



# **JEPPIAAR**

## **ENGINEERING COLLEGE**

**DEPARTMENT OF MANAGEMENT STUDIES**

**MBA / CF / 2025-27 / MB25202**

**COURSE FILE - THEORY**

SUBJECT : FINANCIAL MANAGEMENT

SUBJECT CODE : MB25202

BRANCH : MBA

BATCH : 2025-2027

SEMESTER : II

YEAR : I



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## COURSE DETAILS

**SUBJECT** : FINANCIAL MANAGEMENT

**SUBJECT CODE** : MB25202

### **COURSE OBJECTIVES:**

This course aims to impart a comprehensive understanding of the core financial functions in an organization, emphasizing value creation and efficient resource allocation.

Students will explore decision-making tools related to investment, financing, working capital, and dividend distribution. Emphasis is laid on time value of money, capital budgeting, risk-return trade-offs, cost of capital, and modern capital market instruments. The course prepares students to make effective financial decisions under real-world constraints and uncertainties.

### **COURSE OUTCOMES:**

<b>Subject Code</b>	<b>MB25202</b>
<b>Subject Name</b>	<b>FINANCIAL MANAGEMENT</b>
<b>CO1</b>	Demonstrate conceptual knowledge of financial management, time value of money, capital budgeting, capital structure, dividend policies, working capital management, and long-term financing options.
<b>CO2</b>	Interpret and relate the objectives of financial management, risk and return analysis, capital budgeting techniques, leverage and capital structure theories, dividend policies, and the role of capital markets in a company's financial decisions.
<b>CO3</b>	Apply financial management principles, time value of money concepts, and capital budgeting techniques to make informed investment, financing, and working capital decisions.
<b>CO4</b>	Analyse financial data, including cash flows, leverage, and working capital components, to evaluate investment proposals, capital structure, and liquidity management strategies.
<b>CO5</b>	Evaluate capital structure and dividend policy theories, working capital financing options, and long-term financing instruments to formulate a comprehensive financial strategy for a firm.
<b>CO6</b>	Develop a financial management framework by integrating knowledge of investment, financing, and working capital decisions to create value, manage risk, and support the long-term growth of a business.

## CO-PO-PSO MAPPING MATRIX:

CO	PO1	PO2	PO3	PO4	PO5	PSO1	PSO2
CO1	3	2	2	2	1	3	2
CO2	3	3	3	3	2	3	3
CO3	3	3	3	3	2	3	3
CO4	3	3	3	3	2	3	3
CO5	3	3	3	3	3	3	3
CO6	3	3	3	3	3	3	3



**JEPPIAAR**  
ENGINEERING COLLEGE

**DEPARTMENT OF MANAGEMENT STUDIES**

**DETAILED SYLLABUS**

<b>MB25202</b>	<b>FINANCIAL MANAGEMENT</b>	<b>L</b>	<b>T</b>	<b>P</b>	<b>C</b>
		<b>3</b>	<b>0</b>	<b>0</b>	<b>3</b>

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**Foundations of Financial Management**

Introduction, Nature and Scope of Financial Management –Objectives of Financial Management –Major Financial Decisions –Role of Finance Manager –Organization of Finance Functions –Time Value of Money –Valuation of Shares and Bonds –Risk and Return Analysis: Single Asset and Portfolio Context.

**Investment and Capital Budgeting Decisions**

Capital Budgeting: Concepts and Relevance –Identification of Cash Flows –Evaluation Techniques: Payback, ARR, NPV, IRR, Profitability Index (**Problem**)–Comparison of DCF and Non-DCF Methods –Cost of Capital: Specific Costs and Weighted Average Cost (Problem) –Application of Investment Appraisal Tools.

**Financing Decisions and Capital Structure**

Leverages –Operating and Financial Leverage(Problem)–Combined Leverage –EBIT-EPS Analysis –Indifference Point(**Problem**)–Capital Structure Theories: NI, NOI, MM Approach –Determinants of Capital Structure –Financial Planning and Strategy.

**Dividend Policy Decisions**

Dividend Policy: Importance and Issues –Relevance and Irrelevance Theories –Walter’s Model, Gordon’s Model, MM Hypothesis –Types and Forms of Dividends –Factors Influencing Dividend Decisions –Real-World Dividend Practices.

**Working Capital Management**

Working Capital: Concepts, Determinants and Estimation(**Problem**)–Operating Cycle –Receivables Management –Inventory and Cash Management –Working Capital Financing:

Trade Credit, Commercial Paper, Bank Finance, Company Deposits –Liquidity vs Profitability Trade-offs.

## **Long-Term Financing and Capital Markets**

Indian Capital Market Overview –Primary and Secondary Markets –Long-Term Sources: Equity, Debentures, Term Loans –Lease and Hire Purchase –Venture Capital and Private Equity –SEBI Regulations –Financing Strategies for Start-ups.

### **References:**

1. I.M. Pandey, Financial Management, Vikas Publishing, 12th Ed., 2023.
2. M.Y. Khan & P.K. Jain, Financial Management: Text, Problems and Cases, TMH, 9th Ed., 2023.
3. Aswath Damodaran, Corporate Finance: Theory and Practice, Wiley, 4th Ed., 2014
4. James C. Van Horne, Fundamentals of Financial Management, PHI Learning, 14th Ed., 2021.
5. Brigham & Ehrhardt, Financial Management: Theory and Practice, Cengage, 15th Ed., 2022.
6. Prasanna Chandra, Financial Management, TMH, 10th Ed., 2022.
7. Srivastava & Mishra, Financial Management, Oxford University Press, 2nd Ed., 2019.

### **E-Resources:**

- Investopedia Financial Education –<https://www.investopedia.com>
- NSE India Corporate Finance Modules –<https://www.nseindia.com>
- Coursera: Corporate Finance Specializations –<https://www.coursera.org>
- SEBI Investor Awareness Resources –<https://investor.sebi.gov.in>
- Harvard Business Review Finance Insights –<https://hbr.org>

### **COURSE OUTCOME:**

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# JEPPIAAR ENGINEERING COLLEGE

Jeppiaar Nagar, Rajiv Gandhi Salai, Chennai - 119.  
(ISO 9001:2008 & NBA Accredited Institution)

## DEPARTMENT OF MANAGEMENT STUDIES

Name of the Subject : FINANCIAL MANAGEMENT

Semester, Year & Branch : I, II & MBA

Subject Code : MB25202

Name of the Staff Handling  
the Subject : Ms. Haritha Hari K

Students Batch : 2025-2027

**Signature of Staff**

SIGNATURE OF HOD



# **JEPPIAAR**

## **ENGINEERING COLLEGE**

**DEPARTMENT OF MANAGEMENT STUDIES**

**I YEAR / II SEMESTER**

**MB25202: FINANCIAL MANAGEMENT**

# **LECTURE NOTES– NOTES**

**Faculty In charge**

**MS. HARITHA HARI K**



**Anna University Chennai**

**Regulation 2025**

# UNIT 1

## FOUNDATIONS OF FINANCIAL MANAGEMENT

### SYLLABUS

Introduction, Nature and Scope of Financial Management –Objectives of Financial Management – Major Financial Decisions –Role of Finance Manager –Organization of Finance Functions –Time Value of Money –Valuation of Shares and Bonds –Risk and Return Analysis: Single Asset and Portfolio Context.

S.No	Topic	Course Outcome (CO)	Programme Outcomes (POs)	Bloom's Taxonomy Level
1	Introduction to Financial Management	CO1	PO1, PO2, PO3	BT2 – Understand
2	Nature and Scope of Financial Management	CO1	PO1, PO2, PO3	BT2 – Understand
3	Objectives of Financial Management	CO1	PO1, PO2, PO3	BT2 – Understand
4	Major Financial Decisions	CO1	PO1, PO2, PO3	BT4 – Analyze
5	Role of Finance Manager	CO1	PO2, PO3,	BT3 – Apply
6	Organization of Finance Functions	CO1	PO2, PO3	BT2 – Understand
7	Time Value of Money	CO1	PO1, PO2	BT3 – Apply
8	Valuation of Shares and Bonds	CO1	PO1, PO2,	BT4 – Analyze
9	Risk and Return Analysis (Single Asset & Portfolio)	CO1	PO1, PO2	BT4 – Analyze

### INTRODUCTION TO FINANCIAL MANAGEMENT

Financial Management is concerned with the **planning, organizing, directing and controlling of financial resources** of an organization. It ensures that adequate funds are available at the right time and are utilized efficiently to achieve organizational objectives.

In modern business, finance is considered the **lifblood of business**, because all business activities such as production, marketing, and human resource management require financial support.

Financial management has evolved from a traditional approach (raising funds) to a modern approach that focuses on **efficient utilization of funds and wealth creation**.

### Nature of Financial Management

Financial Management is managerial in character and plays a strategic role in business decision-making. Its nature can be explained as follows:

## 1. Managerial in Nature

Financial management involves **planning, organizing, directing, and controlling financial resources**. It requires managers to take decisions related to investment, financing, and dividend distribution. These decisions directly influence profitability, liquidity, and growth of the organization.

## 2. Continuous Process

Financial management is not a one-time activity. Financial decisions such as cash management, budgeting, investment evaluation, and financing are taken **continuously** to meet the changing needs of the business. It ensures smooth flow and proper utilization of funds at all times.

## 3. Forward-Looking

Financial management focuses on **future planning and forecasting**. Decisions are taken based on expected cash flows, future profitability, risk, and market conditions. Tools like budgeting, financial forecasting, and capital budgeting reflect the forward-looking nature of financial management.

## 4. Interdisciplinary in Nature

Financial management is closely related to other disciplines:

- **Accounting** – for financial statements and records
- **Economics** – for cost analysis, demand, and pricing decisions
- **Statistics** – for risk analysis and forecasting
- **Management** – for planning and control

This interdisciplinary approach helps in better decision-making.

## 5. Risk-Oriented

Every financial decision involves some degree of **risk and uncertainty**. Financial management aims to analyse and manage risk through techniques like diversification, risk-return analysis, and capital budgeting methods. The objective is to minimize risk while maximizing returns.

## Scope of Financial Management

The scope of financial management is wide and covers all financial activities of the organization. The major areas are:

### 1. Financial Planning

Financial planning involves estimating the **capital requirements** of the business and determining the sources of funds. It ensures:

- Adequate availability of funds
- Proper allocation of resources
- Balanced growth of the organization

## 2. Capital Budgeting

Capital budgeting deals with decisions related to **long-term investment** in fixed assets such as plant, machinery, and technology. These decisions are critical because they involve large funds and long-term commitment. Techniques like NPV, IRR, and Payback Period are used.

## 3. Capital Structure Decisions

Capital structure refers to the **mix of debt and equity** used to finance business operations. Financial management aims to achieve an **optimum capital structure** that minimizes the cost of capital and maximizes the value of the firm.

## 4. Dividend Policy

Dividend policy determines how much profit should be distributed to shareholders and how much should be retained for future growth. A proper dividend policy balances:

- Shareholder expectations
- Company's financial needs

## 5. Working Capital Management

Working capital management deals with management of **current assets and current liabilities** such as cash, inventory, receivables, and payables. Efficient working capital management ensures liquidity and smooth day-to-day operations.

## 6. Financial Control and Reporting

Financial control involves:

- Budgetary control
- Cost control
- Financial performance evaluation

Financial reporting provides accurate financial information to management, investors, and other stakeholders for decision-making.

## OBJECTIVES OF FINANCIAL MANAGEMENT

### Primary Objective

#### **Wealth Maximization**

The main objective of financial management is **maximization of shareholders' wealth**. It aims to increase the market value of shares by making sound financial decisions.

Wealth maximization considers:

- Return on investment
- Risk involved
- Time value of money

- Long-term growth

It is considered superior to profit maximization.

## Secondary Objectives

### 1. Profit Maximization

Financial management aims to earn reasonable profits for business survival and growth. However, profit maximization alone is not sufficient as it ignores risk and future value of money.

### 2. Liquidity

Maintaining adequate liquidity is essential to meet short-term obligations such as salaries, creditors, and operating expenses. Proper liquidity avoids insolvency.

### 3. Financial Stability

Financial management ensures stability by maintaining balanced capital structure and steady earnings.

### 4. Optimal Utilization of Funds

Funds should be used efficiently to avoid wastage and idle resources. Proper utilization improves profitability and growth.

### 5. Growth and Survival

Long-term survival and expansion of the business is an important objective. Financial decisions must support sustainable growth.

### 6. Minimization of Risk

Financial management aims to reduce financial risk by careful planning, diversification, and sound investment decisions.

## MAJOR FINANCIAL DECISIONS

Financial management involves three major decisions that directly affect the **profitability, risk, and value of a firm**. These decisions are taken by the finance manager to achieve the objective of **wealth maximization**.

### 1. Investment Decision (Capital Budgeting Decision)

Investment decisions involve deciding where, when, and how much to invest in long-term assets. These decisions relate to the allocation of funds to projects that generate future benefits.

#### Features

- Involves large amount of funds
- Long-term and irreversible in nature

- High degree of risk and uncertainty
- Direct impact on growth and profitability

### **Areas of Investment**

- Purchase of plant and machinery
- Expansion of existing business
- Introduction of new products
- Investment in technology and R&D

### **Example**

A manufacturing company plans to install a **new automated machine** costing ₹50 lakhs. The finance manager evaluates whether the expected future cash inflows justify the investment using techniques like **NPV or IRR**. If the project yields positive returns, the investment is accepted.

## 2. Financing Decision (Capital Structure Decision)

### **Meaning**

Financing decisions determine the **source of funds** to finance investments. It involves deciding the proportion of **equity and debt** in the capital structure.

### **Sources of Finance**

- Equity shares
- Preference shares
- Debentures
- Bank loans
- Retained earnings

### **Factors Affecting Financing Decision**

- Cost of capital
- Risk and return
- Control and ownership
- Financial flexibility
- Market conditions

### **Objective**

To achieve an **optimum capital structure** that minimizes cost of capital and maximizes firm value.

### **Example**

A company requires ₹10 crores for expansion. It may raise:

- ₹6 crores through equity shares
- ₹4 crores through bank loans

The finance manager chooses this mix after analysing interest cost, repayment ability, and impact on control.

### 3. Dividend Decision

#### Meaning

Dividend decisions involve deciding **how much of the profit should be distributed to shareholders** and how much should be retained in the business.

