FINANCIAL MANAGEMENT 1

INTRODUCTION TO FINANCE AND FINANCIAL MANAGEMENT

Meaning Financial Management means planning, organizing, directing and controlling the financial activities such as procurement and utilization of funds of the enterprise. It means applying general management principles to financial resources of the enterprise. Scope/Elements Investment decisions includes investment in fixed assets (called as capital budgeting). Investment in current assets are also a part of investment decisions called as working capital decisions. Financial decisions - They relate to the raising of finance from various resources which will depend upon decision on type of source, period of financing, cost of financing and the returns thereby.

Dividend decision - The finance manager has to take decision with regards to the net profit distribution.

Net profits are generally divided into two:

Dividend for shareholders- Dividend and the rate of it has to be decided. Retained profits- Amount of retained profits has to be finalized which will depend upon expansion and diversification plans of the enterprise.

Objectives of Financial Management In simple terms objective of Financial Management is to maximize the value of firm, however it is much more complex than that. The management of the firm involves many stakeholders, including owners, creditors, and various participants in the financial market. Effective procurement and efficient use of finance lead to proper utilization of the finance by the business concern. It is the essential part of the financial manager. Hence, the financial manager must determine the basic objectives of the financial management

The objectives of financial management are given below:

1. Profit maximization Main aim of any kind of economic activity is earning profit. A business concern is also functioning mainly for the purpose of earning profit. Profit is the measuring techniques to understand the business efficiency of the concern. The finance manager tries to earn maximum profits for the company in the short-term and the long-term. He cannot guarantee profits in the long term because of business uncertainties. However, a company can earn maximum profits even in the long-term, if: The Finance manager takes proper financial decisions He uses the finance of the company properly The main aim of any form of business is to earn a profit. All the business entity operates to earn the maximum amount of return in terms of profits. Profit earning capacity is a measuring technique to evaluate the efficiency of the concerned business.
   Profit Maximization is the traditional and narrow approach that aims to maximize the profit for an organization. Profit Maximization consists of the following features: Profit Maximization is also known as cash per share maximization. It helps in achieving the objects to maximize the business operation for profit maximization. The ultimate objective of any business is to earn a huge amount of return in terms of profit. Thus, this objective of financial management considers all the possible ways to increase the profitability of the business concern. Profit earning capacity is kind of a parameter for measuring the efficiency of a particular business. Thus, it shows the entire position of business along with the measures to improve and increase profitability. Profit Maximization is an objective that helps in reducing risk.

2. Wealth maximization Wealth maximization (shareholders' value maximization) is also a main objective of financial management. Wealth maximization means to earn maximum wealth for the shareholders. So, the finance manager tries to give a maximum dividend to the shareholders. He also tries to increase the market value of the shares. The market value of the shares is directly related to the performance of the company. Better the performance, higher is the market value of shares and vice-versa. So, the finance manager must try to maximize shareholder's value Wealth maximization is also called as value maximization or net present worth maximization. This objective of Financial Management is universally acceptable in all forms of business concern. It's one of the modern approaches that involve the latest innovations and improvement in the fields of business operations. The term wealth means shareholders' wealth or the wealth of the persons involved the business concern.

Wealth Maximization Objective is also known as "Value Maximization" or "Net Present Worth Maximization."

This objective is considered appropriate for decision making. Wealth means wealth of shareholders. Wealth of shareholders is determined by market value of shares. Wealth also signifies Net Present Value(NPV) which is the difference between present value of cash inflows and present value of cash outflows. In this way, wealth maximization objective considers time value of money and assign different values to cash inflows occurring at different point of time. So, according to wealth maximization objective, investments should be made in such a way that it maximizes Net Present Value.

Introduction to Corporate Finance Introduction:

An organisation needs finance for its various activities, operations and projects. It needs to ensure that there is enough finance at every stage of development i.e., right from incorporation to its maturity. In the incorporation stage, the organisation needs finance to develop its basic infrastructures, such as establishing plants and machinery. In the development stage, it requires finance to expand its business operations by entering into joint ventures and mergers and acquisitions and funding its working capital requirements. Thereafter, in the maturity stage, the organisation needs finance to stay competitive in the business through effective advertisement and constant improvement in its products.

The process of managing the funds of an organisation is called financial management. Corporate finance plays a vital role in every business. Irrespective of the size or type of business operations, every company seeks to streamline its corporate financing arm for optimum wealth distribution and return generation.

Corporate finance meaning thus extends to an array of financing and investment decisions that encompass four primary aspects, viz: Planning finances Raising funds Investing Monitoring Corporate finance refers to activities and transactions related to raising capital for the creation, development and acquisition of a business. It is directly related to company decisions which have financial or monetary impacts. It can be considered as a liaison between the capital market and the organisation.

The corporate finance definition also encompasses effective resource utilisation and expenditure minimisation. Factors that contribute to its decision include term requirements of the company, urgency, risk appetite, etc. A business undertakes such decisions to achieve pre-set financial goals while ensuring maximisation of shareholder value.

Features of Corporate Finance Financial Activity:

Corporate finance is a financial activity.

It includes planning, raising, investing and monitoring the finance of the company. In short, it includes all the financial aspects of the company. This work is done by the financial department headed by the finance manager.

Raising the finance: Corporate finance includes raising (collecting) finance for the company. Finance can be collected through shares, debentures, bank loans, etc. It is very difficult for new companies to collect finance because the investors do not have confidence in new companies. However, it is very easy for reputed companies to collect finance due to their well-established goodwill in the market.

Investing the finance: Corporate finance also includes investing (using) the finance. The finance is used to achieve the objectives of the company. It is used to purchase fixed assets. It is also used for running the company. The finance must be used profitably. Objective oriented: Corporate finance is objective oriented. That is, it is used to achieve the objectives of the company.

The main objectives are, viz.,

(i) To earn maximum profits

(ii) To give a proper dividend to the shareholders, and

(iii) To create a proper reserve for future growth and expansion, etc. Types of finance: There are two types of corporate Finance, viz., fixed capital and working capital. Fixed capital is also called long-term finance. It is used to meet the long-term needs of the company. It is used to purchase fixed assets. Working capital is also called short-term finance. It is used to meet the short-term needs of the company. It is used to pay the day-to-day expenses of the company. Medium term finance is also used to meet the medium term needs of the company. Relationship with other departments: Corporate finance has a close relationship with all other departments in the company, i.e. Production Department, Marketing Department, etc. This is because all departments need finance continuously.

(iv) Dynamic in nature: Corporate finance is dynamic in nature. It goes on changing according to the changes in environment, circumstances, times, etc. So, the finance manager must use new and innovative ideas for collecting and investing money. He must use creativity while doing his job. Requires proper planning and control: Corporate finance requires proper planning and control. Planning is required to collect finance from the investors. It is also required for investing the finance. Control is required to find out whether the finance is invested properly or not. If the finance is not invested properly, then corrective measures must be taken.

Managing finance is an art and science: Managing finance is an Art because it requires human skills and judgement. It is a Science because it follows a systematic approach.

Legal requirements: There are many legal requirements for corporate finance. The company has to take permission, from the Controller of Capital Issues, for collecting finance from the public. The company also has to follow all the rules of SEBI. A Sole Trader and Partnership Firm need not follow these rules. part of business management: Corporate finance is an important part of business finance.

"Finance is the life blood of business." Finance is required for all business activities. It is required for promoting business. It is required for conducting the business smoothly. It is required for expansion, diversification, modernization, replacement of assets, etc. Finance is also required for paying taxes, dividend, interest and for meeting contingencies.

Need and importance of Corporate Finance Research and Development :

Corporate Finance is needed for Research and Development. Today, a company cannot survive without continuous research and development. The company has to go on making changes in its old products. It must also invent new products. If not, it will be get automatically thrown out of the market. Motivating Employees : Manager and employees must be continuously motivated to improve their performance. They must be given financial incentives, such as bonus, higher salaries, etc. They must also be given non-financial incentives such as transport facilities, canteen facilities (eatery), etc. All this requires finance. Promoting a Company : Finance is needed for promoting (starting) a company. It is needed for preparing Project Report, Memorandum of Association, Articles of Association, Prospectus, etc. It is needed for purchasing Land and Buildings, Plant and Machinery and other fixed assets. It is needed to purchase raw materials. It is also needed to pay wages, salaries and other expenses. In short, we cannot start a company without finance.

Smooth Conduct of Business : Finance is needed for conducting the business smoothly. It is needed as working capital. It is needed for paying day-to-day expenses. It is needed for advertising, sales promotion, distribution, etc. A company cannot run smoothly without finance. Expansion and Diversification : Expansion means to increase the size of the company. Diversification means to produce and sell new products. Modern machines and modern techniques are needed for expansion and diversification. Finance is needed for purchasing modern machines and modem technology. So, finance becomes mandatory for expansion and diversification of a company. Meeting Contingencies : The company has to meet many contingencies. For e.g. Sudden fall in sales, loss due to natural calamity, loss due to court case, loss due to strikes, etc. The company needs finance to meet these contingencies. Government Agencies : There are many government agencies such as Income Tax authorities, Sales Tax authorities, Registrar of Companies, Excise authorities, etc. The company has to pay taxes and duties to these agencies. Finance is needed for paying these taxes and duties. Dividend and Interest : The company has to pay dividends to the shareholders. It has to pay interest to the debenture holders, banks, etc. It also has to repay the loans. Finance is needed to pay dividends and interest. Replacement of Assets : Plant and Machinery are the main assets of the company. They are used for producing goods and services. However, after some years, these assets become old and outdated. They have to be replaced by new assets. Finance is needed for replacement of old assets. That is, finance is needed to buy new assets. Qualities of a Financial Manager Qualities of Financial Manager Good personality Intelligence Initiative Innovation Self Confidence Communication skill.

