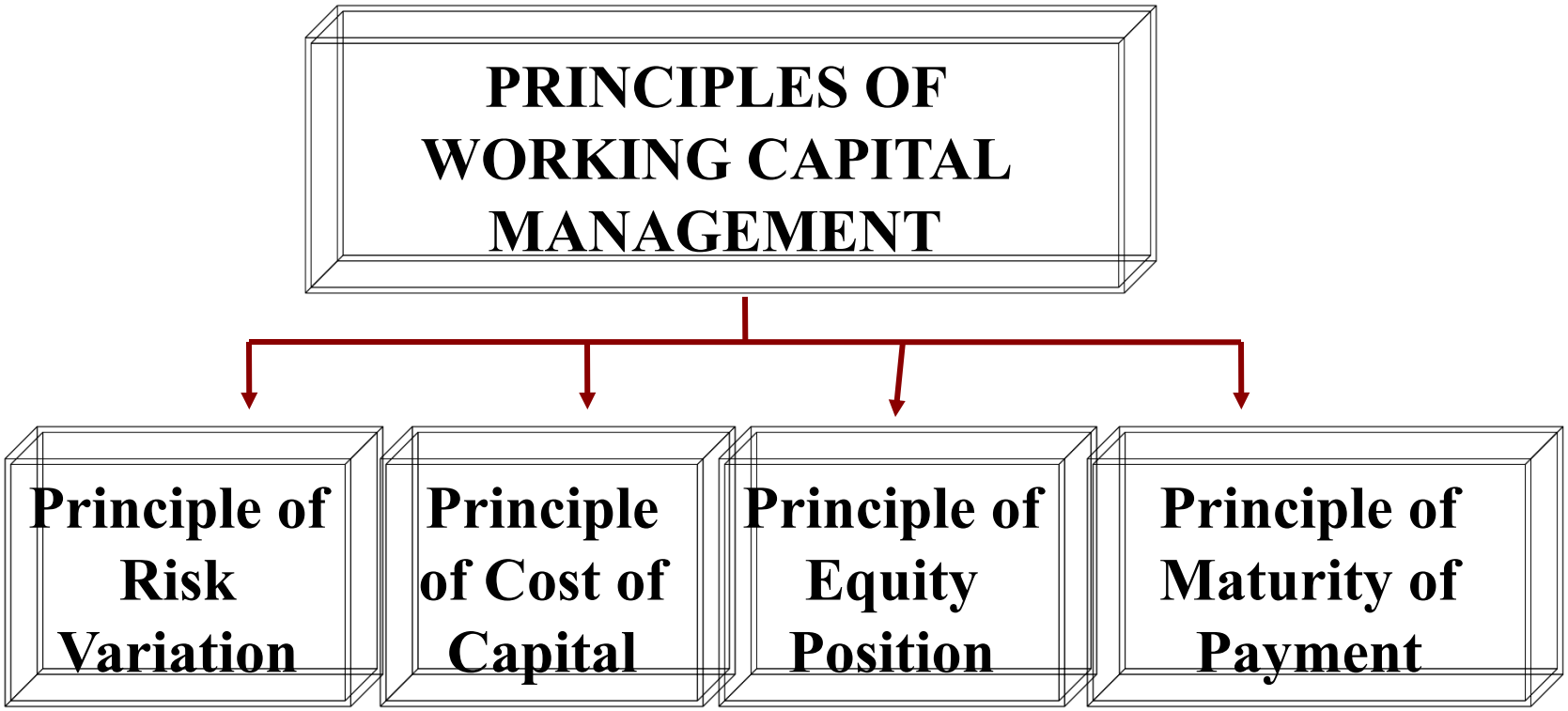
Management of working capital is concerned with the problems that arise in attempting to manage the current assets, the current liabilities and the inter-relationship that exists between them. In other words, it refers to all aspects of administration of CA and CL.

Working Capital Management Policies of a firm have a great effect on its *profitability, liquidity and structural health of the organization.*

3D Nature of Working Capital Management



PRINCIPLES OF WORKING CAPITAL MANAGEMENT / POLICY



- Inventory conversion period

$$= \frac{\text{Avg. inventory}}{\text{Cost of sales}} * 365$$

- Receivable conversion period

$$= \frac{\text{Accounts receivable}}{\text{Annual credit sales}} * 365$$

- Payables deferral period

$$= \frac{\text{Accounts payable + Salaries, etc}}{\text{(Cost of sales + selling, general and admn,. Expenses)}} * 365$$

PROFORMA - WORKING CAPTIAL ESTIMATES

1. TRADING CONCERN

STATEMENT OF WORKING CAPITAL REQUIREMENTS

		Amount (Rs.)
Current Assets		
(i) Cash		----
(ii) Receivables (For…..Month's Sales)----		----
(iii) Stocks (For……Month's Sales)-----		----
(iv)Advance Payments if any		----
Less : Current Liabilities		
(i) Creditors (For….. Month's Purchases)-		----
(ii) Lag in payment of expenses		-----
WORKING CAPITAL (CA – CL)	**xxx**	
Add : Provision / Margin for Contingencies		-----
NET WORKING CAPITAL REQUIRED	**XXX**	