#### Forms of Dividend

- Cash dividend
- Bonus shares
- Interim dividend

#### Factors Affecting Dividend Decision

- Earnings and profitability
- Liquidity position
- Growth opportunities
- Shareholder expectations
- Legal provisions

#### Example

A company earns a profit of ₹5 crores. The finance manager decides to:

- Distribute ₹2 crores as dividends
- Retain ₹3 crores for future expansion

This decision balances shareholder income and long-term growth.

### ROLE OF FINANCE MANAGER

A Finance Manager plays a crucial role in managing the **financial resources of an organization**. The primary responsibility of a finance manager is to **ensure adequate availability of funds and their effective utilization** to achieve the objective of wealth maximization.

#### 1. Financial Planning and Forecasting

The finance manager prepares financial plans by estimating future financial requirements. This includes forecasting income, expenses, profits, and cash flows. Proper financial planning helps the organization to avoid shortage or surplus of funds.

#### 2. Estimation of Capital Requirements

The finance manager estimates both:

- **Fixed capital requirements** (for long-term assets like plant and machinery)
- **Working capital requirements** (for day-to-day operations)

Accurate estimation ensures smooth functioning of business activities.

### 3. Investment Decision (Capital Budgeting)

The finance manager evaluates and selects profitable investment opportunities. He/she uses techniques such as:

- Payback Period
- Net Present Value (NPV)
- Internal Rate of Return (IRR)

Sound investment decisions lead to growth and increased firm value.

### 4. Financing Decision

The finance manager decides the **source of funds** by selecting an appropriate mix of equity and debt. The aim is to achieve an **optimum capital structure** that minimizes cost of capital and financial risk.

### 5. Dividend Decision

The finance manager determines the dividend policy of the firm. This involves deciding how much profit should be distributed to shareholders and how much should be retained for future growth, keeping in mind liquidity and shareholder expectations.

### 6. Cash and Working Capital Management

Efficient management of cash, receivables, inventory, and payables is essential to maintain liquidity. The finance manager ensures that the firm can meet its short-term obligations without affecting profitability.

### 7. Financial Control

The finance manager establishes effective financial controls through:

- Budgetary control
- Cost control
- Performance analysis

This helps in comparing actual performance with planned performance and taking corrective actions.

### 8. Risk Management

Financial decisions involve risk due to uncertainty in cash flows and market conditions. The finance manager identifies, measures, and manages financial risks using techniques like diversification and insurance.

### 9. Maintaining Relations with Financial Institutions

The finance manager maintains good relations with:

- Banks
- Financial institutions
- Investors
- Credit rating agencies

This helps in raising funds easily and at favourable terms.

## 10. Legal and Regulatory Compliance

The finance manager ensures compliance with:

- Company law
- Tax laws
- SEBI regulations
- Accounting standards

This avoids legal penalties and maintains corporate reputation.

## ORGANIZATION OF FINANCE FUNCTIONS

### Meaning

Organization of finance functions refers to the **systematic arrangement and division of financial activities** within an organization to ensure effective planning, control, and utilization of financial resources. A proper organization helps in smooth functioning, accountability, and efficient decision-making.

In modern organizations, finance functions are centralized and handled by qualified finance professionals.

## OBJECTIVES OF ORGANIZING FINANCE FUNCTIONS

- To ensure **efficient utilization of funds**
- To establish **clear authority and responsibility**
- To maintain **effective financial control**
- To support management in financial decision-making
- To ensure compliance with legal and financial regulations

### Structure of Finance Organization

The finance function is usually headed by the **Chief Financial Officer (CFO)** or **Finance Director**, who is responsible for overall financial management.

### **Typical Organization Structure**

**Board of Directors**

↓

**Chief Financial Officer (CFO) / Finance Director**



**Treasurer**

**Controller**

## Key Finance Executives and Their Functions

### **1. Chief Financial Officer (CFO)**

The CFO is the top executive in charge of finance.

#### **Functions:**

- Formulating financial policies
- Strategic financial planning
- Coordinating finance with other departments
- Advising top management on financial matters

### **2. Treasurer**

The Treasurer is responsible for **fund management**.

#### **Functions:**

- Raising short-term and long-term funds
- Cash management
- Credit and receivables management
- Maintaining relations with banks and financial institutions
- Investment of surplus funds

### **3. Controller**

The Controller is responsible for **financial accounting and control**.

#### **Functions:**

- Preparation of financial statements
- Budgeting and budgetary control
- Cost accounting
- Internal auditing
- Financial reporting and analysis
- Maintaining accounting records

## Importance of Organization of Finance Functions

- Ensures **effective financial planning and control**
- Avoids duplication of work
- Improves coordination between departments
- Helps in timely and accurate decision-making
- Strengthens internal control system

## Centralization vs Decentralization of Finance Functions

### **Centralized Finance**

- All financial decisions taken at head office
- Better control and uniformity
- Suitable for large organizations

### **Decentralized Finance**

- Financial decisions delegated to departments or units
- Faster decision-making
- Suitable for diversified organizations

## TIME VALUE OF MONEY (TVM)

The **Time Value of Money** states that **a rupee received today is worth more than a rupee received in the future**. This is because money available today can be invested to earn returns, whereas future money involves uncertainty and loss of purchasing power.

TVM is a fundamental concept in financial management and forms the basis for investment appraisal, valuation of securities, and capital budgeting decisions.

### Reasons for Time Value of Money

1. **Earning Capacity of Money**  
Money received today can be invested to earn interest or returns.
2. **Inflation**  
Inflation reduces the purchasing power of money over time.
3. **Risk and Uncertainty**  
Future cash flows are uncertain and may not be received as expected.
4. **Preference for Present Consumption**  
Individuals prefer present consumption to future consumption.

### Components of Time Value of Money

- **Principal (P or PV)** – Present value of money
- **Interest Rate (r)** – Rate of return or discount rate
- **Time Period (n)** – Number of years or periods
- **Future Value (FV)** – Value of money at a future date

### Applications of Time Value of Money

- Capital budgeting decisions
- Valuation of shares and bonds
- Investment appraisal
- Retirement planning

- Loan and EMI calculations

### **Importance of Time Value of Money**

- Helps in comparing investment alternatives
- Assists in long-term financial planning
- Supports wealth maximization objective
- Forms foundation for modern financial management

### **Limitations of Time Value of Money**

- Assumes certainty of cash flows
- Selection of discount rate may be subjective
- Ignores qualitative factors

## **UNIT II**

### **INVESTMENT AND CAPITAL BUDGETING DECISIONS**

#### **SYLLABUS**

Capital Budgeting: Concepts and Relevance – Identification of Cash Flows – Evaluation Techniques: Payback, ARR, NPV, IRR, Profitability Index (**Problem**) – Comparison of DCF and Non-DCF Methods – Cost of Capital: Specific Costs and Weighted Average Cost (Problem) – Application of Investment Appraisal Tools.

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2	Capital Budgeting: Concepts and Relevance	C02	PO1, PO2	BT2 – Understand
3	Identification of Cash Flows	C02	PO1, PO2, PO3, PO4	BT3 – Apply
4	Payback Period Method	C02	PO1, PO2	BT3 – Apply
5	Accounting Rate of Return (ARR)	C02	PO1, PO2	BT3 – Apply
6	Net Present Value (NPV)	C02	PO1, PO2, PO3, PO4	BT4 – Analyze
7	Internal Rate of Return (IRR)	C02	PO1, PO2, PO3, PO4	BT4 – Analyze
8	Profitability Index (PI)	C02	PO1, PO2, PO3, PO4	BT4 – Analyze
9	Comparison of DCF and Non-DCF Methods	C02	PO2, PO4	BT4 – Analyze
10	Cost of Capital – Specific Costs	C02	PO1, PO2	BT3 – Apply
11	Weighted Average Cost of Capital (WACC)	C02	PO1, PO2, PO3, PO4	BT3 – Apply
12	Application of Investment Appraisal Tools	C02	PO1, PO2, PO3, PO4	BT5 – Evaluate

### Capital Budgeting Decisions

**Capital Budgeting Decisions** involve planning and selecting long-term investment projects that will yield benefits over a period of time. It is one of the most important functions of financial management because large sums of money and long-term commitments are involved.

#### **Definition**

*Capital budgeting is the process of evaluating and selecting long-term investments that are in line with the goal of wealth maximization.* – Ross, Westerfield, and Jaffe

#### MEANING OF CAPITAL BUDGETING

*Capital budgeting is the process of evaluating, selecting, and managing long-term investment projects based on their potential to generate returns over time.*

#### **Key Points:**

- Focuses on **long-term investment decisions**
- Decisions are **irreversible** and involve large funds
- Evaluates **future cash flows** generated by the project
- Helps achieve the firm's **objective of wealth maximization**

## CONCEPTS OF CAPITAL BUDGETING

### **A. Long-Term Investment**

- Capital budgeting relates to **acquisition or replacement of fixed assets**.
- Examples: new plant, machinery, technology upgrades, or infrastructure.

### **B. Cash Flows**

- Only **incremental cash inflows and outflows** are relevant.
- **Non-cash expenses** like depreciation are generally excluded from evaluation except for **tax shield purposes**.

### **C. Time Value of Money**

- Capital budgeting considers **time value of money (TVM)** for evaluating long-term projects.
- Cash flows in the future are **discounted to present value**.

### **D. Risk and Uncertainty**

- Future cash flows are **uncertain** due to market, technological, or financial factors.
- Risk assessment is an essential part of capital budgeting decisions.

### **E. Long-Term Commitment**

- Capital investments are **irreversible or difficult to reverse**.
- Wrong decisions can lead to financial losses.

### **F. Profitability and Strategic Alignment**

- Projects are evaluated based on **profitability, returns, and alignment with business strategy**.

## RELEVANCE OF CAPITAL BUDGETING

Capital budgeting is **critical for financial and strategic management** for the following reasons:

### **1. Efficient Use of Resources**

- Ensures funds are invested in **profitable and productive projects**
- Avoids wastage and underutilization of capital

### **2. Long-Term Profitability**

- Focuses on **long-term cash inflows and returns**
- Projects selected increase firm's **net worth** and shareholder wealth

### **3. Risk Management**

- Evaluation methods (NPV, IRR) incorporate **risk and uncertainty**
- Helps managers select projects with **acceptable risk-return trade-off**

### **4. Strategic Growth**

- Supports business expansion, modernization, and diversification
- Aligns investment decisions with **company's long-term goals**

### **5. Liquidity Planning**

- Ensures that large-scale investments do not **hamper day-to-day operations**
- Helps in planning **working capital requirements** along with long-term investments

## 6. Basis for Financial Planning

- Capital budgeting forms the **foundation for budgeting and financial planning**
- Guides **funding decisions, financing mix, and dividend policy**

## EXAMPLES OF CAPITAL BUDGETING PROJECTS

- Purchase of **new machinery** to increase production
- Expansion to a **new market or region**
- Introduction of **new product lines**
- Acquisition of **competitor or business unit**
- Upgrading **technology or infrastructure**

## IDENTIFICATION OF CASH FLOWS IN CAPITAL BUDGETING

### Meaning

Identification of cash flows refers to the process of **determining and estimating all relevant cash inflows and cash outflows** associated with an investment project over its entire life. Correct identification of cash flows is crucial because **capital budgeting decisions are based on cash flows, not accounting profits.**

## PRINCIPLES OF CASH FLOW IDENTIFICATION

1. **Cash Flows, Not Profits**  
Only **actual cash inflows and outflows** should be considered. Non-cash items such as depreciation and amortization are excluded, though depreciation is considered for its tax impact.
2. **Incremental Cash Flows**  
Only **additional cash flows** arising due to acceptance of a project should be included. Existing costs or revenues that remain unchanged are ignored.
3. **After-Tax Cash Flows**  
Cash flows should be measured **after tax**, as tax is a real cash outflow that affects project profitability.
4. **Consistency Principle**  
Cash flows must be consistent with the **discount rate** used in evaluation (both should be after-tax or before-tax).
5. **Exclusion of Financing Costs**  
Interest, dividends, and repayment of loans are excluded from cash flows because they are reflected in the cost of capital.

## CLASSIFICATION OF CASH FLOWS

Cash flows in capital budgeting are classified into **three main stages**:

### 1. Initial Cash Outflow

These are cash flows occurring at the **beginning of the project (time zero)**.

## Components

- Cost of land, building, plant, and machinery
- Installation and transportation costs
- Cost of technology, patents, or licenses
- Increase in working capital
- Less: Sale value of old assets (if any)

## Importance

Initial outflow represents the **total investment required** to start the project and is usually a large cash commitment.

### 2. Operating Cash Flows

These occur **during the life of the project** and are generated from regular business operations.

## Components

- Cash inflows from sales or services
- Cash outflows for operating expenses (raw materials, wages, power, maintenance)
- Tax payments

## Key Points

- Depreciation is excluded as a cash expense
- Tax savings from depreciation (depreciation tax shield) are included
- Operating cash flows determine the project's ability to generate returns

### 3. Terminal Cash Flows

Terminal cash flows arise at the **end of the project's life**.

## Components

- Scrap or salvage value of assets
- Recovery of working capital
- Sale proceeds of land or machinery
- Tax impact on sale of assets

## Importance

Terminal cash flows reflect the **final value realization** from the project.

## SPECIAL CASH FLOW CONSIDERATIONS

### 1. Sunk Costs

Costs already incurred (e.g., market research) should be **ignored** as they do not affect future cash flows.

### 2. Opportunity Costs

Benefits foregone by using resources in a project must be **included** as cash outflows.

3. **Replacement Projects**

Loss of revenue from old equipment replaced by new equipment should be considered.

4. **Inflation**

Expected inflation should be incorporated in future cash flow estimates.

5. **Working Capital Changes**

Increase in working capital is treated as cash outflow; decrease is treated as inflow.

**COMPONENTS OF INITIAL INVESTMENT:**

1. **Cost of Fixed Assets** – Machinery, building, equipment

2. **Installation and Transportation Costs** – Freight, insurance, installation

3. **Increase in Working Capital** – Cash, inventory, receivables

4. **Miscellaneous Costs** – Training, legal fees, licensing

**EVALUATION TECHNIQUES OF CAPITAL BUDGETING (THEORY)**

Capital budgeting evaluation techniques are used to assess the **feasibility and profitability of long-term investment projects**. These techniques help management in selecting projects that contribute to the **wealth maximization objective**.

1. Payback Period Method

**Meaning**

The Payback Period refers to the **time required to recover the initial investment** from the cash inflows generated by a project.