Finance holds the key to all business activities. No business activity can ever be pursued without financial support. Finance is necessary throughout the activities of promotion, organisation and regular operations of business. All functions of business are ultimately dependent on finance. The Finance needed by business organisation is termed as 'Capital'. Every business organisation needs certain capital for its activities. A joint stock company, which is a modern form of business organisation and being a large undertaking, requires huge capital for business. This huge capital collection or capital formation has special significance in the management of joint stock company. Capital formation is a process of collection of capital from various sources according to financial plan of company.

2 CLASSIFICATION OF SHARE CAPITAL: Share capital refers to the capital made up of Equity Shares and Preference Shares. Usually, in share capital, the proportion of Equity shares is more than Preference shares. Share Capital can be classified as Authorised or Nominal or Registered Capital (1,00,000 Equity Shares ₹ 10/- each ₹ 10,00,000) Issued Capital (40000 Equity Shares ₹ 10/- each ₹ 4,00,000) Un-Issued Capital (60000 Equity Shares ₹ 10/- each ₹ 6,00,000) Subscribed Capital (30000 Equity Shares ₹ 10/- each ₹ 3,00,000) Un-subscribed Capital (10000 Equity Shares ₹10/- each ₹ 1,00,000) Called-up Capital (30000 Equity Shares ₹ 5/- each ₹ 1,50,000) Un-Called Capital (30000 Equity Shares ₹ 4/- each ₹ 1,20,000) Reserve Capital (30,000 Equity Shares ₹ 1/-each ₹ 30,000 Paid-up Capital (20000 Equity shares ₹ 5/- each ₹ 1,00,000) Calls In Arrears (10000 Equity shares ₹ 5/- each ₹ 50,000 Shares The term share is defined by Section 2 (84) of the Companies Act 2013, 'Share means a share in the share capital of a company and includes stock'. Share is a unit by which the share capital is divided. The total capital of company is divided into small parts and each part is called share and the value of each part / unit is known as face value.

Share is a small unit of capital of a company. It facilitates the public to subscribe to the capital in smaller amount. A person can purchase any number of shares as he wishes. A person who purchases shares of a company is known as a shareholder or a member of that company. Kinds of Shares (As per Section 43 of the Companies Act 2013 A company can issue different types of shares depending upon right to control, income and risk. The following chart shows different kinds of shares. Shares Equity Shares Equity Shares with voting right. Equity Shares with differential voting right. Preference Shares Cumulative Preference Shares. Non-Cumulative Preference Shares. Participating Preference Shares. Non-participating Preference Shares. Convertible Preference Shares. Non-Convertible Preference Shares. Redeemable Preference Shares. Irredeemable Preference Shares.

4 Equity Shares: Equity shares are also known as ordinary shares. Companies Act defines equity shares as 'those shares which are not preference shares'. The above definition reveals that: The equity shares do not enjoy preference for dividend. The equity shares do not have priority for repayment of capital at the time of winding up of the company. Equity shares are fundamental source of financing business activities. Equity shareholders own the company and bear ultimate risk associated with the ownership. After paying claims of all other

investors the remaining funds belong to equity shareholders. Thus equity shareholders are ‘residual claimants’ of the income and assets. Equity shareholders do not carry any fixed commitment of dividend. They are paid dividend at the rate recommended by Board of Directors. If there is no profit, no dividend will be payable. Similarly if there is less profit, lesser dividend will be paid. Thus the fortune of equity shareholders is tied up with the ups and downs of the company. If the company is successful, they enjoy great financial rewards and if the company fails, the risk falls mainly on them. It is exactly because of this position equity share capital is known as ‘venture capital’ or ‘risk capital’. The owners of equity shares are real risk bearers. Features of Equity Shares: Permanent Capital: Equity shares are irredeemable shares. The amount received from equity shares is not refundable by the company during its life time. Equity shares become refundable only in the event of winding up of the company or company decides to buy back shares. Thus equity share capital is long term and permanent capital of the company. Fluctuating Dividend: Equity shares do not have a fixed rate of dividend. The rate of dividend depends upon amount of profit earned by company. If company earns more profit, dividend is paid at higher rate. On the other hand if there is insufficient profit or loss, Board of Directors may postpone the payment of dividend. Equity shareholders cannot compel them to declare and pay dividend. The income of equity shares is uncertain and irregular. The equity shares get dividend at fluctuating rate. Rights: Equity Shareholders enjoy certain rights : Right to vote: It is the basic right of equity shareholders through which they elect directors, alter Memorandum and Articles of Association, etc. Right to share in profit: It is an important right of equity shareholders. They have right to share in profit, when distributed as dividend. If the company is successful and makes handsome profit, they have advantage of getting large dividend.

Right to inspect books: Equity shareholders have right to inspect statutory books of their company.

Right to transfer shares: The equity shareholders enjoy the right to transfer shares as per the procedure laid down in the Articles of Association. No preferential right: Equity shareholders do not enjoy preferential right in respect of payment of dividend. They are paid dividend only after dividend on preference shares has been paid. Controlling power: The control of company is vested with the equity shareholders. They are often described as ‘real masters’ of the company. It is because they enjoy exclusive voting rights. The Act

5 provides the right to cast vote in proportion to shareholding. They can exercise their voting right by proxies, without even attending meeting in person. Risk: Equity shareholders bear maximum risk in the company. They are described as ‘shock absorbers’ when company has financial crisis. Residual claimant: Equity shareholders as owners are residual claimants to all earnings after expenses, taxes, etc. are paid. A residual claim means the last claim on the earnings of company. Although equity shareholders come last, they have advantage of receiving entire earnings that is left over.

No charge on assets: The equity shares do not create any charge over assets of the company. Bonus Issue: Bonus shares are issued as gift to equity shareholders.

These shares are issued free of cost to existing equity shareholders. These are issued out of accumulated profits. Bonus shares are issued in proportion to the shares held. Thus capital investment of (ordinary) equity shareholder tends to grow on its own. This benefit is available only to the equity shareholder. Right Issue: When a company needs more funds for expansion purpose and raises further capital by issue of shares, the existing equity shareholders may be given priority to get newly offered shares. This is called 'Right Issue'. The shares are offered to equity shareholder first, in proportion to their existing shareholding. Face Value: The face value of equity shares is low. It can be generally ₹ 10 per share or even ₹ 1 per share. Market Value: Market value of equity shares fluctuates according to the demand and supply of these shares. The demand and supply of equity shares depend on profits earned and dividend declared. When a company earns huge profit, market value of its shares increases.

Types of Equity Shares:

The equity share can be of two types: Equity shares with normal voting right: Voting right of such equity holders is in proportion to his share holdings. Equity shares with differential voting right: Such equity holders shall have varying rights regarding dividend, voting or otherwise in accordance with Rule 4 of Companies (Share Capital and Debentures) Rules 2014.

Preference Shares: As the name indicates, these shares have certain preferential rights distinct from those attached to equity shares.

The shares which carry following preferential rights are termed as preference shares : A preferential right as to payment of dividend during the life time of company. A preferential right as to the return of capital in the event of winding up of company. The holder of preference share have a prior right to receive fixed rate of dividend before any dividend is paid to equity shares. The rate of dividend is prescribed at the time of issue.

Normally preference shares do not carry any voting power. They have voting right only on matters which affect their interest, such as selling of undertaking or changing rights of preference shares, etc. or they get voting rights if dividend remains unpaid. The preference shareholders are co-owners of the company but not controllers. These shares are purchased by cautious investors who are interested in safety of investment and who want steady returns on investments. Features of Preference Shares: Preference for dividend: Preference shares have the first charge on the distributable amount of annual net profit. The dividend is payable to preference shareholders before it is paid to equity shareholders. Preference for repayment of capital: Preference shareholders have a preference over equity shareholders in respect of return of capital when the company is liquidated. It saves preference shareholders from capital losses. Fixed Return: These shares carry dividend at fixed rate.

The rate of dividend is pre-determined at the time of issue. It may be in the form of fixed sum or may be calculated at fixed rate. The preference shareholders are entitled to dividend which can be paid only out of profits.

Nature of Capital: Preference shares do not provide permanent share capital. They are redeemed after certain period of time. A company cannot issue irredeemable preference shares.