**Features**

- Simple and easy to understand
- Focuses on liquidity and capital recovery
- Emphasizes quick return of funds

**Merits**

- Easy to calculate and interpret
- Useful in projects with high risk and uncertainty
- Helps in maintaining liquidity

**Limitations**

- Ignores time value of money
- Ignores cash flows after payback period
- Not a true measure of profitability

2. Accounting Rate of Return (ARR)

## Meaning

Accounting Rate of Return measures the **profitability of an investment** based on accounting profits rather than cash flows.

## Features

- Uses accounting data from financial statements
- Expressed as a percentage return
- Focuses on average profits

## Merits

- Simple and easy to compute
- Based on readily available accounting information
- Useful for comparing projects with accounting targets

## Limitations

- Ignores time value of money
- Uses accounting profit instead of cash flows
- Different accounting policies may distort results

### 3. Net Present Value (NPV)

## Meaning

Net Present Value is the **difference between the present value of cash inflows and the present value of cash outflows** of a project.

## Decision Rule

- Accept the project if NPV is positive
- Reject the project if NPV is negative

## Merits

- Considers time value of money
- Considers entire life of the project
- Directly relates to wealth maximization

## Limitations

- Requires estimation of discount rate
- Difficult to understand for non-financial managers
- Sensitive to changes in cash flow estimates

### 4. Internal Rate of Return (IRR)

## Meaning

Internal Rate of Return is the **rate of discount at which the present value of cash inflows equals the present value of cash outflows**.

## Decision Rule

- Accept the project if IRR exceeds the cost of capital
- Reject if IRR is less than cost of capital

### **Merits**

- Considers time value of money
- Easy to understand as a percentage return
- Widely used in investment decisions

### **Limitations**

- Difficult to calculate
- May give conflicting results compared to NPV
- Not suitable for mutually exclusive projects

## 5. Profitability Index (PI)

### **Meaning**

Profitability Index measures the **benefit–cost relationship** of a project by comparing present value of cash inflows with present value of cash outflows.

### **Decision Rule**

- Accept the project if PI is greater than 1
- Reject if PI is less than 1

### **Merits**

- Considers time value of money
- Useful when capital is limited
- Helps in ranking projects

### **Limitations**

- Requires accurate estimation of discount rate
- May give misleading results for mutually exclusive projects

## **COMPARISON OF DCF AND NON-DCF METHODS**

### Meaning of DCF and Non-DCF Methods

- **Discounted Cash Flow (DCF) Methods** consider the **time value of money**, i.e., the fact that money received today is worth more than money received in the future.
- **Non-Discounted Cash Flow (Non-DCF) Methods** do **not** consider the time value of money and are based on **accounting profits or simple cash flows**.

### Major DCF Methods

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

### Major Non-DCF Methods

- Payback Period

- Accounting Rate of Return (ARR)

### COMPARISON TABLE

Basis	DCF Methods	Non-DCF Methods
Time value of money	Considered	Not considered
Cash flow focus	Based on cash flows	Based on profits or simple cash flows
Accuracy	More accurate and scientific	Less accurate
Risk consideration	Partially considers risk	Ignores risk
Decision reliability	High	Low
Complexity	More complex	Simple and easy
Usefulness	Best for long-term decisions	Useful for preliminary screening

DCF methods are **superior and recommended** for capital budgeting decisions, while Non-DCF methods are mainly used for **initial evaluation**.

### COST OF CAPITAL

Cost of capital **is the** minimum rate of return that a firm must earn on its investments to satisfy the expectations of its investors (equity, preference shareholders, and debt holders). It acts as a benchmark (cut-off rate) for accepting or rejecting investment projects.

### IMPORTANCE OF COST OF CAPITAL

#### 1. Basis for Capital Budgeting Decisions

Cost of capital acts as a **cut-off rate** for evaluating investment projects.

- If the return on a project is **higher than the cost of capital**, the project is accepted.
- If the return is **lower**, the project is rejected.

Thus, it helps in selecting **profitable investment opportunities**.

#### 2. Helps in Capital Structure Decisions

Cost of capital assists management in deciding the **best mix of debt, equity, and preference shares**.

- Sources with **lower cost** are preferred.
- An optimum capital structure minimizes overall cost and maximizes firm value.

#### 3. Measurement of Financial Performance

Cost of capital is used as a **benchmark** to evaluate the performance of investments and divisions.

- Returns above the cost of capital indicate **efficient performance**.
- Returns below it indicate **inefficiency**.
-

#### **4. Useful in Valuation of the Firm**

It is used to **discount future cash flows** while valuing shares, projects, or the entire firm. A lower cost of capital increases the **market value of the firm**.

#### **5. Helps in Financing Decisions**

Cost of capital guides management in choosing between **different sources of finance**. For example, if debt is cheaper than equity, the firm may prefer debt financing, subject to risk considerations.

#### **6. Assists in Dividend Policy Decisions**

Management considers the cost of capital while deciding whether profits should be **distributed as dividends or retained for reinvestment**. If retained earnings can earn more than the cost of capital, retention is preferred.

#### **7. Facilitates Risk Assessment**

Higher risk investments require a **higher cost of capital**. Thus, it helps in assessing the **risk-return trade-off** and in making prudent financial decisions.

#### **8. Helps in Long-Term Planning**

Cost of capital is useful in **long-term financial planning**, expansion decisions, mergers, and acquisitions. It ensures that long-term investments contribute to **wealth maximization**.

### **APPLICATION OF INVESTMENT APPRAISAL TOOLS**

Meaning

**Investment appraisal tools** are techniques used by management to **evaluate, compare, and select capital investment projects**. These tools help in deciding whether an investment will be **profitable, viable, and value-creating**.

#### **Objectives of Investment Appraisal**

- To select **profitable investment projects**
- To ensure **optimum utilization of funds**
- To reduce **risk and uncertainty**
- To maximize **shareholders' wealth**
- To support **long-term financial planning**

### **Major Investment Appraisal Tools and Their Applications**

#### **1. Payback Period Method**

Application

- Used to determine the **time required to recover the initial investment**
- Suitable for firms facing **liquidity constraints**
- Helpful in assessing **risk**, especially in uncertain environments

Practical Use

- Short-term projects
- Projects with high uncertainty

- Preliminary screening of projects

## 2. Accounting Rate of Return (ARR)

### Application

- Measures **profitability based on accounting profits**
- Useful for comparing projects with similar investment size
- Helpful for internal performance evaluation

### Practical Use

- Projects where accounting profit is important
- Evaluation based on financial statements

## 3. Net Present Value (NPV)

### Application

- Measures the **net value added to the firm**
- Used when the objective is **wealth maximization**
- Most suitable for **long-term investment decisions**

### Decision Rule

- Accept the project if **NPV > 0**

### Practical Use

- Expansion and diversification projects
- Capital-intensive investments
- Strategic decision-making

## 4. Internal Rate of Return (IRR)

### Application

- Indicates the **rate of return earned by the project**
- Helps compare project return with **cost of capital**
- Useful for ranking projects

### Decision Rule

- Accept if **IRR > Cost of Capital**

### Practical Use

- Comparing alternative investment proposals
- Investment justification to investors and lenders

## 5. Profitability Index (PI)

### Application

- Measures **value created per rupee invested**
- Useful in **capital rationing** situations
- Helps in selecting the best combination of projects

### Decision Rule

- Accept if **PI > 1**

Practical Use

- Limited capital availability
- Ranking multiple projects

### 6. Discounted Payback Period

Application

- Measures recovery period considering **time value of money**
- Provides a better risk assessment than simple payback

Practical Use

- Projects where early recovery is critical
- High-risk investments

### 7. Use of Cost of Capital in Appraisal

Application

- Used as **discount rate** in DCF techniques (NPV, PI)
- Acts as **benchmark** in IRR method
- Ensures selection of value-adding projects

## UNIT III

### FINANCING DECISIONS AND CAPITAL STRUCTURE

#### SYLLABUS

Leverages –Operating and Financial Leverage(Problem)–Combined Leverage –EBIT-EPS Analysis –Indifference Point(**Problem**)–Capital Structure Theories: NI, NOI, MM Approach –Determinants of Capital Structure –Financial Planning and Strategy.

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#### CO/PO & BT LEVEL OF LECTURE NOTES

S. No.	Topic	CO	PO	BT Level
1	Leverage – Meaning and Concept	CO3	PO1	BT2
2	Types of Leverage (Operating, Financial, Combined)	CO3	PO1, PO2	BT2

S. No.	Topic	CO	PO	BT Level
3	Operating Leverage (Meaning, Risk, Advantages & Disadvantages)	CO3	PO2	BT4
4	Financial Leverage (Meaning, Risk, Advantages & Disadvantages)	CO3	PO2	BT4
5	Combined Leverage (Concept, Significance & DCL)	CO3	PO2	BT4
6	Relationship between Leverage and Risk	CO3	PO2	BT4
7	EBIT–EPS Analysis (Concept & Objectives)	CO3	PO2	BT4
8	Relationship between Combined Leverage and EBIT–EPS Analysis	CO3	PO2, PO3	BT5
9	Capital Structure – Meaning and Objectives	CO3	PO1	BT2
10	Capital Structure Theories (NI, NOI, MM)	CO3	PO2	BT4
11	Financial Planning – Meaning, Objectives & Steps	CO3	PO1, PO2	BT2
12	Financial Strategy – Meaning and Importance	CO3	PO2, PO3	BT5

## LEVERAGE – MEANING

**Leverage** refers to the use of **fixed costs** to increase the potential return to shareholders. A small change in sales or earnings can lead to a **larger change in profits** due to leverage.

**Leverage** refers to the use of fixed costs (operating or financial) to magnify the effect of changes in sales on a firm's profits. It helps management understand **risk–return trade-off**.

There are three types of leverage:

1. Operating Leverage
2. Financial Leverage
3. **Combined Leverage**

### 1. Operating Leverage (OL)

#### Meaning

**Operating Leverage** measures the impact of **fixed operating costs** (like rent, salaries, depreciation) on a firm's **operating profit (EBIT)**. It shows how sensitive **EBIT** is to a change in **sales**.

#### Formula

$$\text{Degree of Operating Leverage (DOL)} = \frac{\% \text{ Change in EBIT}}{\% \text{ Change in Sales}}$$

$$\text{DOL} = \frac{\text{Contribution}}{\text{EBIT}}$$

### Interpretation

- **High Operating Leverage** → High fixed costs → Small change in sales leads to large change in EBIT
- **Low Operating Leverage** → Low fixed costs → EBIT is less sensitive to sales changes

#### Example

If sales increase by 10% and EBIT increases by 20%,

$$DOL = \frac{20}{10} = 2$$

↓

### Advantages

- Higher profit potential at higher sales levels
- Useful for cost structure analysis

### Disadvantages

- High business risk
- Profits fall sharply if sales decline

## OPERATING RISK

Operating leverage is associated with **Business Risk**.

## 2. Financial Leverage (FL)

### Meaning

**Financial Leverage** arises due to the use of **fixed financial charges** such as **interest on debt and preference dividends**.

It measures the effect of changes in **EBIT on Earnings per Share (EPS)**.

### Formula

$$\text{Degree of Financial Leverage (DFL)} = \frac{\% \text{ Change in EPS}}{\% \text{ Change in EBIT}}$$

OR

$$\text{DFL} = \frac{\text{EBIT}}{\text{EBIT} - \text{Interest}}$$

## Interpretation

- **High Financial Leverage** → More debt → Higher EPS volatility
- **Low Financial Leverage** → Less debt → Stable EPS

## Example

If EBIT increases by **10%** and EPS increases by **30%**,

$$DFL = \frac{30}{10} = 3$$

## Advantages

- Increases EPS when return on investment exceeds cost of debt
- Tax advantage due to interest tax shield

## Disadvantages

- Higher financial risk
- Fixed interest obligations even during losses

## Financial Risk

Financial leverage is associated with **Financial Risk**.

### 3. Combined Leverage

**Combined Leverage (CL)** measures the combined effect of **operating leverage and financial leverage** on the firm's earnings.

It shows the impact of a change in **sales on Earnings Per Share (EPS)**. **Combined Leverage explains how sensitive EPS is to changes in sales.**

#### Definition of Combined Leverage

Combined Leverage is defined as the percentage change in **EPS** resulting from a percentage change in **sales**.

Formula for Combined Leverage

#### Method 1: Product Method

$$\text{Combined Leverage (CL)} = \text{Operating Leverage (OL)} \times \text{Financial Leverage (FL)}$$

#### Method 2: Direct Formula

$$CL = \frac{\text{Contribution}}{\text{EBIT} - \text{Interest}}$$

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### Components of Combined Leverage

1. **Operating Leverage**
  - Arises due to **fixed operating costs**
  - Measures effect of sales on **EBIT**
2. **Financial Leverage**
  - Arises due to **fixed financial charges** (interest)
  - Measures effect of EBIT on **EPS**

Combined Leverage integrates **both business risk and financial risk**.

### SIGNIFICANCE OF COMBINED LEVERAGE

1. Shows the **total risk** faced by the firm
2. Helps in assessing the **overall profitability position**
3. Useful in **capital structure decisions**
4. Assists management in **planning sales levels**
5. Helps investors understand **earnings volatility**

Degree of Combined Leverage (DCL)

**Degree of Combined Leverage** indicates how much EPS will change for a given change in sales.

Example interpretation:

- DCL = 3
- A 10% increase in sales will result in a **30% increase in EPS**

### EBIT–EPS ANALYSIS

**EBIT–EPS Analysis** is a technique used to study the effect of different **financing options** on **Earnings Per Share (EPS)** at various levels of **EBIT**. It helps in selecting the most appropriate **capital structure**.

### OBJECTIVES OF EBIT–EPS ANALYSIS

1. To maximize **EPS**
2. To choose the best **financing mix**
3. To analyze **financial risk**

4. To evaluate the impact of **debt vs equity**
5. To determine the **indifference point**

### EBIT–EPS ANALYSIS AND LEVERAGE

- EBIT–EPS analysis focuses **on financial leverage**
- Combined leverage links **sales → EBIT → EPS**
- Higher leverage results in:
  - Higher returns during good performance
  - Higher risk during poor performance

### INDIFFERENCE POINT

The **Indifference Point** is the level of EBIT at which **EPS remains the same** under different financing plans.

- Below this point → equity financing is preferable
- Above this point → debt financing is preferable

### ADVANTAGES OF EBIT–EPS ANALYSIS

1. Simple and easy to understand
2. Helps in profit maximization
3. Useful for long-term financing decisions
4. Assists in risk assessment

### LIMITATIONS OF EBIT–EPS ANALYSIS

1. Ignores market conditions
2. Does not consider business risk
3. Assumes constant EBIT
4. Focuses only on EPS, not overall wealth

### RELATIONSHIP BETWEEN COMBINED LEVERAGE AND EBIT–EPS ANALYSIS

Aspect	Combined Leverage	EBIT–EPS Analysis
Focus	Sales → EPS	EBIT → EPS
Risk Coverage	Operating + Financial	Financial
Purpose	Risk assessment	Capital structure decision
Outcome	Sensitivity of EPS	Optimal financing plan

### CAPITAL STRUCTURE – MEANING

**Capital Structure** refers to the mix of **long-term sources of finance** used by a firm, such as:

- Equity Shares
- Preference Shares

- Debentures / Long-term Debt
- Retained Earnings

The main objective is to achieve an **optimal capital structure** that minimizes cost of capital and maximizes firm value.

## CAPITAL STRUCTURE THEORIES

### **1 Net Income (NI) Approach**

The **Net Income Approach** states that a firm can **increase its value** and **reduce its cost of capital** by increasing the proportion of **debt** in its capital structure.

#### **Assumptions**

1. Cost of debt is **cheaper** than cost of equity
2. Cost of debt and equity remain **constant**
3. No corporate taxes
4. Debt increases do not increase financial risk

#### **Implications**

- Higher debt → Lower WACC
- Higher leverage → Higher firm value
- Optimal capital structure exists at **maximum debt**

#### **Criticism**

- Unrealistic assumptions
- Ignores financial risk
- Cost of equity actually increases with leverage

### **2. Net Operating Income (NOI) Approach**

The **NOI Approach** argues that **capital structure is irrelevant** to the value of the firm.

#### **Assumptions**

1. Overall cost of capital (WACC) remains **constant**
2. Increase in debt raises the cost of equity
3. No taxes
4. Business risk is constant

#### **Implications**

- Change in debt–equity mix **does not affect** firm value
- No optimal capital structure
- Market determines firm value

### 3 Modigliani–Miller (MM) Approach

The MM approach has **two versions**:

#### A. MM Theory – Without Taxes

##### Proposition I

Capital structure **does not affect** the value of the firm.

$$\text{Value of Levered Firm} = \text{Value of Unlevered Firm}$$

##### Proposition II

Cost of equity increases with leverage due to increased financial risk.

##### Assumptions

1. Perfect capital markets
2. No taxes
3. No transaction costs
4. Investors have homogeneous expectations

##### Conclusion

Capital structure is **irrelevant**.

#### B. MM Theory – With Corporate Taxes

##### Key Concept: Tax Shield

Interest on debt is **tax-deductible**, which increases firm value.

$$\text{Value of Firm} = \text{Unlevered Value} + \text{Tax Shield}$$

##### Implications

- Debt financing is beneficial
- Higher debt → Higher firm value
- Optimal capital structure at **maximum debt**

##### Limitation

Ignores bankruptcy and financial distress costs.

### DETERMINANTS OF CAPITAL STRUCTURE

The following factors influence capital structure decisions:

### **1. Cost of Capital**

Lower-cost sources are preferred to minimize WACC.

### **2. Business Risk**

Higher business risk → Lower use of debt.

### **3. Financial Risk**

Excessive debt increases risk of insolvency.

### **4. Profitability**

Highly profitable firms prefer **internal financing**.

### **5. Control**

Equity dilutes ownership; debt does not.

### **6. Flexibility**

Ability to raise funds in future.

### **7. Tax Considerations**

Interest provides tax shield; dividends do not.

### **8. Market Conditions**

Favourable markets encourage equity issues.

### **9. Company Size**

Large firms can raise debt more easily.

### **10. Legal & Regulatory Framework**

Debt capacity depends on regulations.

## FINANCIAL PLANNING – MEANING

Financial planning is the process of estimating, organizing, and managing the financial resources of an individual or a business to achieve specific goals. It involves determining future financial needs and creating strategies to meet those needs effectively.

**Definition:** Financial planning refers to the **systematic process of forecasting financial requirements, developing financial policies, and ensuring that adequate funds are available** at the right time, from the right sources, and at the right cost.

## OBJECTIVES OF FINANCIAL PLANNING

### **1. Adequate Funds Availability**

This means ensuring the business always has enough money to meet its needs. A company must plan so it has sufficient funds for daily operations (like paying salaries and buying materials) as well as for long-term investments (like new machinery or expansion). Without proper planning, the business may run short of cash and fail to operate smoothly.

### **2. Balanced Capital Structure**

Capital structure refers to the mix of **debt** (borrowed money) and **equity** (owners' funds) used to finance a business. A balanced capital structure means choosing an appropriate ratio of debt and

equity so the company can maximize returns while keeping financial risk low. Too much debt is risky, while too little may limit growth.

### **3. Ensuring Liquidity**

Liquidity means having enough cash or assets that can quickly be converted into cash. Financial planning ensures the company can meet short-term obligations such as paying suppliers, wages, and bills. Proper liquidity avoids situations where the business is profitable on paper but cannot pay its immediate expenses.

### **4. Long-term Solvency**

Solvency is the ability of a business to meet its long-term financial obligations. Financial planning ensures the company maintains a strong financial position over time by managing debts, building reserves, and investing wisely. It helps the business survive and grow in the long run.

### **5. Cost Minimization**

One major objective of financial planning is to reduce the overall cost of financing. This includes choosing the least expensive source of funds, avoiding unnecessary expenses, and efficiently managing resources. Lower costs lead to higher profits and better financial health.

## STEPS IN FINANCIAL PLANNING

### **1. Estimation of Capital Requirements**

This step involves estimating how much total money the business needs for starting, operating, and expanding. It includes funds for fixed assets (machines, buildings) and working capital (raw materials, salaries).

**Example:** A manufacturing company estimates it needs ₹50 lakh for machines and ₹10 lakh for working capital, so total capital required is ₹60 lakh.

### **2. Determination of Capital Structure**

This step decides the proportion of debt (borrowed funds) and equity (owners' funds) the company will use to finance its needs.

**Example:** If a company needs ₹60 lakh, it may choose 40% equity (₹24 lakh) and 60% debt (₹36 lakh).

### **3. Forecasting Cash Flows**

The business predicts how much cash will come in (sales, investments) and how much will go out (expenses, loan payments). This helps ensure the company always has enough cash to operate.

**Example:** A company forecasts monthly cash inflows of ₹15 lakh and expenses of ₹12 lakh, showing a ₹3 lakh surplus.

### **4. Selection of Financing Sources**

The company chooses the best sources of funds such as bank loans, equity shares, retained earnings, debentures, or venture capital.

**Example:** A start-up may choose equity funding from investors, while an established firm might take a bank loan with low interest.

## **5. Periodic Review and Control**

The financial plan must be continuously reviewed to check if goals are met and to make changes when necessary based on market conditions, performance, or unexpected events.

**Example:** If material costs rise suddenly, the company revises its financial plan to adjust budgets and seek additional funds.

## **FINANCIAL STRATEGY – MEANING**

**Financial Strategy** refers to long-term decisions related to:

- Capital structure
- Investment planning
- Dividend policy
- Risk management

It aligns financial decisions with corporate objectives.

## **IMPORTANCE OF FINANCIAL STRATEGY**

### **1. Maximizes Shareholder Wealth**

A good financial strategy increases profits and the overall value of the company, benefiting shareholders through higher dividends and rising share prices.

**Example:** When a company invests in high-return projects, its profits grow, causing its share price to rise and increasing shareholder wealth.

### **2. Ensures Financial Stability**

Financial strategy helps maintain steady cash flow, balanced debt levels, and controlled expenses, ensuring the company can meet both short-term and long-term obligations.

**Example:** A firm that keeps enough cash reserves can pay bills on time even during low-sales periods, ensuring stability.

### **3. Improves Competitive Advantage**

A strong financial strategy allows a business to invest in technology, marketing, and innovation, helping it stay ahead of competitors.

**Example:** A company with sound finances upgrades its machinery, reducing production costs and offering lower prices than rivals.

### **4. Supports Growth and Expansion**

It helps identify the best opportunities for expansion and ensures the necessary funds are available for opening new units, launching new products, or entering new markets.

**Example:** A financially strong company can easily open branches in new cities because it has planned funds for expansion.

## **5. Reduces Financial Risk**

By choosing the right balance of debt and equity, planning for uncertainties, and managing finances carefully, the strategy lowers business risks.

**Example:** A company that avoids excessive borrowing reduces the risk of defaulting on loan payments during tough times.

# UNIT IV

## DIVIDEND POLICY DECISIONS

### SYLLABUS

Dividend Policy: Importance and Issues – Relevance and Irrelevance Theories – Walter’s Model, Gordon’s Model, MM Hypothesis – Types and Forms of Dividends – Factors Influencing Dividend Decisions – Real-World Dividend Practices.

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### CO/PO AND BT LEVEL OF LECTURE NOTES

S. No.	Topic / Content	CO	PO	BT Level
1	Meaning of Dividend Policy	CO4	PO1	K2
2	Importance of Dividend Policy	CO4	PO1, PO2	K2
3	Issues in Dividend Policy	CO4	PO2	K4
4	Relevance Theory of Dividend	CO4	PO2	K4
5	Walter’s Model	CO4	PO1, PO2	K4
6	Gordon’s Model	CO4	PO2	K4
7	Irrelevance Theory of Dividend	CO4	PO2	K4
8	MM Hypothesis	CO4	PO1, PO2	K4
9	Types of Dividends	CO4	PO1	K2
10	Forms of Dividends	CO4	PO1	K2
11	Factors Influencing Dividend Decisions	CO4	PO2	K4
12	Real-World Dividend Practices	CO4	PO2, PO3	K5

### MEANING OF DIVIDEND POLICY

Dividend policy refers to the decision of a firm regarding how much of its earnings should be distributed to shareholders as dividends and how much should be retained in the business for future growth.

It is a crucial financial decision because it affects:

- Shareholders’ wealth
- Firm’s liquidity
- Capital structure
- Market value of shares

### IMPORTANCE OF DIVIDEND POLICY

Dividend policy is important due to the following reasons:

- **Shareholder Income**  
Dividends provide regular income to shareholders, especially risk-averse investors.
- **Market Value of Shares**  
A stable dividend policy increases investor confidence and positively impacts share price.
- **Growth and Expansion**

- Retained earnings finance internal growth without increasing cost of capital.
- **Liquidity Position**  
Dividend payments involve cash outflow and affect working capital.
- **Signalling Effect**  
Dividend changes signal management's confidence about future earnings.

### ISSUES IN DIVIDEND POLICY

The major issues involved in dividend decisions are:

- How much profit should be distributed?
- Should dividends be stable or fluctuating?
- Whether to pay dividends in cash or stock?
- Whether to retain earnings or distribute them?
- Impact of dividend policy on shareholders' wealth?

### RELEVANCE AND IRRELEVANCE OF DIVIDEND POLICY

#### **A. Relevance Theory of Dividend**

This theory states that **dividend policy affects the value of the firm.**

Key contributors:

- **Walter's Model**
- **Gordon's Model**

#### **B. Irrelevance Theory of Dividend**

Proposed by **Modigliani and Miller (MM)**, this theory states that **dividend policy does not affect firm value** under perfect market conditions.

#### Walter's Model of Dividend Policy

##### **Meaning**

Walter's Model explains the relationship between **dividends, earnings, investment opportunities, and market price of shares.**

##### **Formula**

$$P = \frac{D + \frac{r}{k}(E - D)}{k}$$

Where:

P = Market price per share

D = Dividend per share

E = Earnings per share

r = Internal rate of return

k = Cost of equity

##### **Assumptions**

- Firm finances investments only through retained earnings
- Constant rate of return (r) and cost of capital (k)

- All earnings are either distributed or reinvested immediately
- Firm has infinite life

### Implications

- If  $r > k$  → Retain earnings (Low dividend)
- If  $r < k$  → Pay higher dividends
- If  $r = k$  → Dividend policy is irrelevant

### Limitations

- Unrealistic assumptions
- Ignores external financing
- Assumes constant  $r$  and  $k$

## Gordon's Model of Dividend Policy

### Meaning

Gordon's Model supports the relevance theory and emphasizes the **impact of dividends on share price**, considering investors' preference for certainty (Bird-in-Hand theory).

### Formula

$$P = \frac{E(1 - b)}{k - br}$$

Where:

P = Market price per share

E = Earnings per share

b = Retention ratio

r = Rate of return

k = Cost of equity

### Assumptions

- No external financing
- Constant growth rate
- $r$  and  $k$  are constant
- Investors prefer current dividends over future gains

### Implications

- Higher dividends → Higher market value
- Investors are risk-averse

### Limitations

- Growth rate may not remain constant
- Ignores market imperfections
- Overemphasizes dividends

## Modigliani–Miller (MM) Hypothesis

MM Hypothesis states that **dividend policy is irrelevant** and does not affect the value of the firm in perfect capital markets

$$P_0 = \frac{D_1 + P_1}{1 + k}$$

Where:

$P_0$  = Current share price

$D_1$  = Dividend at end of period

$P_1$  = Share price at end of period

$k$  = Cost of equity

### Assumptions

- Perfect capital markets
- No taxes
- No transaction costs
- Rational investors
- No flotation costs
- Investment policy is fixed

### Criticism / Limitations

- Unrealistic assumptions
- Ignores taxes and flotation costs
- Dividend information has signalling effects

## TYPES AND FORMS OF DIVIDENDS

### A. Types of Dividends

1. **Regular Dividend** – Paid at fixed intervals
2. **Interim Dividend** – Paid during the accounting year
3. **Final Dividend** – Paid at year-end
4. **Special Dividend** – Paid during abnormal profits
5. **Liquidating Dividend** – Paid during liquidation

### B. Forms of Dividends

1. **Cash Dividend** – Most common form
2. **Stock Dividend / Bonus Shares** – Paid in shares
3. **Property Dividend** – Non-cash assets
4. **Scrip Dividend** – Promise to pay later

## FACTORS INFLUENCING DIVIDEND DECISIONS

### Internal Factors

- Profitability
- Liquidity position
- Growth opportunities
- Stability of earnings
- Nature of business

## 1. Profitability

Companies with higher profits are more likely to pay higher dividends because they have more earnings available for distribution.

**Example:** If a company earns ₹10 crore profit, it may declare a higher dividend compared to a year when it earned only ₹2 crore.

## 2. Liquidity Position

Even if profits are high, the company must have enough cash (liquidity) to actually pay dividends.

**Example:** A company has good profits but most of the money is stuck in inventory, so it may reduce dividends due to lack of cash.

## 3. Growth Opportunities

Companies with high growth plans prefer to retain more profits to fund expansion instead of paying high dividends.