Market Value: The market value of preference share does not change as the rate of dividend payable to them is fixed. The capital appreciation is considered to be low as compared with equity shares.
Voting rights: The preference shares do not have normal voting rights. They do not enjoy right of control on the affairs of the company. Risk: The investors who are cautious, generally purchase preference shares. Safety of capital and steady return on investment are advantages attached with preference shares. These shares are boon for shareholders during depression period when interest rate is continuously falling.
Face Value: Face value of preference shares is relatively higher than equity shares. They are normally issued at a face value of Rs. 100/-. Rights or Bonus Issue: Preference shareholders are not entitled for Rights or Bonus issues. Nature of Investor: Preference shares attract moderate type of investors. Investors who are conservative, cautious, interested in safety of capital and who want steady return on investment generally purchase preference shares.
Types of Preference Shares Cumulative Preference Shares: Cumulative Preference Shares are those shares on which dividend goes on accumulating until it is fully paid. This means, if the dividend is not paid in one or more years due to inadequate profits, then this unpaid dividend gets accumulated.
This accumulated dividend is Redeemable and Irredeemable Preference Shares Convertible and Non-convertible Preference Shares Participating and Nonparticipating Preference Shares Cumulative and Non-cumulative Preference Shares paid when company performs well. The arrears of dividend are paid before making payment to equity shareholders.
Non-cumulative Preference Shares: Dividend on these shares does not get accumulated. This means, the dividend on shares can be paid only out of profits of that year. The right to claim dividend will lapse, if company does not make profit in that particular year. If dividend is not paid in any year, it is lost forever. Participating Preference Shares: The holders of these shares are entitled to participate in surplus profit besides preferential dividend. The surplus profit which remains after the dividend has been paid to equity shareholders, up to certain limit, is distributed to preference shareholders.
Non-participating Preference Shares: The preference shares are deemed to be non-participating, if there is no clear provision in the Articles of Association. These shareholders are entitled to fixed rate of divided, prescribed at the time of issue. Convertible Preference Shares: The holders of these shares have a right to convert their preference shares into equity shares. The conversion takes place within a certain fixed period.
Non-convertible Preference Shares: These shares cannot be converted into equity shares. Redeemable Preference Shares: Shares which can be redeemed after certain fixed period of time are called redeemable preference shares. A company limited by shares, if authorised by Articles of Association, issues redeemable preference shares. Such shares must be fully paid. These shares are redeemed out of divisible profit only or out of fresh issue of shares made for this purpose. Irredeemable Preference Shares: Shares which are not redeemable i.e. payable only on winding up of the company are called irredeemable preference

shares. As per Section 55(1) of the Companies Act 2013, a company cannot issue irredeemable preference shares.

Retained Earnings: Business organisations are subject to variation in earnings. It would be a wise decision to keep aside a part of earning during a period of high profit. A prudent company does not distribute the entire profit earned among shareholders. A part of profit is retained by company in the form of reserve fund. These reserves are the retained earnings of the company. The sum total of retained earnings gets accumulated over the years. This accumulated profits are reinvested in the business rather than distributed as dividend. "The process of accumulating corporate profits and their utilisation in business is called retained earnings." In simple words, a part of net profit, which is not distributed to shareholders as dividend is retained by company in the form of 'Reserve Fund'. Company converts it's reserves into 'bonus share capital' and capitalise it's profit. This capitalisation of profit by issue of bonus shares is known as ploughing back of profit or self-financing.

Bonus shares are issued free of cost to the existing equity shareholders out of the retained earnings. The Management can convert retained earnings into permanent share capital by issuing bonus shares. It is an important source of raising long term capital. It is simple and cheapest method of raising finance. It is used by established companies. It is an internal source of finance. Determinants of retained earnings:

Total earnings of company: If there is ample profit, company can save and retain some parts of profit. More the earnings, a company can save more. Attitude of top management also determines the amount of retained earnings. Taxation Policy: The taxation policy of government is also an important determinant of corporate savings. If the taxes levied are at high rates, company cannot save much of the profits in the form of reserves.

Dividend Policy:

It is a policy of Board of Directors in regards to distribution of profits. A conservative dividend policy is needed for having good accumulation of profit. But this policy affects shareholders as they get dividend at a lower rate.

Government Control: A government is regulatory body of economic system of the country. It's policies, rules and regulations ensures that the companies work as per its regulations. Company has to formulate its dividend policy in accordance with the rules and regulations framed by the Government.

SOURCES OF BORROWED CAPITAL Only owned capital is not sufficient to carry on all business activities of a joint stock company. A company needs borrowed capital to supplement its owned capital. Every trading company is entitled to borrow money. However, it is a normal practice to have an express provision in the Memorandum of Association, enabling a company to borrow money. Memorandum authorises company to exercise borrowing powers whereas Articles of Association provides as to how and by whom these powers shall be exercised. The power to borrow money is normally exercised by Board of Directors of the company. The capital may be borrowed for short, medium or long term requirement. It is better to raise borrowed capital at a later stage of

company's business, when company want to expand or diversify its business and it requires additional capital.
This additional capital can be raised by :
a) issue of debentures
b) Accepting deposits
c) bonds
d) Loans from commercial banks and Financial institutions, etc. Interest is paid on borrowed capital. It is paid at fixed rate. Borrowed capital is repayable after a specific period of time. Debentures Debentures are one of the principal sources of raising borrowed capital to meet long and medium term financial needs. Over the years debentures have occupied a significant position in the financial structure of the companies. The term debenture has come from the Latin word 'debere' which means to 'owe'. The term debenture has not been defined clearly under Companies Act. Palmer defines : "A debenture as an instrument under seal evidencing debt, the essence of it being admission of indebtedness." Features Promise: Debenture is a promise by company that it owes specified sum of money to holder of the debenture. Face Value: The face value of debenture normally carries high denomination. It is ₹ 100 or in multiples of ₹ 100. Time of Repayment: Debentures are issued with the due date stated in the debenture certificate. The principal amount of debenture is repaid on maturity date.
Priority of Repayment: Debenture holders have a priority in repayment of debenture capital over the other claimants of company.
Assurance of Repayment: Debenture constitutes a long term debt. They carry an assurance of repayment on due date. Interest: A fixed rate of interest is agreed upon and is paid periodically in case of debentures. Payment of interest is a fixed liability of the company. It must be paid by company irrespective of the fact, whether the company makes profit or not.
Types of Debentures Debentures
On the basis of security Secured and Unsecured Debentures.
On the basis transfer Registered and Bearer Debentures.
On the basis of repayment Redeemable and Irredeemable Debenture.
On the basis conversion Convertible and Non-convertible Debenture.
Secured debentures: The debentures can be secured. The property of company may be charged as security for loan. The security may be for some particular asset (fixed charge) or it may be the asset in general (floating charge). The debentures are secured through 'Trust Deed'.
Unsecured debentures: These are the debentures that have no security. The issue of unsecured debentures is now prohibited by the Companies Act, 2013.
Registered Debentures: Registered debentures are those debentures on which the name of holders are recorded. A company maintains 'Register of Debenture holders' in which the name, address and particulars of holdings of debenture holders are entered. The transfer of registered debentures requires the execution of regular transfer deed. Bearer Debentures: Name of holders are not recorded on the bearer debentures. Their names do not appear on the 'Register of Debenture holders'. Such debentures are transferable by mere delivery. Payment of interest is made by means of coupons attached to debenture certificate.

Redeemable Debentures: Debentures are mostly redeemable i.e. Payable at the end of some fixed period, as mentioned on the debenture certificate. Repayment can be made at fixed date at the end of specific period or by instalment during the life time of the company. The provision of repayment is normally made in 'Trust Deed'.

Irredeemable Debentures: These kind of debentures are not repayable during life time of the company. They are repayable only after the liquidation of the company, or when there is breach of any condition or when some contingency arises.

Convertible Debentures: Convertible debentures give right to holder to convert them into equity shares after a specific period of time. Such right is mentioned in the debenture certificate. The issue of convertible debenture must be approved by special resolution in general meeting before they are issued to public. These debentures are advantageous for the holder. Because of this conversion right, convertible debenture holder is entitled to equity shares at a rate lower than market value. Non-convertible Debentures: Non-convertible debentures are not convertible into equity shares on maturity. These debentures are redeemed on maturity date. These debentures suffer from the disadvantage that there is no appreciation in value.

Bond Bond is a debt security. It is a formal contract to repay borrowed money with interest. Bond is a loan. The holder of bond is a lender to the institution. He is a creditor of the company. He gets fixed rate of interest. All bonds have maturity date and is paid in cash at certain date in future. According to Webster Dictionary, 'A bond is an interest bearing certificate issued by the government or business firm, promising to pay the holder a specific sum at a specified date.' Thus a company borrows money and issues bonds as an evidence of debt. Interest is payable on bonds at fixed interval or on maturity of bonds. Features Nature of Finance: It is a debt Finance. It provides long term finance. The bonds can be issued for longer period i.e. 5 years, 10 years, 25 years, 50 years. Status of bondholder: The bondholders are creditors. Since they are creditors and non-owners they are not entitled to participate in general meeting. They have no voting right and hence no participation in the management. Return on bonds: The bondholder gets a fixed rate of interest. It is payable at regular interval or on the maturity of bond.