**Example:** A tech company investing in new projects may pay low dividends to save money for innovation.

## 4. Stability of Earnings

Firms with stable and predictable earnings usually pay regular dividends.

**Example:** A utility company (electricity, water) earns steady income every year, so it pays consistent dividends.

## 5. Nature of Business

Businesses in stable industries pay higher dividends, while companies in uncertain or capital-intensive industries retain profits for future needs.

**Example:** A steel manufacturing company needs huge funds for machinery, so it may keep dividends low.

### External Factors

- Legal restrictions
- Taxation policy
- Market conditions
- Shareholder preferences
- Inflation

#### 1. Legal Restrictions

Companies must follow government laws before declaring dividends, such as maintaining reserves or paying dividends only from profits.

**Example:** A firm cannot pay dividends if it has accumulated losses as per Companies Act rules.

#### 2. Taxation Policy

Tax rates on dividends or corporate profits influence dividend decisions.

**Example:** If dividend tax increases, companies may reduce dividends and prefer bonus shares.

#### 3. Market Conditions

During stable or booming markets, firms pay higher dividends to attract investors; in recession, they may cut dividends to conserve cash.

**Example:** During an economic slowdown, a company may lower dividends to strengthen its financial position.

#### 4. Shareholder Preferences

Some shareholders prefer regular dividends, while others prefer company growth. Companies may decide dividends based on what most investors want.

**Example:** Retired investors prefer regular income, so a company with many such shareholders may pay higher dividends.

#### 5. Inflation

High inflation increases costs, so companies may retain more profits to maintain working capital instead of paying dividends.

**Example:** When raw material prices rise due to inflation, a firm may reduce dividends to manage rising expenses.

### REAL-WORLD DIVIDEND PRACTICES

- **Stable Dividend Policy**  
Firms prefer stable or gradually increasing dividends.
- **Residual Dividend Policy**  
Dividends paid after financing profitable projects.
- **Dividend Smoothing**  
Firms avoid frequent changes in dividends.
- **Industry Practices**  
Utilities pay high dividends; growth firms retain earnings.
- **Indian Corporate Practices**  
Many firms prefer bonus shares and moderate cash dividends due to taxation and liquidity considerations.

## UNIT V

### WORKING CAPITAL MANAGEMENT

#### SYLLABUS

Working Capital: Concepts, Determinants and Estimation (**Problem**) – Operating Cycle – Receivables Management – Inventory and Cash Management – Working Capital Financing: Trade Credit, Commercial Paper, Bank Finance, Company Deposits – Liquidity vs Profitability Trade-offs.

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S. No.	Main Topic	CO	PO	BT Level
1	Working Capital – Concept and Meaning	CO3	PO1	BT2
2	Determinants of Working Capital	CO3	PO1, PO2	BT2
3	Estimation of Working Capital (Problems)	CO3	PO1,PO2	BT3
4	Operating Cycle – Concept and Analysis	CO3	PO2	BT4
5	Receivables Management	CO3	PO2	BT4
6	Inventory Management	CO3	PO2	BT4

S. No.	Main Topic	CO	PO	BT Level
7	Cash Management	CO3	PO2	BT4
8	Working Capital Financing – Overview	CO3	PO1	BT2
9	Trade Credit as a Source of Working Capital	CO3	PO1, PO2	BT4
10	Commercial Paper	CO3	PO1	BT2
11	Bank Finance for Working Capital	CO3	PO1, PO2	BT4
12	Company Deposits	CO3	PO1	BT2
13	Liquidity vs Profitability Trade-off	CO3	PO2, PO3	BT5

## WORKING CAPITAL – MEANING AND CONCEPT

Working Capital refers to the **capital required for the day-to-day operations** of a business. It represents the firm's ability to meet **short-term obligations** and operate smoothly.

### Formula

- **Gross Working Capital** = Total Current Assets
- **Net Working Capital** = Current Assets – Current Liabilities

### Example

If a firm has:

- Cash ₹2,00,000
- Inventory ₹5,00,000
- Debtors ₹3,00,000
- Creditors ₹4,00,000

$$\begin{aligned}
 &\text{Net Working Capital} \\
 &= (2,00,000 + 5,00,000 + 3,00,000) - 4,00,000 \\
 &= \mathbf{₹6,00,000}
 \end{aligned}$$

A positive working capital indicates good short-term financial health.

## DETERMINANTS OF WORKING CAPITAL

Determinants are the **factors that influence the amount of working capital required** by a firm.

### Key Determinants with Examples

- **Nature of Business**

Manufacturing firms need more WC than service firms.

*Example:* A textile factory needs raw materials, WIP, and finished goods.

- **Scale of Operations**

Larger firms need higher WC.

*Example:* A company producing 1 lakh units needs more WC than one producing 10,000 units.

- **Business Cycle**

Boom → High WC  
Recession → Low WC

- **Credit Policy**

Liberal credit increases receivables.

*Example:* Offering 3 months credit increases WC requirement.

- **Inventory Turnover**

Slow turnover → High WC  
Fast turnover → Low WC

## ESTIMATION OF WORKING CAPITAL (PROBLEM-BASED EXPLANATION)

Estimation of Working Capital means **calculating the amount of funds required to finance current assets after considering current liabilities.**

### **Steps with Example**

Assume:

- Monthly production = 10,000 units
- Cost per unit = ₹50
- Raw material holding = 1 month
- Debtors collection = 2 months
- Creditors payment = 1 month

### **Calculation**

- Monthly cost =  $10,000 \times 50 = ₹5,00,000$
- Raw material investment = ₹5,00,000
- Debtors = ₹10,00,000
- Creditors = ₹5,00,000

Working Capital  
= (RM + Debtors) – Creditors  
= (5,00,000 + 10,00,000) – 5,00,000  
= **₹10,00,000**

## OPERATING CYCLE

Operating Cycle is the **time taken to convert cash into inventory, inventory into sales, and sales back into cash.**

### **Formula**

Operating Cycle = RM Period + WIP Period + FG Period + Debtors Period – Creditors Period

### **Example**

- RM = 30 days
- WIP = 15 days
- FG = 20 days
- Debtors = 25 days
- Creditors = 30 days

$$\begin{aligned} \text{Operating Cycle} \\ &= 30 + 15 + 20 + 25 - 30 \\ &= \mathbf{60 \text{ days}} \end{aligned}$$

Shorter cycle = lower working capital requirement.

## RECEIVABLES MANAGEMENT

Receivables Management involves **controlling credit sales and ensuring timely collection of dues.**

### **Objectives**

- Increase sales
- Reduce bad debts
- Improve cash flow

### **Example**

A firm allows:

- Credit period: 60 days
- Average debtors: ₹12,00,000

$$\begin{aligned} \text{Debtors Turnover Ratio} \\ &= \text{Credit Sales} / \text{Average Debtors} \\ &= 72,00,000 / 12,00,000 \\ &= \mathbf{6 \text{ times}} \end{aligned}$$

$$\begin{aligned} \text{Average Collection Period} \\ &= 365 / 6 \approx \mathbf{61 \text{ days}} \end{aligned}$$

Efficient collection improves liquidity.

## INVENTORY MANAGEMENT

Inventory Management ensures **optimal stock levels** to avoid both shortage and excess storage.

### **Costs Involved**

- Ordering cost
- Holding cost
- Stock-out cost

### **Example (EOQ Concept)**

A firm needs 10,000 units per year.

- Ordering cost = ₹200
- Holding cost = ₹10 per unit

EOQ helps determine **optimal order size** to minimize total cost.

Better inventory control reduces WC blockage.

### CASH MANAGEMENT

Cash Management refers to **planning and controlling cash inflows and outflows** to maintain adequate liquidity.

#### **Motives for Holding Cash**

1. Transaction motive
2. Precautionary motive
3. Speculative motive

#### **Example**

A firm maintains:

- Minimum cash = ₹1,00,000
- Peak requirement = ₹3,00,000

Excess cash beyond this should be invested to earn returns.

### WORKING CAPITAL FINANCING

#### **A. Trade Credit**

- Credit extended by suppliers.
- *Example:* “2/10, Net 30” terms.

#### **B. Commercial Paper**

- Short-term unsecured instrument.
- *Example:* Issued by large corporations for 90 days.

#### **C. Bank Finance**

- Cash credit, overdraft, bill discounting.

#### **D. Company Deposits**

- Fixed deposits from public for short duration.

## LIQUIDITY VS PROFITABILITY TRADE-OFF

### **Explanation**

- High liquidity → idle funds → low profitability
- Low liquidity → risk of insolvency

### **Example**

- A firm keeps excess cash of ₹10 lakhs earning no return. If invested at 10%, it could earn ₹1 lakh profit.
- Optimal working capital balances **risk and return**

## UNIT VI

### LONG-TERM FINANCING AND CAPITAL MARKETS

#### **SYLLABUS**

Indian Capital Market Overview – Primary and Secondary Markets – Long-Term Sources: Equity, Debentures, Term Loans – Lease and Hire Purchase – Venture Capital and Private Equity – SEBI Regulations– Financing Strategies for Startups.

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<b>S. No.</b>	<b>Main Content</b>	<b>CO</b>	<b>PO</b>	<b>BT Level</b>
1	Indian Capital Market – Overview	CO3	PO1	K2
2	Primary Market	CO3	PO1	K2
3	Secondary Market	CO3	PO1	K2
4	Equity Shares as a Long-Term Source of Finance	CO3	PO1, PO2	K4
5	Debentures as a Long-Term Source of Finance	CO3	PO1, PO2	K4
6	Term Loans	CO3	PO1, PO2	K4
7	Lease Financing	CO3	PO1, PO2	K4
8	Hire Purchase Financing	CO3	PO1, PO2	K4
9	Venture Capital	CO3	PO2	K4
10	Private Equity	CO3	PO2	K4
11	SEBI Regulations related to Capital Markets	CO3	PO1, PO2	K2
12	Financing Strategies for Start-ups	CO3	PO2, PO3	K5

## LONG-TERM FINANCING AND CAPITAL MARKETS

### INDIAN CAPITAL MARKET – OVERVIEW

The Indian Capital Market is a **market for long-term funds**, where savings are mobilized and channelized into productive investments. It plays a vital role in **economic growth, industrial development, and capital formation**.

#### Components of Indian Capital Market

1. **Primary Market** – New issues of securities
2. **Secondary Market** – Trading of existing securities

### PRIMARY MARKET – NEW ISSUES OF SECURITIES

The primary market is where companies issue securities **for the first time** to raise fresh capital. This includes Initial Public Offerings (IPOs), rights issues, and private placements. Investors buy shares directly from the company, and the money goes to the company for its business needs.

**Example:** When a company launches an IPO for the first time, investors purchase those new shares in the primary market.

### SECONDARY MARKET – TRADING OF EXISTING SECURITIES

The secondary market is where already issued shares and securities are **bought and sold among investors**. The company does not receive any money from these transactions; the trade happens between investors. Stock exchanges like NSE and BSE facilitate this trading.

**Example:** When an investor buys shares of Reliance Industries on the stock exchange from another investor, this transaction takes place in the secondary market.

### INSTITUTIONS IN INDIAN CAPITAL MARKET

- SEBI (Regulator)
- Stock Exchanges (BSE, NSE)
- Financial Institutions (LIC, UTI, Banks)
- Mutual Funds

#### SEBI (Regulator)

SEBI (Securities and Exchange Board of India) regulates and monitors the securities market to protect investors and ensure fair practices. It makes rules for companies, stock exchanges, brokers, and mutual funds.

**Example:** SEBI checks that companies give true information before launching an IPO.

#### Stock Exchanges (BSE, NSE)

Stock exchanges provide a platform where buyers and sellers trade existing securities. They ensure transparent and efficient trading. **Example:** Investors buy and sell shares of companies like Tata or Infosys on NSE or BSE.

## Financial Institutions (LIC, UTI, Banks)

These institutions provide long-term finance, invest in securities, and support industrial and economic development. **Example:** LIC invests in government bonds and large companies, providing them with long-term funds.

## Mutual Funds

Mutual funds collect money from many small investors and invest it in diversified portfolios like shares, bonds, and money market instruments, managed by professional fund managers. **Example:** An investor buys units of SBI Mutual Fund, and the fund manager invests that money in various stocks.

## PRIMARY MARKET

Primary Market is the market where **new securities are issued for the first time** to raise long-term capital.

### Methods of Issue

1. Public Issue (IPO / FPO)
2. Rights Issue
3. Private Placement
4. Preferential Allotment

### 1. Public Issue (IPO / FPO)

A public issue is when a company offers its shares to the general public.

- **IPO (Initial Public Offering):** First-time issue of shares.
- **FPO (Follow-on Public Offer):** Additional shares issued after the IPO.

**Example:** Zomato launched an IPO to raise funds; later it can issue more shares through an FPO.

### 2. Rights Issue

Existing shareholders are given the right to buy additional shares at a discounted price in proportion to their existing holdings. **Example:** If a shareholder owns 100 shares, a rights issue may offer them 20 more shares at a lower price.

### 3. Private Placement

Securities are offered to a small group of selected investors such as banks, mutual funds, or wealthy individuals instead of the general public. **Example:** A company may sell ₹50 crore worth of shares to a group of institutional investors privately.

### 4. Preferential Allotment

Shares are issued to a specific group of people—like promoters, directors, or strategic investors—at a pre-determined price. **Example:** A company may allot shares to its promoter group to strengthen their ownership or raise quick funds.

### Functions

- Mobilizes savings
- Provides funds to companies
- Encourages investment culture

### **Example**

The **IPO of Zomato** allowed the company to raise funds directly from the public.

## SECONDARY MARKET

Secondary Market deals with the **purchase and sale of already issued securities**.

### **Functions**

- Provides liquidity
- Facilitates price discovery
- Encourages investment

### **Major Stock Exchanges**

- Bombay Stock Exchange (BSE)
- National Stock Exchange (NSE)

### **Bombay Stock Exchange (BSE)**

BSE is one of the oldest stock exchanges in Asia and provides a platform for buying and selling existing securities like shares, bonds, and derivatives. It ensures transparent and efficient trading. **Example:** If an investor buys shares of Tata Motors on BSE, the trade happens through the BSE platform.

### **National Stock Exchange (NSE)**

NSE is India's largest stock exchange in terms of trading volume. It offers advanced, fully automated electronic trading and is known for its benchmark index NIFTY 50. **Example:** When investors trade shares of Infosys or Reliance on NSE, the transactions occur through NSE's electronic system.

### **Example**

Buying shares of TCS on NSE is a secondary market transaction

## EQUITY SHARES AS A LONG-TERM SOURCE OF FINANCE

Equity shares represent **ownership in a company**. Equity shareholders are the **residual owners** and bear maximum risk.

### **Features**

- Permanent capital
- Dividend is not compulsory
- Voting rights

### **Advantages**

- No repayment obligation
- Improves creditworthiness
- No fixed charge

### **Limitations**

- Dilution of control

- Costly source
- Dividend uncertainty

### Example

Infosys raised capital through equity shares during its early growth stage.

## DEBENTURES AS A LONG-TERM SOURCE OF FINANCE

Debentures are long-term debt instruments issued by companies to borrow money from the public. The company promises to pay interest regularly and return the principal amount at maturity.

**Example:** If a company issues a debenture of ₹1,00,000 at 10% interest, it must pay ₹10,000 yearly to the investor.

### Types

- Secured / Unsecured
- Convertible / Non-convertible
- Redeemable / Irredeemable

#### Secured / Unsecured

- **Secured Debentures:** Backed by company assets as security. If the company fails to pay, assets can be sold to repay investors. **Example:** A company pledges its building as security for secured debentures.
- **Unsecured Debentures:** Not backed by any asset; repayment depends on the company's creditworthiness. **Example:** Investors rely only on the company's reputation to get their money back.

#### Convertible / Non-convertible

- **Convertible Debentures:** Can be converted into equity shares after a certain period. **Example:** A ₹1,000 debenture may convert into 10 shares of the company.
- **Non-convertible Debentures (NCDs):** Cannot be converted into shares; only interest and principal are paid. **Example:** A company issues NCDs with 8% interest for 5 years.

#### Redeemable / Irredeemable

- **Redeemable Debentures:** Repaid by the company after a fixed period. **Example:** A 7-year debenture is redeemed by the company at the end of 7 years.
- **Irredeemable Debentures:** No fixed maturity date; repayment happens only when the company is liquidated. **Example:** Investors receive interest, but the principal is returned only if the company shuts down.

#### Advantages

- Fixed interest cost
- No dilution of control
- Tax-deductible interest

#### Limitations

- Fixed repayment obligation
- Increases financial risk

#### Example

Tata Motors issued **Non-Convertible Debentures (NCDs)** to raise long-term funds.

## TERM LOANS

Term loans are **medium to long-term loans** provided by banks and financial institutions to businesses for a fixed period. These loans are usually taken for 3 to 10 years and must be repaid in regular instalments along with interest. Companies use term loans mainly for purchasing machinery, setting up factories, expanding operations, or other long-term investments. Term loans generally carry a fixed or variable interest rate and may require collateral (security).

### **Example:**

A company wants to buy new machinery costing ₹50 lakh. It takes a **5-year term loan** from a bank and repays the amount in monthly instalments along with interest.

### **Characteristics**

- Fixed repayment schedule
- Usually secured
- Long repayment period

### **Advantages**

- Large amount of finance
- Flexible repayment
- Retains ownership

### **Example**

SBI providing term loan to a manufacturing firm for plant expansion.

## LEASE FINANCING

Lease financing is an arrangement in which the owner of an asset (**lessor**) allows another party (**lessee**) to use the asset in return for regular (periodic) lease payments. The lessee uses the asset without owning it, making leasing a good option for businesses that need expensive equipment but want to avoid huge upfront costs.

**Example:** A company leases a machine for 5 years and pays monthly rent instead of buying it.

### **Types**

- Operating Lease
- Financial Lease

### **Operating Lease**

An operating lease is a short-term lease where the lessor retains ownership and bears the risks of the asset. The lessee uses the asset for a short period, usually less than its full useful life. Maintenance is often done by the lessor.

**Example:** Renting a photocopier for 2 years; after the lease ends, the machine is returned to the owner.

### **Financial Lease**

A financial lease (also called a capital lease) is a long-term lease that covers most of the asset's useful life. The lessee bears the cost of maintenance and cannot usually cancel the lease early. In many cases, the lessee may get the option to purchase the asset at the end.

**Example:** A company leases heavy machinery for 7 years and maintains it as if it owns it; after the lease

period, it may be allowed to buy the machine at a low price.

#### **Advantages**

- No immediate capital outflow
- Tax benefits
- Flexibility

#### **Limitations**

- Higher long-term cost
- No ownership

#### **Example**

Airlines leasing aircraft instead of purchasing them.

### HIRE PURCHASE

Hire Purchase is a method of buying an asset where the buyer gets **immediate use** of the asset by paying an initial down payment, while the remaining amount is paid in **instalments**. However, **ownership is transferred only after the final instalment is paid**. Until then, the seller retains ownership, and the buyer is considered a hirer. Hire purchase is commonly used for vehicles, machinery, and appliances.

#### **Example:**

A person buys a bike worth ₹80,000 by paying ₹20,000 upfront and the remaining ₹60,000 in monthly instalments. They can use the bike immediately, but the **ownership is transferred only after all instalments are paid**.

#### **Example**

Purchasing machinery on hire purchase basis by a small manufacturer.

### VENTURE CAPITAL

Venture Capital refers to **equity financing provided to high-risk, high-growth start-ups**.

#### **Stages**

- Seed stage
- Start-up stage
- Expansion stage

Venture Capital is a form of **equity financing** provided by venture capital firms or investors to **high-risk, high-potential start-ups**. These investors provide funds in exchange for ownership (shares) in the company. Venture capital helps new businesses develop products, scale operations, and enter markets when traditional banks are unwilling to lend due to high risk.

#### **Example:**

An investor provides ₹5 crore to a new tech start-up in exchange for 20% ownership in the company.

### STAGES OF VENTURE CAPITAL FINANCING

#### **Seed Stage**

Funds are provided to develop an idea, create a prototype, or conduct initial research.

**Example:** A start-up gets funding to build the first sample version of an app.

### **Start-up Stage**

Financing is given to begin actual business operations such as product development, marketing, and hiring employees.

**Example:** A new company receives funding to launch its product in the market.

### **Expansion Stage**

Funds are provided to scale the business, enter new markets, or increase production once the company has achieved initial success.

**Example:** A growing start-up receives funding to expand to new cities or countries.

### **Advantages**

- Provides both finance and expertise
- No immediate repayment

### **Example**

Sequoia Capital investing in **Byju's** during early growth stage.

## PRIVATE EQUITY

Private Equity (PE) refers to **equity capital provided by investors to private companies** or to public companies with the intention to **delist them from stock exchanges**. It involves investing in companies with high growth potential, restructuring opportunities, or undervalued assets, with the objective of generating **high returns** over the medium to long term.

Private equity investments are typically made by **PE firms, venture capitalists, institutional investors, pension funds, high-net-worth individuals, and sovereign wealth funds**

## MEANING OF PRIVATE EQUITY

Private Equity is a type of **long-term financing** provided in exchange for **ownership stake** in companies that are not publicly traded. PE investors actively participate in management, growth strategy, and restructuring to improve the company's value, and later exit the investment at a profit.

## FEATURES / CHARACTERISTICS OF PRIVATE EQUITY

### **✓ Long-term investment horizon**

PE investments usually last **5–10 years**.

### **✓ Active involvement**

PE investors participate in management decisions, governance, and strategy.

### **✓ High risk, high return**

PE targets firms with high growth or turnaround potential, making it riskier than normal equity.

### **✓ Not publicly traded**

Investments are made in **private companies** or by taking public companies private.

### **✓ Illiquid investment**

PE cannot be easily sold or traded.

## ✓ Performance-based gains

Returns are generated when the investor exits via sale, IPO, or merger.

## TYPES OF PRIVATE EQUITY

### (A) Venture Capital (VC)

Provides funding to **early-stage or startup companies** with high growth potential.

Stages include:

- **Seed funding**
- **Early-stage financing**
- **Expansion financing**

### (B) Growth Capital

Investment in **mature firms** for expansion, acquisitions, or restructuring.

### (C) Buyouts

Investor acquires majority or full control of a company.

Types:

- **Leveraged Buyout (LBO):** acquisition mostly financed through debt.
- **Management Buyout (MBO):** managers purchase the company using PE support.

### (D) Mezzanine Financing

Hybrid form: **debt + equity**.

Offers fixed interest plus conversion to equity if unpaid.

### (E) Distressed / Turnaround Financing

PE firms invest in financially troubled companies for restructuring.

### (F) Fund of Funds (FoF)

Invests in a **portfolio of PE funds** rather than directly in companies.

## PROCESS OF PRIVATE EQUITY INVESTMENT

The PE investment cycle typically includes:

### 1. Fundraising

PE firms raise capital from institutional investors, pension funds, HNIs, etc.

### 2. Deal Sourcing

Finding potential companies through:

- networks
- investment bankers
- industry research

### **3. Due Diligence**

Detailed examination of financial, legal, operational, and market factors.

### **4. Negotiation & Deal Structuring**

Agreeing on valuation, ownership %, governance rights.

### **5. Investment & Value Creation**

PE firms help improve:

- operations
- marketing
- cost efficiency
- technology
- management

### **6. Exit Strategy**

PE firms exit by:

- **Initial Public Offering (IPO)**
- **Trade sale** (selling to another company)
- **Secondary sale** (selling to another PE firm)
- **Buyback** by promoters

## **BENEFITS OF PRIVATE EQUITY**

### **✓ Access to large capital**

Firms receive funds for expansion, technology, or restructuring.

### **✓ Professional expertise**

PE firms provide strategic, operational, and managerial support.

### **✓ Improved corporate governance**

Promotes transparency and accountability.

### **✓ Long-term focus**

PE investors support sustained value creation, not short-term gains.

### **✓ Enhances competitiveness**

Helps companies scale rapidly and professionally.

## **SEBI REGULATIONS**

**SEBI** is the regulatory authority for the securities (capital) market in India. It was established to protect investors, promote fair trading, and regulate the functioning of stock exchanges and financial intermediaries.

### **Establishment**

- **Set up:** 1988 (as a non-statutory body)
- **Became statutory:** 1992 through the SEBI Act, 1992
- **Headquarters:** Mumbai

- **Regulator for:** Primary & secondary markets

## OBJECTIVES OF SEBI

### ✓ **Protect investor interests**

Ensures investors are not cheated by fraudulent practices.

### ✓ **Ensure fair and transparent markets**

Creates a stable and efficient capital market environment.

### ✓ **Regulate intermediaries**

Controls brokers, merchant bankers, underwriters, etc.

### ✓ **Promote market development**

Introduces reforms, new products, and better trading systems.

## POWERS OF SEBI

### **1. Legislative Power**

Can **frame rules and regulations** for the capital market under SEBI Act.

### **2. Executive Power**

Can **conduct inspections**, issue guidelines, and take action against violators.

### **3. Judicial Power**

Can **pass judgments**, impose penalties, ban trading, suspend licenses.

### **4. Power to regulate IPOs**

Controls issue of shares, prospectus rules, book building, allotment, etc.

### **5. Power to regulate stock exchanges**

Monitors, approves, and penalizes stock exchanges.

## ROLE/FUNCTIONS OF SEBI

SEBI regulates the capital market to:

- Protect investors
- Promote transparency
- Prevent malpractices

### **Key Regulations**

- Disclosure requirements
- Insider trading regulations
- Issue of Capital and Disclosure Requirements (ICDR)

### **Example**

SEBI mandating disclosures during IPOs to protect investors.

## **1. Prohibits insider trading**

Insider trading means buying or selling shares using **confidential, price-sensitive information**. SEBI bans this to ensure fairness for all investors.

## **2. Prevents fraudulent and unfair trade practices**

SEBI takes action against:

- Fake trading
- Manipulative transactions
- Misleading information
- This protects investors from being cheated.

## **3. Promotes investor education**

SEBI conducts programs, workshops, and online courses to educate investors about:

- Risks
- Rights
- Safe investment practices

## **4. Checks price manipulation**

SEBI monitors stock prices to prevent artificially increasing or decreasing prices to deceive investors.

## **5. Provides guidelines for IPOs and disclosures**

For companies issuing shares for the first time (IPOs), SEBI ensures:

- Accurate information in prospectus
- Proper disclosures
- No false statements
- This ensures informed decision-making.

## **B. REGULATORY FUNCTIONS (Regulating Market Participants)**

These functions ensure that the capital market works smoothly, legally, and ethically.

### **1. Registration of intermediaries**

SEBI makes it compulsory for:

- Stockbrokers
- Merchant bankers
- Underwriters
- Credit rating agencies to get registered before operating.
- This helps maintain accountability.

### **2. Regulates takeover of companies**

SEBI ensures takeovers follow proper rules so that shareholders' interests are protected.

### **3. Creates and enforces rules for stock exchanges**

SEBI drafts rules for listing, trading, and operations. This ensures fair functioning of stock exchanges.

### **4. Conducts audits and inspections**

SEBI checks whether intermediaries and companies follow rules. If violations are found, action is taken.

### **5. Imposes penalties for violation of rules**

SEBI can:

- Fine companies
- Ban them from the market
- Suspend licenses
- This maintains discipline in the market.

### **6. Regulates mutual funds**

SEBI ensures mutual funds:

- Follow investment rules
- Disclose correct information
- Do not mislead investors

## **C. DEVELOPMENT FUNCTIONS (Improving the Market)**

These functions aim at **modernizing, growing, and making the capital market more efficient.**

### **1. Introduces electronic trading (dematerialisation)**

SEBI helped move from **paper-based share certificates** to **demat (electronic) accounts**, making trading:

- Faster
- Safer
- More transparent

### **2. Transparency in trading systems**

SEBI ensured automated, screen-based trading where everyone can see the best prices. This reduces manipulation.

### **3. Promotes research and training**

SEBI encourages training of market participants and supports research in:

- Market behavior
- New financial products
- Risk management

#### **4. Enhances investor communication**

SEBI ensures companies communicate regularly with investors through:

- Annual reports
  - Disclosures
  - Announcements
- This builds trust.

#### **5. Introduces new products (derivatives, ETFs, etc.)**

SEBI encourages new financial products such as:

- Derivatives
- Exchange Traded Funds (ETFs)
- REITs
- Commodity derivatives
- These help deepen and expand the market.

### **FINANCING STRATEGIES FOR STARTUPS**

#### **Sources**

- Bootstrapping
- Angel investors
- Venture capital
- Private equity
- Crowdfunding

#### **Strategy Example**

A startup may:

1. Start with personal savings
2. Raise angel funding
3. Move to venture capital in growth stage

#### **Indian Example**

Flipkart started with bootstrapping and later raised venture capital funding.