Repayment:

Bonds have specific maturity date on when the principal amount is repaid. American Depository Receipt (ADR) and Global Depository Receipt (GDR) In India, the shares of public company are listed and traded on various stock exchanges like Bombay Stock Exchange (BSE) and National Stock Exchange (NSE). With adoption of free economic policy and due to globalization some of the Indian company's shares are also listed and traded on foreign stock exchanges like New York Stock Exchange (NYSE) or National Association of Securities Dealer Automated Quotation (NASDAQ). To list shares on these stock exchanges, company has to comply with policies of those stock exchanges. The policies of these stock exchanges are different than the policies of Indian Stock Exchanges. Therefore, those Indian companies which cannot list their shares

directly on foreign stock exchanges, get listed indirectly using ADR and GDR. ADR and GDR are Dollar/Euro denominated instrument traded in USA and Europe Stock Exchanges. Indian Company issues shares to an intermediary called 'Depository'. Bank of New York, Citigroup etc. act as foreign Depository Bank. This Depository bank issues ADR and GDR to investors against these shares. The ADR / GDR represent fixed number of shares. These ADR / GDR are then sold to people in foreign country. The ADR / GDR are traded like regular shares. They are listed on stock exchanges. The prices fluctuate depending on demand and supply. Both ADR and GDR are depository receipts, but only difference is the location where they are traded. If the Depository Receipt is traded in USA, it is called American Depository Receipts (ADR) and if it is traded in a country other than USA is called Global Depository Receipts (GDR). Non-Resident Indians (NRI) and Foreign nationals can invest their money in India by purchasing ADR and GDR. They can buy ADR / GDR using their regular equity trading Account. The company pays dividend in home currency to the depository bank and the depository bank converts it into the currency of investor and pays dividend. The exchanges on which GDR is traded are as follows : London stock exchange. Luxembourg Stock exchange. NASDAQ Dubai. Singapore Stock exchange. Hongkong Stock exchange.
Commercial Banks There are number of sources of financing short and medium term business requirements. Among these, commercial bank constitute the most predominant source. Commercial banks play significant role in corporate financing in India. Commercial banks, by introducing variety of deposit schemes tailored to individual depositor's need, mop up savings of people and make use of these savings to meet varied requirements of corporate enterprises.
Commercial banks assist corporate enterprises - By Granting term loans to companies. By subscribing to shares and debentures of companies. By underwriting the issue of securities of the Company. Commercial banks also play an important role in providing short term finance. They have become primary source of financing working capital of the business. In India, primary source of financing working capital are bank credit and trade credit. Banks have introduced many innovative schemes for disbursement of credit.
They are as follows : Overdraft: A company having current account with bank is allowed overdraft facility. The borrower can withdraw funds as and when needed. He is allowed to overdraw on his current account, up to the credit limit which is sanctioned by bank. Within this stipulated limit any number of drawings are permitted. Repayments can be made whenever required during the time period. The interest is determined on the basis of actual amount withdrawn.
Cash Credit: It is also an important and popular form of financial aid. This form of credit is operated in same manner as overdraft facility. The borrower can withdraw amount from his cash credit account up to a stipulated limit based on security margin. Cash credit is given against pledge or hypothecation of goods or by providing alternative securities. Interest is charged on outstanding amount borrowed and not on the credit limit sanctioned.
Cash loans: Under this, the total amount of loan is credited by bank to the borrowers account. Interest is payable on actual balance outstanding. Discounting

bills of exchange: The drawer of the bill i.e. (seller) can receive money from drawee (i.e. buyer) on due date or after the due date. Drawer can receive money before due date by discounting the bill with the bank. This is nothing but selling the bill to the bank. The bank gives money to drawer Development Banks RCTC TDICI TFCI LIC UTI less than the face value of the bill. Thus bill of exchange are trade bills. They are accepted by bank and cash is advanced against them. Financial Institutions First industrial policy was declared in 1948 for rapid industrial development in the country. The Central Government and State Government have established special financial institutions for providing industrial finance. These institutions provide medium and long term finance. The assistance of these institutions has become important for new companies as well as going concerns.

Financial Institutions are classified into four categories as follows.

Financial Institutions in India Development Banks Industrial Development Bank of India (IDBI).

Industrial Finance Corporation of India Ltd. (IFCI)

Industrial Credit and Investment Corporation of India (ICICI)

Small Industries Development Bank of India (SIDBI) Industrial Reconstruction Bank of India (IRBI)

Financial Institutions Risk Capital and Technology Finance Corporation Ltd. (RCTC) Technology Development and Information Company of India Ltd. (TDICI) Tourism Finance Corporation of India Ltd. (TFCI) Investment Institutions Life Insurance Corporation of India (LIC) Unit Trust of India (UTI) General Insurance Corporation of India (GIC) GIC SFC SIDC Financial Institutions Investment Institutions State Level Institutions IDBI IFCI ICICI SIDBI IRBI State Level Institutions State Finance Corporations (SFC) State Industrial Development Corporation (SIDC) Above mentioned institutions provide financial assistance in the following forms : To provide term lending facilities. To subscribe to shares and debentures. To underwrite the issue of securities. To lend money. To guarantee term loans raised by company. Trade Credit No business can be run without ‘credit’. Credit is the soul of business. Trade credit financing is major source of short term financing. Manufacturers, wholesalers and suppliers of goods or materials are called ‘trade creditors’. They sell tangible goods to other business concerns on the basis of deferred payment i.e. future payment credit is extended by these business concerns with an intention to increase their sales. The business firm extends credit, also because of custom that has been built up overtime. Trade credit is not cash loan. It results from a credit sale of goods / services, which has to be paid at a future date after the sale takes place. In other words, when goods are delivered by supplier to a customer and the payment is made after some time, it is called as trade credit. Hire Purchase Hire Purchase is one of the most commonly used modes of financing for acquiring various assets. It aids by spreading the huge cost of an asset over a longer period of time. Thus, it frees a lot of capital to be directed to other important purposes. In case of hire purchase, the buyer pays for an article in periodical instalments but becomes the owner of the article only after the final instalment is paid. Till the final instalment is paid, the seller remains the owner

of the article. However, the buyer gets the possession of the article immediately and can start using it. Also, the buyer has to pay interest in addition to the purchase price on the outstanding amount. If the buyer fails to pay any instalment, the seller can take away (repossess) the article. Hire Purchase – Terminologies

HIRE PURCHASE AGREEMENT: The Purchaser/hirer and the vendor enter into a written agreement known as Hire Purchase Agreement under Hire Purchase Act,1972, which contains the following details: Hire purchaser/Hirer – A person who purchase asset on H.P. basis, also known as Hirer. Hire Vendor – A person who sale assets on H.P. basis Cash price – Original cost of Asset or Price at which asset can be purchase without instalments Down Payment – Initial amount to be paid on agreement Interest – Specific rate of Interest to be charged on balance amount ,Interest charged by vendor on Cash price of Asset H.P. Price = Cash Price + Interest Instalments = H.P. price – Down payment. Balance amount after paying down payment is divided in to equal instalments, which can be Monthly, Quarterly, half yearly or yearly. For e.g. Mr. Nayan purchase motor car from Cars.com Ltd on Hire purchase basis, the price of car is ₹5,00,000 and Mr. Nayan has to pay ₹1,00,000 at the time of signing the agreement and balance in 3 equal instalments. Car.com ltd. Will charge 12% interest p.a. which comes to ₹50,000. Lease Finance Lease financing is a contractual agreement between the owner of the assets (lessor) and user of the assets (lessee), whereby the owner permits the user to economically use the asset on the payment of periodical amount which is in the form of lease rent for a specific period of time. The title of goods remains with the owner (lessor) of the asset. It is the most important source of long term financing. Lease financing is the source of payment which comes when the owner of assets (lesser) ready to provide their assets to another person in exchange of that lessor provides some agreed payment. In this way, the lessor leases the assets for a period of time on rent and lesser gets funds from the lessor. The periodical payment made by the lessee to the lessor is called the lease rental. Under lease financing, the lessee is given the right to use the asset but the ownership lies with the lessor and at the end of the lease contract, the asset is returned to the lessor or an option is given to the lessee either to purchase the asset or to renew the lease agreement. Hirer Mr. Nayan Hire Vendor Car.comLtd Cash price ₹5,00,000 Down payment ₹1,00,000 Interest ₹50,000 H.P. price ₹5,50,000 Instalments = ₹ 5,50,000 - ₹ 1,00,000 = ₹ 4,50,000 Instalment of ₹ 1,50,000 each for 3 months Purpose of Leasing Benefits of Taxes The tax benefit is availed to both the parties, i.e. Lessor and Lessee. Lessor, being the owner of the asset, can claim depreciation as an expense in his books and therefore get the tax benefit. On the other hand, the lessee can claim the MLPs i.e. lease rentals as an expense and achieve tax benefit in a similar way. Avoid Ownership and thereby Avoiding Risks of Ownership Ownership is avoided to avoid the investment of money into the asset. It indirectly keeps the leverage low and hence opportunities of borrowing money remain open for the business. A Lease is an off-balance sheet item. Advantages • A lease contract is often worked over a longer period than a bank loan • Cash Flow for business, especially a start-up will not be affected by massive outlay for Capital Expenditure. • Lease payments

are tax deductible business expense • It is easier to get leasing finance with poor credit rating • Leasing terms are lower than using another form of capital financing Disadvantages • Relatively high cost of lease. • More burden with interest rates decline in market. • Miscellaneous expenses are owned by lessee. • No capital gains when asset prices are poorer. Financial Lease V/s Operating Lease Financial Lease Operating Lease

1. A Commercial contract in which lessor lets the lessee to use an asset in lieu of periodical payments for usually long period of time. 1. A Commercial contract in which lessor lets the lessee to use an asset in lieu of periodical payments for usually Short period of time.