# **MB25201 – Financial Management Question Bank**

## **PART – A**

### **UNIT 1 – FOUNDATIONS OF FINANCE**

1. What is financing decision.
2. Differentiate between systematic and unsystematic risk.
3. What is meant by wealth maximization?
4. List out the various goals of financial management.
5. What is Risk Premium?
6. Why does money have time value?
7. What is the present value of Rs. 500 receivable three years hence, if the interest rate is 10%?
8. How do you compute the value of a bond with a 10 year period of maturity having 12 percent coupon rate with a par value of Rs. 1,000?
9. How do you classify financial assets?
10. Briefly explain about risk and return.
11. Define financial management.
12. What is Yield to Maturity?
13. A Rs.10, 000 per value bond bearing a coupon rate of 12% will mature after 5 years. Compute the value of bond, if the discount rate is 15%?
14. What is nominal interest rate?
15. How is bond different from equity?

### **UNIT 2 – INVESTMENT DECISIONS**

1. What is capital budgeting?
2. What is cost of capital?
3. State the meaning of Net Present Value.
4. Write a note on Profitability Index.

5. Write a note on IRR.
6. What is meant by Capital Rationing?
7. What are the features of a Capital Budget?
8. How is cost of equity calculated according to the security market line approach?
9. State the significance of Capital Budgeting.
10. Explain Pay Back Period.
11. What is opportunity cost of capital?
12. Compare NPV and IRR.
13. What is the cost of retained earnings?
14. Suppose the dividend per share of firm is expected to be Re.1 per share next year and is expected to grow at 6% per year perpetually. Determine the cost of equity capital, assuming the market price per share is Rs.25.

### **UNIT 3 – FINANCING AND DIVIDEND DECISION**

1. What is net operating income approach?
2. Define optimum Capital Structure.
3. What is composite leverage?
4. Define operating leverage. How do you calculate operating leverage?
5. Define Indifference Point in BEIT–EPS analysis.
6. State the significance of financial leverage.
7. What are the different forms of dividend?
8. What is dividend?
9. State any four forms of dividend.
10. What is dividend policy?
11. What is meant by Weighted Average Cost of Capital?
12. What is stock–split and reverse stock–split?
13. Differentiate bonus dividend and stock–split.
14. What are the simplifying assumptions made to study the relationship between capital structure and firm value?
15. Define dividend pay–out ratio? Brief with a simple illustration.

### **UNIT 4 – WORKING CAPITAL MANAGEMENT**

1. State the meaning of working capital management.
2. Define the expression working capital.
3. Mention two factors influencing working capital.
4. Distinguish between gross and net working capital.

5. What is operating cycle?
6. What is the mechanism involved in factoring?
7. What is credit policy?
8. Explain aging schedule.
9. Write a note on economic order quantity.
10. List out the motives of holding cash.
11. What is cash budget?
12. What is cash management?
13. What is trade credit?
14. Define Treasury Bill.
15. State the meaning of Commercial Paper.

### **UNIT 5 – LONG TERM SOURCES OF FINANCE**

1. How would you compare a debenture and a preference share?
2. What are the sources of internal financing of a firm?
3. What are the key functions of venture capital?
4. What is leasing?
5. What is venture capital?
6. State the meaning of venture capital financing.
7. How do you classify financial assets?
8. State the objectives of ploughing back of earnings.
9. What is private equity?
10. What is meant by book-building?
11. List 10 companies represented in the Sensex.
12. Who is a lame duck?
13. What are the benefits of project financing?
14. Elucidate the process of private equity.
15. What do you mean by listing?
16. How will you estimate the risk in venture capital firms?
17. Compare hire purchase and lease.
18. How do you interpret Restrictive Covenants?

## PART – B & C

### UNIT 1

What is return? Write the various components of total return. Whether unrealised capital gain or loss be included in the calculations of returns?

1. ABC company is currently paying a dividend of Rs. 2 per share. The dividend is expected to grow at 15% annual rate for three years, then at 10% rate for the next three years, after which it is expected to grow at 5% rate forever.
  - i. What is the present value of the share if the capitalization rate is 9%?
  - ii. If the share is held for three years, what shall be its present value?

Year	1	2	3	4	5	6
PVF@9%	0.917	0.842	0.772	0.708	0.650	0.596

2. Discuss in detail the objective, function and scope of financial management.
3. Explain the various modern approaches of financial management.
4. State and explain the functions of finance. Why is wealth maximization considered as the prime objective of financial management over profit maximization? (8)

The market price of Rs. 1,000 par value bond carrying a coupon rate of 14 percent and maturing after 5 years is Rs. 1,050. What is the Yield-to-Maturity (YTM) on this bond? What is the approximate YTM? (5)
5. You have decided to buy 500 shares of an IT company with the intention of selling out at the end of five years. You estimate that the company will pay Rs. 3.50 per share as dividends for the first two years and Rs. 4.50 per share for the next three years. You further estimate that at the end of the five-year holding period, the shares can be sold for Rs. 85. What would you be willing to pay today for these? (5)

What is risk? Discuss the methods of calculating risk for single asset and of a portfolio? (8)
6. A finance company advertises that it will pay a lumpsum of Rs. 44,650 at the end of five years to investors who deposit annually Rs. 6,000 for 5 years. What is the interest rate implicit in this offer? (4)

The equity shares of Rex limited is currently selling for Rs. 30 per share. The dividend expected next year is Rs. 2.00. The investor required rate of return on this stock is 15 percent. If the constant growth model applies to Rex limited, what is the expected growth? (12)
7. Explain the measures of yield commonly applied to bonds. (12)

In your own words, explain the concept of risk and return and explain how diversification influences risk. (4)

## UNIT 2

A company has to select one of the following two projects:

	Project A	Project B
Cost	Rs. 22,000	Rs. 20,000
<b>Cash Inflows</b>		
Year 1	Rs. 12,000	Rs. 2,000
Year 2	Rs. 4,000	Rs. 2,000
Year 3	Rs. 2,000	Rs. 4,000
Year 4	Rs. 10,000	Rs. 20,000

Using the Internal Rate of Return method, suggest the profitable project.

1. Explain ARR, NPV and IRR in capital budgeting.
2. A company has two alternative proposals. The details are as follows:

	Proposal 1	Proposal 2
	Automatic Machine	Ordinary Machine
Cost of the machine	Rs. 2,20,000	Rs. 60,000
Estimated Life	5.5 Years	8 Years
Estimated Sales Per Annum	Rs. 1,50,000	Rs. 1,50,000
Cost: Material	Rs. 50,000	Rs. 50,000
Labour	Rs. 12,000	Rs. 60,000
Variable Overheads	Rs. 24,000	Rs. 20,000

Compute the profitability of the proposals under the return on investment method. (8 Marks)

XYZ issues 20,000, 8% preference shares of Rs. 100 each. Cost of issue is Rs. 2 per share. Calculate cost of preference share capital if these shares are issued a) at par b) at a premium of 10% and c) a discount of 6%. (7 Marks)

3. A Ltd., issues Rs. 10,00,000, 8% debentures at par. The tax rate applicable to the company is 50%. Compute the cost of debt capital. (3 Marks)

B Ltd., issues Rs. 1,00,000, 8% debentures at a premium of 10%. The tax rate applicable to the company is 60%. Compute the cost of debt capital. (4 Marks)

A Ltd., issues Rs. 1,00,000, 8% debentures at a discount of 5%. The tax rate applicable to the company is 60%. Compute the cost of debt capital. (4 Marks)

B Ltd., issues Rs. 10,00,000, 9% debentures at a premium of 10%. The costs of floatation are 2%. The tax rate applicable to the company is 50%. Compute the cost of debt capital. (4 Marks)

In all cases, compute the after-tax cost of debt as the firm saves on account of tax by using debt as a source of finance.

4. What is Capital Budgeting? Explain the merits and demerits of time adjusted methods of evaluating the investment projects. Under what circumstances does NPV method and IRR method give different results?
5. You are required to determine the weighted average cost of capital of Ananya Ltd., using book value weights. The following information is available for your perusal:

The present book value of capital structure of the company is:

Debenture (Rs. 100 per debenture)                      Rs. 7,00,000

Preference shares (Rs. 100 per share) Rs. 3,00,000

Equity shares (Rs. 10 each) Rs. 10,00,000

Anticipated external financing opportunities are:

- i. Rs. 100 per debenture redeemable at par after 8 years, 13% coupon rate, 4% floatation costs, sale price Rs. 100
- ii. Rs. 100 preference shares redeemable at par, 5 year maturity, 14% dividend rate, 5% floatation costs, sale price Rs. 100
- iii. Equity shares: Rs 2 per share brokerage, sale price Rs. 22

Dividend expected on the equity share at the end of the year is Rs. 2 per share, the anticipated growth rate in dividend is 6% and the company has the practice of paying all its earning in the form of dividends. The corporate tax rate is 35%.

6. Raja Ltd., is thinking of investing in a project costing Rs. 20 lakhs. The life of the project is five years and the estimated salvage value of the project is zero. Straight line depreciation is followed. The tax rate is 50%. The expected cash flows before tax are as follows:

Year	1	2	3	4	5
Estimated cash flow before depreciation and tax (Rs. Lakhs)	4	6	8	8	10

You are required to determine the (i) Pay back method (ii) Average rate of return (iii) Net present value (iv) Internal rate of return. Cost of capital is 10%.

7. How is accounting rate of return calculated? Explain its merits and demerits.
8. Machine X has a cost of Rs. 75,000 and net cash flow of Rs. 20,000 per year, for six years. A substitute machine Y would cost Rs. 50,000 and generate net cash flow of Rs. 14,000 per year for six years. The required rate of return of both machines is 11%. Calculate the IRR and NPV for the machines. Which machine should be accepted and why?

	11%	12%	13%	14%	15%	16%	17%	18%
PVF 6 <sup>th</sup> Year	4.231	4.111	3.998	3.889	3.784	3.685	3.589	3.498

9. Discuss the procedure for determining the WACC. What are the factors affecting the WACC?

You are required to calculate the overall cost of capital, from the following capital structure of a company:

	Rs.
1,000 12% Preference shares of Rs. 100 each issued at par	1,00,000
10,000 Equity shares of Rs. 10 each issued at par	1,00,000
5,000 10% Debentures of Rs. 100 each issued at par	5,00,000
12% Term loan	2,00,000
Retained earnings	1,50,000

The market price of an equity share is Rs. 30. The next expected dividend is Rs 3 per share and the dividend per share is expected to grow at 10%. The preference shares are redeemable after 7 years at par and are currently quoted at Rs. 75 per share. The debentures are redeemable at par after 5 years and are quoted at Rs. 90 per debenture. The tax rate applicable to the company is 40%.

### UNIT 3

1. List out the various types of dividend policies.

2. How does an Operating Leverage (OL) differ from Financial Leverage (FL)?
3. What are the factors to be considered in determining the capital structure of a company?
4. Illustrate how EBIT–EPS analysis can be used to design the appropriate capital structure for a firm.
5. Calculate financial leverage and operating leverage under situations when fixed costs are (i) Rs. 5,000 (ii) Rs. 10,000 under financial plan 1 and 2 respectively, from the following information pertaining to the operation and capital structure of ABC Co.

Total Assets	Rs. 30,000	
Total Asset Turnover based on Sales	2	
Variable Costs as percentage of Sales	60	
<b>Capital Structure</b>	<b>Financial Plans</b>	
	<b>Plan 1</b>	<b>Plan 2</b>
Equity	Rs. 30,000	Rs. 10,000
10% Debentures	Rs. 10,000	Rs. 30,000

6. The EPS of a company is Rs. 12 and the rate of capitalization applicable is 10%. The company has an option of adopting:
  - i) 40% and ii) 60% dividend payout ratio.
 Compute the market price of the company's share as per Walter's Model if it can earn a return of: i) 12.5% ii) 8.5% and iii) 6% on its retained earnings.
7. What are the factors that affect dividend policy? Briefly discuss each of them.
8. Critically analyse the assumptions of MM Hypothesis of irrelevance theory. Explain the arbitrage process.
9. What is an indifference point in the EBIT–EBT analysis? How would you compute it? (8) Distinguish between operating and financial leverage. (5)
10. What are the essentials of Gordon's model? Illustrate with an example. State the criticism against Gordon's model.

## UNIT 4

1. From the following information calculate:
  - a. Reorder Level
  - b. Maximum Level
  - c. Minimum Level
  - d. Average Level

Normal Usage	:	100 Units per week
Maximum Usage	:	150 Units per week
Minimum Usage	:	50 Units per week
Reorder Quantity (EOQ)	:	500 Units
Lead Time	:	5 to 7 weeks
2. Explain the various factors influencing the working capital.
3. Discuss the principles, needs and determinants of working capital to a manufacturing firm.

4. Proforma cost sheet of a company provides the following particulars:

- i) Material 50% ii) Direct Labour 20% and iii) Overheads 10%

The following information is also available:

- It is proposed to maintain a level of activity of 2,50,000 units
- Selling price is Rs. 10 per unit
- Raw materials are expected to remain in store for an average period of one month
- Materials will be in process on an average of half-a-month
- Finished goods are required to be in stock on average period of one month
- Credit allowed to debtors is one-and-a-half month
- Credit allowed by suppliers is half-a-month.

Estimate the working capital required.

5. What are the objectives of cash management and various basic problems in the cash management? Explain.

6. Explain the following:

- a. Baumol's Model
- b. Delinquency Cost
- c. EOQ Model
- d. Just-in-Time Inventory Policy

7. Discuss the various opportunities available to the companies to park their surplus funds for short-term.

8. What is the need to maintain optimum working capital? Discuss the consequences of inadequate or excess working capital.

9. Write short notes on the following:

- I. Credit policy variables
- II. Lock-box system
- III. Commercial paper.

10. Calculate the amount of working capital requirements for Sivam & Co. limited from the following information:

Elements of Cost	Amount per Unit Rs.
Raw-materials	160
Direct Labour	60
Overheads	120
	<b>340</b>
Profit	60
Selling Price	400

- i. Raw materials are held in stock on an average for one month. Materials are in progress on an average for half-month. Finished goods are in stock on an average for one month.
- ii. Credit allowed by Suppliers is one month and credit allowed to debtors is two months. Time lag in payment of wages is 1.5 weeks.

- iii. Time lag in payment of overheads is one month. One fourth of the finished goods are sold against cash.
- iv. Cash in hand and at bank is expected to be Rs. 50,000 and expected level of production amounts to 1,04,000 units.
- v. You may assume that production is carried on evenly throughout the year wages and overheads accrue similarly and a time period of four week is equivalent to a month.