2. The ownership is transferred to the lessee. 2. The ownership remains with lessor. 3. The contract is called loan agreement.

3. The contract is called rental agreement.

4. The lessee would need to take care and maintain the asset. 4. The lessor would need to take care and maintain the asset.

5. The risk of obsolescence lies on the part of lessee. 5. The risk of obsolescence lies on the part of lessor.

6. It is also termed as Full – pay out lease. 6. It is termed as Service lease 7. For e.g. Hiring Taxi

7. For e.g. Aircrafts, Buildings, Railway wagons.

7 Commercial Papers Commercial paper is an unsecured, short period debt tool issued by a company, usually for the finance and inventories and temporary liabilities. The maturities in this paper do not last longer than 270 days. These papers are like a promissory note allotted at a huge cost and exchangeable between the All-India Financial Institutions (FIs) and Primary Dealers (PDs). Most of the commercial paper investors are from the banking sector, individuals, corporate and incorporated companies, Non-Resident Indians (NRIs) and Foreign Institutional Investors (FIIs), etc. However, FII can only invest according to the limit outlined by the Securities and Exchange Board of India (SEBI) In India, commercial paper is a short-term unsecured promissory note issued by the Primary Dealers (PDs) and the All-India Financial Institutions (FIs) for a short period of 90 days to 364 days. Commercial Paper in India On 27th March 1989, commercial paper in India was introduced by RBI in the Indian money market. It was initially recommended by Vaghul working Group on the basis of the following points. • The registration of commercial papers should only be granted to companies having Rs. 5 cores and above net worth with excellent dividend payment record. • The market should follow the CAS discipline. The RBI should manage the paper amount, entry of the market, and total quantum which can be upgraded in a year. • No limitation on the commercial paper market apart from the least size of the note. However, the size of one issue and each lot should not be less than Rs. 1 crore and Rs. 5 lakhs respectively. • It should be eliminated from the provision of insecure advances in the state of banks. • The paper can be made in terms of interest or at a discount rate to face value. • It should not be compelled to stamp duty while issuing and transferring. Types of Commercial Paper According to the Uniform Commercial Code (UCC),
commercial papers are divided into four different types.

Draft – It is written guidance by an individual to another and to pay a stipulated sum to a third party. Check – It is a unique draft where the drawee is a bank. Note – Here, an individual is promised to pay another individual or bank a particular amount. Certificates of Deposit – In this type, a bank confirms the receipt of deposit. According to security, there are two types of commercial papers Unsecured Commercial Papers – These are traditional papers and allotted without any security. Secured Commercial Papers – It is also known as Asset-Backed Commercial Papers (ABCP) and assured by other financial assets. Advantages of Commercial Paper Contributes Funds –
It contributes extra funds as the cost of the paper to the issuing company is cheaper than the loans of the commercial bank. Flexible
– It has a high liquidity value and flexible maturity range giving it extra flexibility. Reliable
– It is highly reliable and does not have any limiting condition. Save Money
– On commercial paper, companies can save extra cash and earn a good return. Lasting Source of Funds
– Maturity range can be customised according to the firm's requirement, and matured papers can be paid by selling the new commercial paper. Venture Capital Financing Entrepreneurs need investments for their start-up companies. The investments or the capital that these entrepreneurs receive from wealthy investors is called Venture Capital and the investors are called Venture Capitalists. VC firms reduce the risk of investments by co-investing with other VC firms. Usually, there will be the main investor called the 'lead investor' and other investors will be called 'followers'.
How does Venture Capital Fund work?
• Venture Capital Fund is made up of investments from wealthy individuals or companies who give their money to a VC firm to manage their investment portfolios for them and to invest in high-risk start-ups in exchange for equity.
• The basic idea is to invest in a company's balance sheet and infrastructure.
• Venture Capitalist nurtures the idea of an entrepreneur for a short period of time and exits with the help of an investment banker.
• In a start-up company, VC will receive an equity partnership in exchange for investments in the start-up company.
• VC's receive liquidation preference, it means in the worst-case scenario where the company fails, VCs are given the first claim to all the company's assets and technology. It also offers voting rights over key decisions like Initial Public Offer (IPO) or even sale of the company.
Advantages of Venture Capital
1. Banks usually prefer to finance a new business which has hard assets. In the current information based economy, new start-ups hardly have any hard asset. Venture Capitalists step in under these circumstances.
2. They can provide more insights into the market.
3. Can help in strategy formulation.
4. Can help in developing strategic networks Merchant Banking Merchant Banking is a combination of Banking and consultancy services. It provides consultancy to its clients for financial, marketing, managerial and legal matters.

Consultancy means to provide advice, guidance, and service for a fee. It helps a businessman to start a business. It helps to raise (collect) finance. They help to expand and modernize the business. It helps in the restructuring of business. This helps to revive sick business units. It also helps companies to register, buy and sell shares at the stock exchange. Merchant Bank is defined as "A Merchant Bank could be best defined as a financial institution conducting money market activities and lending, underwriting and financial advice, and investment services whose organization is characterized by a high proportion of professional staff able to able to approach problems in an innovative manner and to make and implement decisions rapidly." It is skill-based activities and involves serving every financial need of every client. It requires a focused skill-base to provide for the requirements of the client. SEBI has made the quality of manpower as one of the criteria for registration as the merchant banker. These skills should not be concentrated in issue management and underwriting alone, which may hurt business. Merchant bankers can turn to any of the activities mentioned above depending upon resources, such as capital, foreign tie-ups for overseas activities and skills. The depth and sophistication in merchant banking business are improving since the avenues for participating in capital market activities have widened from issue management and underwriting to private placement, bought out deals (BODS), buyback of shares, mergers, and takeovers. Functions of Merchant Banking Organization: 1] Portfolio Management: Merchant banks provide advisory services to institutional investors, on account of investment decisions. They trade in securities, on behalf of the clients, to provide the portfolio management services. 2] Raising funds for clients: Merchant banking organization assists the clients in raising funds from the domestic and international market, by issuing securities like shares, debentures, etc., which can be deployed for starting a new project or business or expansion activities. 3] Promotional Activities: One of the most important activities of merchant banking is the promotion of a business enterprise, during its initial stage, right from conceiving the idea of obtaining government approval. There is some organization, which even provides financial and technical assistance to the business enterprise. 4] Loan Syndication: Loan Syndication means service provided by the merchant bankers, in raising credit from banks and financial institutions, to finance the project cost or working capital of the client's project, also termed as project finance service. 5] Leasing Services: Merchant Banking organizations render leasing services to their customers. There are some banks which maintain venture capital funds to help entrepreneurs.

Financial Goal Setting

Introduction: Financial Goal of a Business The financial goal of a business is to maximise the shareholder's wealth through sound financial decisions.

This may be achieved by: - Investing in assets that add value (prudent) - Keeping cost of capital as low as possible. Financial theory rests on the promise that goal of a firm should be to maximise the value of the firm to its equity shareholders. This means that the goal of the firm should be to maximise the market value of its equity shares – which represents the value of firm to its equity shareholders. Maximisation of the wealth of shareholders appears to be the most appropriate goal for financial decision-making.

Economic Value Added (EVA

) Economic Value Added (EVA) is a value based performance measure that gives importance on value creation by the management for the owners. Profit maximization as a concept is age-old, wealth maximization is matured and value maximization is today's wisdom. Economic Value Added (EVA) is the financial performance measure that comes closer than any other to capturing the true economic profit of an enterprise. Thus, in modern economics and finance area, EVA holds an important part that has less debate among practitioners. It is the performance measure most directly linked to the creation of shareholders wealth over time. Shareholders are very much choosy for their interest into the business and they like management to come up with very specific solution. By the time, it is established that the very logic of using EVA is to maximize the value for the shareholders. More explicitly, EVA measure gives importance on how much economic value is added for the shareholders by the management for which they have been entrusted with.

We know accounting; more often produces historical data or distorted data that may have no relation with the real status of the company. But, EVA goes for adjustments to accounting data to make it economically viable. Under conventional accounting, most companies appear profitable but many in fact are not. Peter Drucker put the matter in a Harvard Business Review article, "Until a business returns a profit that is greater than its cost of capital, it operates at a loss. Never mind that it pays taxes as if it had a genuine profit. The enterprise still returns less to the economy than it devours in resources…until then it does not create wealth; it destroys it." Company may intentionally pay tax to prove that they have made profit for their shareholders and thus a falsification is done with owners that is not a rare corporate practice. EVA corrects this error by explicitly recognizing that when managers employ capital they must pay for it, as if it were a wage. It also adjusts all distortions that are very much prevalent in the information generated by conventional accounting. Thus, it is the most demanded tool for the owners in every situation. It has been implemented in numerous large companies to motivate managers to create shareholder value. The decision role is very simple; if the EVA is positive, the company creates shareholder wealth. Negative EVA indicates that shareholder wealth is destroyed.

EVA is not a new discovery. An accounting performance measure called residual income is defined to be operating profit subtracted with capital charge. EVA is thus one variation of residual income with adjustments to how one calculates income and capital. Economic Value Added (EVA) is a measure of financial performance based on the concept that all capital has a cost and that earning more than the cost of capital creates value for shareholders. It is after-tax net operating profit (NOPAT) minus a capital charge. It is true economic profit consisting of all costs including the cost of capital. If a company's return on capital exceeds its cost of

capital it is creating true value for the shareholder. EVA is the amount of economic value added for the owners by management. The thrust area for today's management is to find means to create value for the owners. In other words, accounting profit is required to be converted into economic profit. Under EVA, all distortions in conventional accounting are identified and accounting profit is adjusted to make it distortion free and finally we get the amount of EVA. Stewart defined EVA as Net Operating Profit After Taxes (NOPAT) subtracted with a capital charge.

EVA = NOPAT – COCE = NOP (1-T) - Capital employed × Cost of Capital = Adjusted NOP (1-T) - Capital employed × WACC Where, NOPAT = Net Operating Profit After Tax COCE = Cost of Capital Employed For e.g. Cost of Capital = 12%, Capital Employed ₹ 1000, Net Gain ₹ 130 EVA = NOPAT – COCE = ₹ 130 – ₹ 120 (₹1000 x 12%) = ₹ 10 This is addition to Shareholder's wealth due to management hard work. Net Operating Profit After Tax (NOPAT) is calculated as follows: Net profit available to Equity Shareholders Add: Interest Expense (1 - Tax rate)

Add: Amortisation of Goodwill Add: Non recurring (unusual) losses or expenses Less: Non recurring (unusual) gains Alternatively, NOPAT = Operating Income x (1 – Tax rate) SYBIM SEM III Financial Management I Nimish sir Capital Employed is calculated as follows: EQUITY SHARE CAPITAL + PREFRENCE SHARE CAPITAL + RES & SURPLUS – MISCELLANEOUS EXPENDITURE + BORROWED FUNDS OR Capital Employed = Total Assets – Current Liabilities Time value of Money If you invest $100 (the present value) for 1 year at a 5% interest rate (the discount rate), then at the end of the year, you would have $105 (the future value). So, according to this example, $100 today is worth $105 a year from today.

The time value of money (TVM) is the concept that money you have now is worth more than the identical sum in the future due to its potential earning capacity. This core principle of finance holds that provided money can earn interest, any amount of money is worth more the sooner it is received. The time value of money (TVM) is an important concept to investors because a ₹ on hand today is worth more than a ₹ promised in the future. The ₹ on hand today can be used to invest and earn interest or capital gains. Today's ₹ is worth more than tomorrow's because of inflation and compound interest. Inflation increases prices over time, which means that each ₹ you own today will buy more in the present time than it will in the future. The time value of money is important because it allows investors to make a more informed decision about what to do with their money. The TVM can help you understand which option may be best based on interest, inflation, risk and return. Money has time value because of the following reasons: Risk and Uncertainty. Future is always uncertain and risky. ... Inflation: In an inflationary economy, the money received today, has more purchasing power than the money to be received in future. Consumption and Investment opportunities.

Present value (PV) - This is your current starting amount. It is the money you have in your hand at the present time, your initial investment for your future. Future value (FV) - This is your ending amount at a point in time in the future. The value of money, as revealed by the money market, is variable. A change in money demand or a change in the money supply will yield a change in the value of money and in the price level. ... It takes more bills to purchase goods and services, and thus the price level increases accordingly. Future Value (Simple Interest) = Po + Po (I) (n) Where, Po = Present value OR Principle Amount i= Interest n= No.

of years Future Value (Compound Interest) = Po (1 + i) n - Annually = Po (1 + i /m) m x n - Semi Annually Discounting Discounting is the process of determining the Present Value of a payment or a stream of payments that is to be received in the future. Given the time value of money, a dollar is worth more today than it would be worth tomorrow. Discounting is the primary factor used in pricing a stream of tomorrow's cash flows. From a business perspective, an asset has no value unless it can produce cash flows in the future. Stocks pay dividends. Bonds pay interest, and projects provide investors with incremental future cash flows. The value of those future cash flows in today's terms is calculated by applying a discount factor to future cash flows.

• Discounting is the process of determining the present value of a future payment or stream of payments.

• A dollar is always worth more today than it would be worth tomorrow, according to the concept of the time value of money.

• A higher discount indicates a greater the level of risk associated with an investment and its future cash flows. Discount Rate A discount rate is the rate used to discount future cash flows back to their present value. In corporate finance, cash flows are normally discounted at a company’s weighted average cost of capital (WACC), its hurdle rate, or the required rate of return. Where: FV is used to denote the future value of cash flow r is used to denote the discount rate t is used to denote the time period that an investment will be held for The present value can also be the sum of all future cash flows discounted back. It is known as the Net Present Value (NPV). Consider a future cash flow of $100, which is set to be received in four years. The discount rate is given at 15%. What is the present value?

NUMERICALS-

PARTICULARS	RS IN LAKHS	RS IN LAKHS

Sales	500	
Interest on investments	10	
Profit on sale of old Assets	5	
Total Income		515
Less Manufacturing cost	180	
Administration cost	60	
Selling and Distribution cost	50	
Depreciation	30	
Loss on sale on old M/C	5	
EBIT		325
Less: Interest		190
EBT		20
Less: Tax (30%)		170
PAT EPS (119 Lakh/5 Lakh)		51
PE RATIO		119
		Rs.23.8
		2

BALACE SHEET (RS IN LAKHS)

PARTICULARS	RS	ASSETS	RS
Equity Capital (Rs. 10 share)	50	Building	80
Retained earnings	40	Machinery	70
Long term loan	60	Stock	10
Creditors	15	Debtors	12
Provisions	13	Bank	6
TOTAL	178	TOTAL	178

The cost of Equity and cost of debt is 10% and 12% respectively. The Company pays 30% corporate tax.

From the information given you are required to calculate the EVA so calculate MVA on the basis of Market Value of Equity capital.

2. Calculate EVA from the following data for the year ended 31st March 2003.

Average Debt (Rs Crs.)	50
Average equity (Rs. Crs.)	
Cost of debt (Post Tax)	2766
Cost of Equity	7.72%
Profit after tax, before exceptional item	16.54%
Interest	
	1541
	5

3. Calculate EVA from the following for the year ended on 31st March 2010:

Average Debt	25 cr.
Average equity	2500 cr.
Cost of debt	8%
Cost of Equity	15%
Profit after tax	12 cr
Interest	4cr

4. From the following date pertaining to XYZ Ltd. for the year ended 31st March 2016, you are required to calculate the missing figure:

Particulars	
Sales value	20,00,000
Income	4,00,000
Average Investment	5,00,000
Sales Margin (%)	?
Capital turnover (times)	?
Rol (%)	?
EVA (RS)	?
WACC	8%

5. The Following information is Available to Tata Steel o. Ltd. Calculate EVA:

4% Debts Capital	3000 (in lakhs)
Equity Capital	800(in lakhs)
Reserve and Surplus	6200(rs lakhs)
Risk Free Rate	9%
Bata Factor	1%
Market Rate of Return	19%
Equity (market) Risk Premium	10%
Operating profit After Tax	2400(Rs in lakhs)
Tax Rate	35%

6. The Capital structure of BHEL Ltd. is as under:
   • 80,00,000 Equity shares of Rs. 10each = Rs 800 Lakhs
   • 1,00,000 12% Preference Shares of Rs 250 each = 250 Lakhs
   • 1,00,000 10% debentures of Rs. 500 each = 500 lakhs.
   • 10% term loan from bank = 450 lakhs.
   The Company's Profit and Loss Account for the Year showed a balance PAT of Rs. 110 Lakhs, after appropriating Equity Dividend at 20%. The company is in the 40% tac bracket. Treasury bonds carry 6.5% interest and beta factor for the company may be taken at 1.5 The long run market rate of return may be taken at 16.5%. Calculate EVA.
7. Calculate the EVA from the following information of HFC Ltd.

Capital Employed	1000 cr
Debt Equity Ratio	1:4
Cost of Equity	18%
Cost of Debt (Pro Tax)	15%
Tax Rate	35%
EBIT	Rs 300cr.

8. Calculate EVA for Seagull Ltd.
   Financial Leverage = 1.40 times
   Cost of Study = 17.50%
   Income Tax Rate = 30%
   Cost of Debenture (Before Tax) = %
9. An investor invests a sum of Rs 12,000 for a period of 3 years at 10% compound interest per annum. How much money would he get back at the end of the three years?