11. From the following information, prepare a cash budget for three months from June to August:

Month	Sales	Purchases	Wages	Overheads	Expenses
June	72,000	25,000	10,000	6,000	5,500
July	97,000	31,000	12,100	6,300	6,700
August	86,000	25,500	10,600	6,000	7,500

- i. Cash balance in hand as on 1<sup>st</sup> June Rs. 72,500
- ii. 50% of sales are cash sales
- iii. A fixed assets has to be purchased for Rs 8,000 in July
- iv. Debtors are allowed one month's credit
- v. Creditors for materials grant one month's credit
- vi. Sales commission at 3% on sales is paid to the salesman each month.

12. Following is the data related to cost sheet of a company. Prepare a statement showing the working capital needed to finance a level of activity of 70,000 units of output.

	Cost per unit Rs.
Raw materials	52.00
Direct labour	19.50
Overheads (including depreciation at 0.50)	39.50
<b>Total Cost</b>	<b>111.00</b>
Profit	19.00
Selling Price	130.00

- Average raw material in stock – one month
- Average material in process – half-a-month
- Finished goods stock – one month
- Credit allowed by suppliers – one month
- Credit allowed to debtors – two months
- Time lag in payment of wages – one and a half weeks
- Overheads – one month
- One fourth of sales are on cash basis
- Cash balance is expected to be Rs. 1,20,000

### UNIT 5 – LONG TERM SOURCES OF FINANCE

1. Discuss the trends in Indian capital market with specific reference to the secondary market.
2. Discuss in detail the process of selecting investment by venture capitalists. Differentiate between hire purchase and leasing.
3. Discuss in detail the new issues market.

4. Explain the sources from which large-size industrial enterprise can raise capital for its various requirements.
5. Explain in brief the features of venture capital financing and SEBI regulations on venture capital finance.
6. Discuss the various procedure involved in obtaining a term loan
7. Differentiate between term loan and working capital loan. Enumerate the criteria in evaluating term loan proposals and working capital proposals.
8. Explain in detail legal aspects of leasing. What are the contents of a lease agreement?
9. Discuss the benefits of going public. (8)  
Explain the norms for preferential allotment (8)
10. 8A9 company is faced with two alternatives (a) leasing the plant and (b) borrowing and purchasing the plant. 8X9 leasing company is willing to lease the plant at an annual lease rental of Rs. 14 million for five years. The lease rental being payable in the arrears.

The tax relevant depreciation rate on the plant is 25 percent as per the WDV method. The net salvage value of the plant after 5 years is expected to be Rs. 10 million.

The marginal rate of tax is 35 percent and its post-tax cost is 8 percent. What is the net advantage of leasing for the company 8A9?

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Reg. No. :

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**Question Paper Code : 30083**

M.B.A. DEGREE EXAMINATIONS, NOVEMBER/DECEMBER 2022.

Second Semester

BA 4202 — FINANCIAL MANAGEMENT

(Regulations 2021)

Time : Three hours

Maximum : 100 marks

Answer ALL questions.

PART A — (10 × 2 = 20 marks)

1. What is Financial Management?
2. Give the meaning of Time Value of Money.
3. What are the objectives of capital budgeting?
4. Give the meaning of Profitability Index.
5. Define Capital Structure.
6. What is meant by dividend policy?
7. Give the meaning of VED analysis.
8. What is Credit policy?
9. What is venture capital financing?
10. Give a short note on hire purchase financing.

PART B — (5 × 13 = 65 marks)

11. (a) Explain the objectives of Financial Management.

Or

- (b) Explain the different types of financial decisions.

12. (a) Explain how to calculate payback period and discuss the advantages and disadvantages of payback period.

Or

- (b) Initial Investment Rs.60,000

Life of the assets 4 years

Estimated net annual cash flows:

Year	Amount
1	15,000
2	20,000
3	30,000
4	20,000

Calculate Internal Rate of Return.

Note: The following table gives the present value of Re.1/- due in "n" number of years

Year	P.V factor at 10%	P.V factor at 12%	P.V factor at 14%	P.V factor at 15%
1	0.909	0.892	0.877	0.869
2	0.826	0.797	0.769	0.756
3	0.751	0.711	0.674	0.657
4	0.683	0.635	0.592	0.571

13. (a) The following figures relate to two companies. You are required to calculate the operating, financial, combined leverages of two companies.

	X Ltd Rs.	Y Ltd Rs.
Sales	4,00,000	8,00,000
Less: variable cost	1,60,000	2,40,000
Contribution	2,40,000	5,60,000
Less: Fixed Cost	1,28,000	2,80,000
Operating profit (EBIT)	1,12,000	2,80,000
Less: Interest	48,000	1,20,000
Profit before Tax	64,000	1,60,000

Or

- (b) Explain the Modigliani-Miller Hypothesis of dividend irrelevance.

14. (a) Discuss how the requirement of the working capital will be assessed?

Or

- (b) Explain different types of inventory control techniques in detail

15. (a) Discuss the different types of debentures in detail.

Or

- (b) Explain how various long term finance will help the financial need of the organization.

PART C— (1 × 15 = 15 marks)

16. (a) Discuss in detail about the theories of capital structure.

Or

- (b) A Limited Company is considering for investing in a project requiring capital outlay of Rs.2,00,000. The annual income after depreciation but before tax is as follows:

Year	Amount
1	1,00,000
2	1,00,000
3	80,000
4	80,000
5	40,000

Depreciation may be taken as 20% on original cost and taxation at 50% of net income.

You are required to evaluate the project according to each of the following methods:

- (i) Pay back method (4)  
(ii) Internal Rate of Return method (6)  
(iii) Discounted cash flow method taking cost of capital at 10% (5)

Year	Discount factor at 10%
1	0.909
2	0.826
3	0.751
4	0.683
5	0.621

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Reg. No. :

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**Question Paper Code : 10198**

M.B.A. DEGREE EXAMINATIONS, APRIL/MAY 2023.

Second Semester

BA 4202 - FINANCIAL MANAGEMENT

(Regulations 2021)

Time : Three hours

Maximum : 100 marks

(Time value Table permitted)

Answer ALL questions.

PART A — (10 × 2 = 20 marks)

1. State the functions of financial management.
2. Recall the major components of time value of money.
3. List out the principles of Capital Budgeting.
4. Write the importance of Net Present Value.
5. What is Financial Leverage? Give an example.
6. What do you mean by dividend decision?
7. Recall the main components of Working Capital.
8. Write a short note on Commercial Papers.
9. What do you mean by Long-term sources of finance?
10. What is Private equity?

PART B — (5 × 13 = 65 marks)

11. (a) (i) Examine the primary objectives of Financial Management. (8)
- (ii) Explain the relationship between risk and return with an example. (5)

Or

- (b) Give a detailed account on valuation of bonds. (13)

12. (a) (i) How to identify the relevant cash flows and capital budgeting process? (8)
- (ii) A company is considering an investment proposal, involving an initial cash outlay of Rs.45 lakh. The proposal has an expected life of 7 years and zero salvage value. At a required rate of return of 12 per cent, the proposal has a profitability index of 1.182. Calculate the annual cash inflows. (5)

Or

- (b) Equipment A has a cost of Rs. 75,000 and net cash flow of Rs. 20,000 per year, for six years. A substitute equipment B would cost Rs.50,000 and generate net cash flow of Rs. 14,000 per year for six years. The required rate of return of both equipment is 11 per cent. Calculate the IRR and NPV for the equipments. Which equipment should be accepted and why? (13)

13. (a) From the following prepare Income statement of Company X and Company Y. (13)

	Company X	Company Y
Financial leverage	4 : 1	5 : 1
Interest	6,00,000	7,00,000
Operating leverage	3 : 1	4 : 1
Variable cost to sales	66.66%	50%
Income tax rate	30%	40%
No. of Equity Shares	1,00,000	70,000

Also calculate and comment on EPS of the company.

Or

- (b) (i) Elucidate the assumptions under net income approach. (6)
- (ii) What are the factors to consider for the dividend policy? (7)
14. (a) (i) Describe the determinants of Working Capital. (5)
- (ii) Following is the information of XYZ Industries Ltd. for the year 30<sup>th</sup> June, 2022. Their plan is to sell 30,000 units in the year 2022-23. The expected cost of goods sold is as under you are required to calculate the working capital requirements. (8)

Particulars	Rs. (per unit)
Raw material	100
Manufacturing expenses	30
Selling, administration and financial expense	20
Selling price	200

The duration at various stages of the operating cycle is expected to be as follows:

Raw material stage 2 months

Work-in-progress stage 1 month

Finished goods stage 1/3 month

Debtors stage 1 month

Assume that the monthly sales level of 2,500 units, estimate the gross working capital necessity. Expected cash balance is 5% of the gross working capital necessity, and working progress is 25% complete with respect to manufacturing expenses.

Or

- (b) (i) A manufacturer uses Rs. 10,000 worth of an item in a year. He has estimated the ordering cost as Rs. 25 per order and carrying costs as 12.5% of average inventory value. Find the optimal order size, number of orders per year, time period, per order and total cost. (8)

- (ii) Bring out the advantages and disadvantages of Trade Credit. (5)

15. (a) Give a detailed account on the role of Indian Capital Market. (13)

Or

- (b) Discuss in detail on the different stages of Venture Capital available to Start-ups. (13)

**PART C — (1 × 15 = 15 marks)**

16. (a) The summarized balance sheet of Sri Ram Ltd. as on 31.12.2016 and 31.12.2017 are as follows:

Liabilities	2016	2017	Assets	2016	2017
Share Capital	1,00,000	1,00,000	Building	46,800	46,000
General Reserve	38,400	42,000	Plant & Machinery	38,280	42,000
Creditors	9,750	8,380	Goodwill	13,000	13,000
Tax provision	19,000	21,000	Investment	10,000	11,250
Doubtful debt	1,000	1,200	Stock	30,000	28,000
			Debtor	22,070	22,300
			Cash	8,000	9,000
	<u>1,68,150</u>	<u>1,70,580</u>		<u>1,68,150</u>	<u>1,70,580</u>

15. (a) (i) What are the features of preference shares? (6.5)

(ii) Is debt the cheapest source of financing? Justify your answer. (6.5)

Or

(b) Explain the role of new issues market and secondary market in aiding businesses to raise capital.

PART C — (1 × 15 = 15 marks)

16. (a) The following are the projections of Good Limited for the financial year 2022-23. Based on the details estimate the working capital requirement.

- Annual sales — Rs 14,40,000
- Cost of production (Includes depreciation of Rs 1,20,000) — Rs 12,00,000
- Raw material purchases — Rs 7,05,000
- Monthly expenses — Rs 30,000
- Opening stock of Raw materials — Rs 1,40,000
- Closing stock of raw materials — Rs 1,25,000

The company has a policy of holding inventory of raw materials for 2 months, Work in progress for  $\frac{1}{2}$  month, and finished goods for 1 month. The firm enjoys a credit period of  $\frac{1}{2}$  month on purchases and has a collection period of 1 month. The company also receives an advance of Rs 15,000 on sales orders. The minimum cash balance desired is Rs 35,000.

Or

(b) A company is considering introducing a new product. The equipment to manufacture will cost Rs 5,60,000. The life of the equipment is 8 years. The selling price of the product is Rs 12, variable cost - Rs 6 and annual fixed cost Rs 4,50,000 (includes depreciation of Rs 70,000 based on straight line method and overheads of Rs 30,000)

Expected sales 1,00,000 units per year. Assume tax rate of 45% and discount rate of 12%. Should the company introduce the new product?

Reg. No. :

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**Question Paper Code : 90077**

M.B.A. DEGREE EXAMINATIONS, APRIL/MAY 2022.

Second Semester

BA 4202 — FINANCIAL MANAGEMENT

(Regulations 2021)

Time : Three hours

Maximum : 100 marks

Answer ALL questions.

PART A — (10 × 2 = 20 marks)

1. What is agency problem?
2. State the ways in which the risk of an individual asset can be measured.
3. Differentiate between independent and mutually exclusive projects.
4. What are the demerits of the Accounting Rate of Return Method?
5. The Financial leverage of a company is 3.5. How do you interpret this?
6. The market price of a company's shares are Rs 25. The face value is Rs 100. The EPS is Rs 125. The company has declared a dividend of Rs. 3 per share. Determine the dividend yield and dividend payout ratio.
7. What are the implications of increasing the collection period on the working capital of a firm?
8. What are the demerits of a conservative working capital policy?
9. State any four key roles of SEBI.
10. How are the shares of an unlisted company bought and sold?

PART B — (5 × 13 = 65 marks)

11. (a) Can a firm satisfy all its stakeholders? Explain in the context of the objective of wealth maximization.

Or

- (b) The market price of Bonds of A Ltd are Rs. 115. The bonds have a face value of Rs. 100 with a 11% coupon and have 18 years to maturity. Determine the YTM of the bond. Explain why the market price of the bond is higher than the par value. Will the price of the bond decrease or increase in future?

12. (a) A company has the following amounts and costs of capital for each source of capital

Source	Book Value (Rs)	Market Value (Rs)	Specific Cost of Capital (%)
Debentures	4,00,000	3,80,000	5
Preference Shares	1,00,000	1,10,000	8
Equity Shares	6,00,000	12,00,000	15
Retained Earnings	2,00,000		13

Determine the Weighted Average Cost of Capital using Book value weights and market value weights. Why are they different?

Or

- (b) The following are the details of a project which has an initial cash outflow of Rs. 50,000, with a life of 5 years.

Year	Cash flow
1	10,000
2	10,450
3	11,800
4	12,250
5	16,750

Determine the payback period, NPV and IRR of the project. Assume a discount rate of 10%.

13. (a) Explain in detail the MM Hypothesis of capital structure.

Or

- (b) Dividend is an internal decision of the firm and is based only on the profitability of the firm. Do you agree?
14. (a) Cash is crucial to any firm. A firm's operations will come to a halt if there is a shortage of cash. Do you agree? What are the ways in which a firm can determine the optimum cash balance that it should hold?

Or

- (b) Factoring is one amongst the common ways in which firms meet their working capital needs. Comment on the above.

15. (a) (i) What are the features of preference shares? (6.5)  
(ii) Is debt the cheapest source of financing? Justify your answer. (6.5)

Or

- (b) Explain the role of new issues market and secondary market in aiding businesses to raise capital.

PART C — (1 × 15 = 15 marks)

16. (a) The following are the projections of Good Limited for the financial year 2022-23. Based on the details estimate the working capital requirement.

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