10. Swaraj has invested Rs 1,00,000 in a scheme @ 10% p.a. compounded half yearly. Find out what will the amount become at the end of one year.

11. Sanjana has invented Rs. 25,000 in a scheme @12% p.a. compounded quarterly. Find out what will the amount become at the end of two years.

12. A deposit of Rs 10,000 is made to earn interest @12% p.a. Find out the future value of this deposit if the compounding period is: a) Annually b) Half-yearly c) Quarterly d) Monthly e) Daily

13. An Investor invests Rs 60,000 in Bank Certificates of deposit for 3 years at 8% interest per annum. Calculate the maturity value of the Investment.

14. An Investment of Rs. 40000 made on 1-4-2010 provides inflows as follows:

YEAR	ALTERNATIVE I	ALTERNATIVE II	DISCOUNT FACTOR
1	20000	10000	0.9091
2	10000	20000	0.8264
3	10000	10000	0.7513
4	10000	10000	0.6830

15. Find the present value of the following cash flow and also flow and also state whether the investment is worthwhile if the amount of cash outflow presently is Rs 60,000.

YEAR	CASH FLOW	DISCOUNT FACTOR
1	20,000	0.9091
2	16,000	0.8264
3	20,000	0.7513
4	30,000	0.6830
5	10,000	0.6209

CAPITAL BUDGETING

CAPITAL BUDGETING Meaning: Capital Budgeting is the process of evaluating the investment opportunity. Capital Budgets involves planning of Capital investment decisions. Capital investment involves large expenditure to purchase fixed assets like Machinery which give benefits for many years.

Capital Budgeting considers both Capital outlay as well as financing, Capital Budgeting decisions include Acquisition; Replacement, Expansion and Modernization of Assets. Each Capital Budget has two aspects,

1) Cash is expected to be paid out i.e. Cash Outflow

2) Cash expected in Return i.e. Cash inflow. The Decision of Capital Expenditure is generally taken on the basis of Cash outflow or Cash inflow.

1 Cash Outflow: Cash Outflow means amount out going on account of investment. The sum paid at the time, the expenditure on investment or the initial investment is called Cash outflow period.

It is calculated as follows: Cost of the New Project xxx Add: Installation Charges xx xxx Add: Increase in working capital xx xxx Less: Freed working capital xx xxx Less: Sales proceeds of Assets (after Tax) xx Net Outflow of Cash xxx 2 Cash Inflow : Cash Inflow means estimation of future benefits accruing from the investment proposal.

An investment may increase either by actual receipt of cash or by reducing expenses. It is calculated on cash basis i.e. ignoring not cash item. i.e. depreciation. It is estimated after tax.

It is calculated as follows:

Net Profit / Annual Saving xxx Less: Depreciation xx Net Profit / Annual Saving Before Tax xxx Less: Income Tax xx Net Profit / Annual Saving After Tax xxx Add: Depreciation xx Cash inflow after Tax xxx Salvage is the estimated value of assets at the end of economic life of asset.

It is treated as cash inflow in that your in which it is received. Investment may increase or free some working capital. Increase in working capital will be recovered at the end of Project life and hence it is treated as Cash inflow in year in which it is received. I st Method : Payback Period (PB) The Payback Period is length of time a Project takes to recover its initial cash Outlay. i.e. Original cost of an investment. For e.g. Project Cost is 10 lakhs and Cash flow is 2.5 lakhs it has payback period of 4 yrs.
Payback Period = **Initial Investment** / **Cash Outflow Salvage** / **Cash Inflow**

There are two ways of calculating Payback (PB) period.

a) When Cash in flow are uniform every year : A.P. (4) Investment 1,00,000 depn. on S.L.M. @ 12.5% NIP 15,000 Tax @ 50% (after depn.) Net Profit B. T. 15,000 Less: Tax 7500 N.P.A.T. 7500 Add: Depn
. (100000 @ 12.5%) 12,500 Net Cash inflow 20,000 P. B. P. = Invt. C.F. = 100000 20,000 = 5 yrs.
b) When the Projected Cash inflow are not equal: In such situation payback is calculated by process of cumulating cash inflow till they equate the original Investment.
Payback Period = **Year before Full recovery** + **Unrecovered amount Cash flow during period**

For e.g. Initial cost is 50,000 Annual Inflow after Tax before depreciation 1 2 3 4 10,000 15,000 20,000 25,000 Soln Year Cash inflow Cumulative inflow 1 10,000 10,000 2 15,000 25,000 3 20,000 45,000 4 25,000 70,000 Initial investment is 50,000 which will be received between 3rd and 4th year. i.e. 45,000 will be covered in 3rd Year 5,000 will be covered in 4th year whose cash flow is 25,000 P. B. P. = 3 rd. = 5,000 25,000 = 3 + 1 5⁄years ∴ Payback period is 3 1 5⁄year.
C) Post Payback Profitability: Payback period method neglects the profitability after the excess period of economic life. So that it is suggested that to calculate post payback period of economic life of various project.

If the post payback profit if higher than project is selected. Formula: Post Payback Profit = Total saving - Investment d) Post Payback Profitability Index:
For the purpose of Company surplus saving is converted into index.
Formula: **Post Payback Profitability** = **Post Payback Profit Net Investment** × **100**

For e.g. Project cost 1,00,000 having life of 20 yrs. Average annual earnings before depreciation and Tax 20,000 Tax @ 50% Find out - Payback Period - Post Payback Profitability - Payback profitability Index
Soln → Payback Period Annual Earning 20,000 Less : Depreciation 5,000 N.P.B.T. 15,000 Less : Tax @ 50% 7,500 N.P.B.T. 7,500 Add : Depreciation 5,000 Cash inflow 12,500 Payback Period = Original Invt. / Cash inflow = 1,00,000 / 12,500 = 8 years → Payback Profitability = Total Saving - Investments = (12,500 × 20 yrs.) - 1,00,000 = 2,50,000 - 1,00,000 = 1,50,000 → **Post Payback Profitability** = **Post Payback Profit Net Investment** × **100** = 1,50,000 1,00,000 × 100 = 150 %

IInd Method : Average Rate of Return (A.R.R.) This Method is also called as Accounting Rate of Return. Here, Average Profit after Tax and depreciation expressed as percentage of investment. **A**.**R**. **R**. = **Average Profit after Tax and depreciation Average Capital Invested** × **100** = _____% Where; Average Profit are found by dividing the project's total expected profits by number of years Average Capital Invested is value of = 1 2⁄of Capital Investment + Additional W.C. (Because invt. in W.C. is made throughout the life of F.A.) When Split of working capital and Investment is not given it is usual to take half (1/2) the value of Invt. If salvage value is given then. Average Investment = 1 2⁄(Investment - Salvage) + Additional W.C. + Salvage Salvage is considered because it is also tie up with life of the project. Generally Higher ARR is preferred in Comparison term.
If Predetermine rate of cut-off rate is given ARR > Cut of Rate g Accepted ARR = Cut of Rate g Considered ARR < Cut of Rate g Rejected. IIIrd Method : Discounted Payback Under this Method cash flow in a project are discounted back to present value. Suppose you have invested 100 in to the Bank. Bank provides 10% compounded interest. Then 100 will grow to 110 at end of 1st year & 121 at the end of 2nd year. Therefore, Present Value is 100 & after 2 years i.e. Future value means how much what you got now grow to when compounded at given rate. Present Value g Compounding future value Future Value g Discounted Present value For e.g. You are going to get 10,000 on 1st Jan for 3 years Discount Rate is 10% Find out Present value Year Cash flow future value PVF Discounted Cash flow (P/V) 1 10,000 0.909 9090 2 10,000 0.826 8260 3 10,000 0.751 7510 30,000 24860 (future) (Present) IVth Method : Net Present Value Method (NPV) This Method recognised that cash flow at different points of time differ in value and are comparable only when they are first brought down to a present value. This Method is discount all cash flows to present value at predetermined rate of interest. Present value of the outflows is then deducted from present value of the inflows to arrive at Net Present Value (NPV)

Evaluation: NPV > 0 → Accepted NPV < 0 → Rejected NPV = 0 → Marginally / Consider accepted. Method : Profitability Index It means Net Present Value Method gives value in absolute rupees without relating into the size of Invt. If project involves different outlay than Profitability indeed is used.

P.I. = Present Value of Cash Inflows Present Value of Cash Outflows

For e.g. Initial Investment of 6,000 Year P/V factor Cash flow Present Value 1 0.909 1,000 909 2 0.826 2,000 1,652 3 0.751 3,000 2253 4 0.683 4,000 2,732 Total present value 7,546 Profitability Index = P/V of Cash Inflows P/V of Cash Outflows = 7,546 6,000 = 12.577%.

NUMERICALS-

1.

PARTICULARS	PROJECT P	PROJECT Q	PROJECT R
Cost	80,000	100000	130000
Cash Flows (before tax& depreciation)			
Year 1	20000	60000	100000
Year 2	30000	60000	90000
Year3	40000	60000	80000
Year 4	70000	60000	30000
Year5	70000	60000	20000
	2,30,000	300000	320000
Estimated life	5 years	5 years	5 years
Estimated salvage value	10000	20000	30000
Income tax rate	50%	50%	50%

Depreciation on straight line basis. You are required to:

1) Calculate the payback period of each project.

2) Which projects would be selected if the company specified that payback must be completed within three years?

3) Which project would be selected if they are mutually exclusive, i.e. only one of them can be undertaken?

A Project costs 50,000 and has scrap value of 10,000. Its stream of income before depreciation and taxes during first year through five years is 10,000, 12,000, 14,000, 16,000 and 20,000. Assume a 50% tax rate and depreciation on straight line basis. Calculate accounting rate of return for the project.

4) Calculate the present value for project X which initially costs 2,500 and generates year-end cash flows of 900, 800, 700, 600 and 500 in one through five years. Assume the required rate of return to be 10%.

Year	Discounting factor at 10%
1	0.909
2	0.826
3	0.751
4	0.683
5	0.620

5) A Firm whose cost of capital is 10% is considering two mutually exclusive projects X and Y, the details of which are:

	PV FACTOR	PROJECT X	PROJECT Y

Investment		70000	70000
Cash inflow			
1	0.909	10000	50000
2	0.826	20000	40000
3	0.751	30000	20000
4	0.683	45000	10000
5	0.621	60000	10000
		1,65,000	1,30,000

Compute the net Present Value at 10%, Profitability Index for the two projects.

6) A Company proposes to buy any one of the two machines whose information is as follows:

	MACHINE X	MACHINE Y
Cost	90000	90000
Life	3 years	3 years
Profit after tax		
Year 1	40000	20000
2	50000	70000
3	40000	50000

The Company follows SLM of depreciation. Suggest which machine should be bought on the basis of: a) Pay-Back Period b) Average Rate of Return.

Cost of Capital

: 2 Cost of Capital Introduction: Cost of Capital is the rate of return the firm expects to ear from its investment in order to increase the value of the firm in the market place. In other words, it is the rate of return that the suppliers of capital require as compensation for their contribution of capital. Cost of capital refers to the amount of return a company should have on a specific investment after cost of capital is accounted for. The cost of capital typically determines the rate of return required to persuade investors to finance a capital budgeting project. Cost of capital is judged internally by companies to determine if the resource expenditure is worth pursuing a capital project. Investors judge cost of capital to determine the risk associated with investing money into a capital project
. The cost of capital is heavily dependent on the type of financing used in the business. A business can be financed through debt or strictly through equity. However, most companies employ a mixture of equity and debt to finance their businesses. Therefore, the cost of capital comes from the weighted average cost of all capital sources or the weighted average cost of capital. Companies should only invest in projects that supply an excess of returns that are greater than the cost of their capital. It provides a benchmark, which is required to be met by the end of a project.

Why is cost of capital important? Cost of capital is important for several reasons. Cost of capital is an essential economic and accounting tool that can maximize potential investments for businesses. Here are some of the detailed reasons why cost of capital is important:
• It helps investors assess their options
• It assists capital budgeting decisions since businesses must decide if a project is worthwhile before starting
• It is essential for businesses to design the ideal capital structure of their firm
• It can also be used to evaluate the performance of certain projects as compared to the cost of capital
Source of Cost of Capital The source of capital employed by the firm is usually in the following form: Capital is always associated with COST i.e. Returns Like, Equity Capital Preference Capital Debentures Bank loan Retained Earnings - Opportunity cost The Cost of Capital is the minimum required rate of earnings or the cut-off rate of capital expenditure.

Weighted Average Cost if Capital / Composite Cost of Capital The weighted average cost of capital (WACC) is a calculation of a firm's cost of capital in which each category of capital is proportionately weighted. All sources of capital, including common stock, preferred stock, bonds, and any other long-term debt, are included in a WACC calculation. WACC is the average of the costs of these types of financing, each of which is weighted by its proportionate use in a given situation. By taking a weighted average in this way, we can determine how much interest a company owes for each dollar it finances. Debt and equity are the two components that constitute a company’s capital funding. Lenders and equity holders will expect to receive certain returns on the funds or capital they have provided. Since the cost of capital is the return that equity owners (or shareholders) and debt holders will expect, WACC indicates the return that both kinds of stakeholders (equity owners and lenders) can expect to receive. Put another way, WACC is an investor’s opportunity cost of taking on the risk of investing money in a company. Dividend Interest
A firm's WACC is the overall required return for a firm. Because of this, company directors will often use WACC internally in order to make decisions, like determining the economic feasibility of mergers and other expansionary opportunities. WACC is the discount rate that should be used for cash flows with the risk that is similar to that of the overall firm.
Component of Cost of Capital × Cost of Debt (Kd): The cost of funds raised in the form of Debentures or Borrowings from FI. INTEREST is cost of Debt and it is always calculated

After tax. There are tax deductions available on interest paid, which are often to companies' benefit.
Because of this, the net cost of a company's debt is the amount of interest it is paying, minus the amount it has saved in taxes as a result of its tax-deductible interest payments. × Cost of Equity (Ke): Equity shareholders are Residual owners.

DIVIDEND is the cost of Equity and it is Highest cost of capital. The cost of equity, then, is essentially the amount that a company must spend in order to maintain a share price that will satisfy its investors. × Cost of Preference shares (Kp): The cost of preference shares is fixed in nature and is less risky. × Cost of Retained Earnings (Kr):

Earning generated by a firm if not distributed and retained by the firm increases the shareholders equity. There is no cost of retained earning paid by the co. but it is calculated on opportunity cost of dividend forgone. From the view point of equity shareholders any retained earnings by the firm could have been profitably invested by equity shareholders themselves, had these been distributed to them. Thus there is an opportunity cost involved in retained earnings.

NUMERCIALS

1. Calculate the weighted average cost of capital from the following data.

PARTICULARS	RS
7 % Debentures	130000
8% Preference Shares	70000
Equity Shares (of Rs. 100 Face Value)	600000
	800000

A Dividend of 10% a year has been paid on the equity shares in recent years. All of the company's securities are quoted on the local stock exchange. Assume corporate tax @40%, The Prices of these securities have recently been at par (i.e. market and issue price same).

2. The Arc Company has the following capital structure:

PARTICULARS	RS
Common Shares (4,00,000 shares)	80,00,000
6% Preference Shares	20,00,000
8% Debentures	60,00,000
	160,00,000

The share of the company sells for Rs. 20. It is expected that company will pay next year a dividend of Rs. 2 per share which will grow at7 % for ever. Assume a 35 per cent tax rate.

(a) Compute a weighted average cost of capital based on existing capital structure

(b) Compute the new weighted average cost of capital if the company raises an additional Rs. 40,00,000 debt by issuing 10 per cent debentures. This would result in increasing the expected dividend to Rs. 3 and leave growth rate unchanged, but the price of share will fall to Rs. 15 per share.

(c) Compute the cost of capital if in (b) above growth rate increases to 12 per cent.

3. . EKKA ltd. Has total capital employed of Rs. 75,00,000. The break-up is as under: 15% Debt – 30% 12% Preference capital – 10% Equity capital and retained earnings are in proportion of 3:1 All shares and debt are in units of Rs. 100 each. The tax rate applicable is 40%. Equity Shareholders expect dividend @15%.
Cost of retained earnings is to be considered @10% You are required to ascertained:
(a) Composite cost of capital
(b)If Earnings before interest and tax is Rs. 15,00,000. Calculate: i. EPS ii. Market price of equity shares.

4. P.G. ltd. Has the following capital structure as on 31st March 2002.

PARTICULARS	RS
Ordinary Shares (4,00,000 shares) 10% Preference Shares 14% Debentures	80,00,000 20,00,000 60,00,000

The shares of the company are presently selling at Rs. 20 per share. It is expected that the company will pay next year dividend of Rs. 2 per share which will grow @ 7% forever. Assume tax rate of 40%. You are required to

i. Compute the weighted average cost of capital based on existing capital structure
ii. If the company raises an additional Rs. 40 lakhs debt by issuing 15% debentures, the expected divided at year end will be Rs. 3, the market 3 price per share will fall to Rs. 15 per share, the growth ate remaining unchanged.
Calculate the new weighted average cost of capital

5. AXE Ltd. Has the following capital structure as an 31st March, 2000:

PARTICULARS	RS
10% Debentures 9% Preference Shares Equity Shares of Rs. 100 each Total	3,00,000 2,00,000 5,00,000 10,00,000

The equity shares of the company the quoted at Rs. 102 and the company is expected to declare a dividend of Rs. 9 per share for the year. Required:

(a) Assuring the tax rate applicable to the company to be 50%, calculate the cost of capital State clearly the assumptions you make.

(b) Assuming that the company can raise additional term loan at 12% for Rs. 5,00,000 to finance an expansion, calculate the revised weighted cost of capital. The company's assessment is that it will be in a position to increase the dividend from Rs. 9 per share to Rs. 10 per share, but the business risk associated with new financing may bring down the market price Rs. 102 to Rs. 96 per share.