SATHYABAMA
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SCHOOL OF MANAGEMENT STUDIES

UNIT – I – Financial Management – SBA1106

I. OBJECTIVES OF FINANCIAL MANAGEMENT

Types of finance: public and private finance- Importance and Scope of financial management- Financial decisions- Factors influencing financial decisions - Functions areas of financial management, Functions of a finance manager.

INTRODUCTION

The industrial sector plays a vital role in the economic development of the nation. The development of industrial sector creates huge need of finance. Finance plays an important role in the economic development of a nation. Finance is called the life blood of business. Finance is the money which is used to run a business an activity or any project. Finance manager of a company with the objective to achieve an optimal allocation of scarce resources available to the concern and to maximize shareholder's wealth, mainly performs the following three:

Functions:-

1) **Planning for resources:-** Evaluation of different sources to raise funds

2) **Allocation of resources:-** Evaluation of different investment proposals to deploy funds

3) **Control of resources**: - Evaluation whether funds are being used effectively or not. It basically involves broad range of decision making with within. For this purpose as a foundation the deep knowledge of financial markets, financial statements, theory of risk & return, time value of money, tools for measuring and forecasting firm's activities, etc. are required by the finance manager.

IMPORTANCE OF FINANCE

Finance is regarded as the life blood of a business enterprise. This is because in the modern money-oriented economy, finance is one of the basic foundations of all kinds of economic activities. It has rightly been said that business needs money to make more money. However, it is also true that money be gets more money, only when it is properly managed. Hence, efficient management of every business enterprise is closely linked with efficient management of its finance.

MEANING OF FINANCIAL MANAGEMENT

The term business finance mainly involves, rising of funds and their effective utilization keeping is view the overall objective of the firm. Financial management, therefore, means the entire gamut of managerial efforts devoted to the management of finance-both its source and uses-of the enterprise.

DEFINITION OF FINANCIAL MANAGEMENT

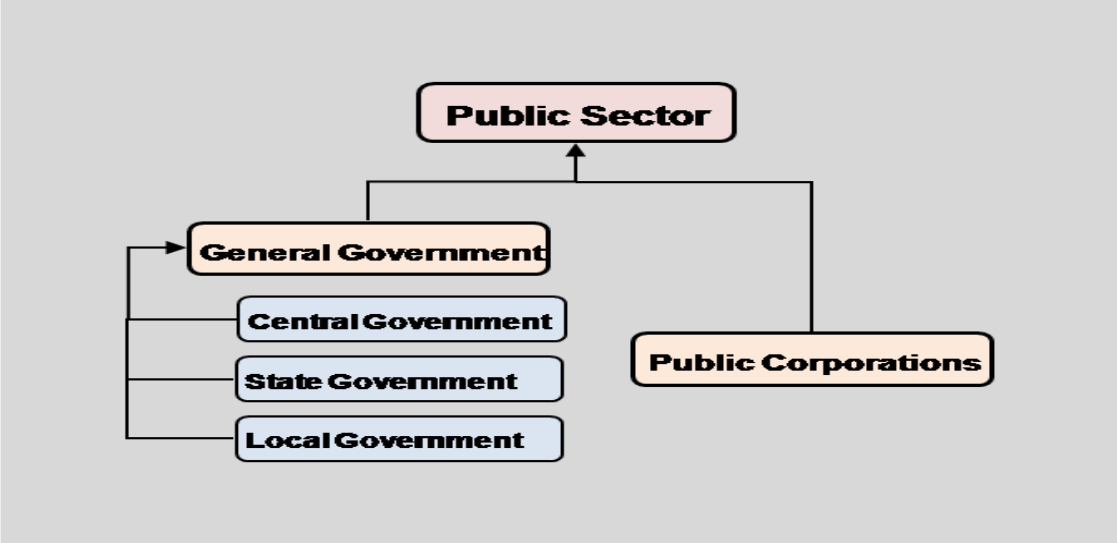
Prof.J.F Bradley defined financial management is an "area of business management devoted to a judicious use of capital and careful selection of sources of capital in order to enable a business firms to move in the direction of reaching its goals".

Prof.H.G. Fathman and **H.E.Dongall,** defined financial management as" the activity concerned with planning, raising, controlling and administration of funds used in the business". According to S**oloman, "**Financial management is concerned with the efficient use of an important economic resource, namely, capital funds".

According to **Phillippatus"** financial management is concerned with the managerial decisions that result in the acquisition and financing of long –term and short-term credits for the firm. As such it deals with the situations that require selection of specific assets (or combination of assets), the selection of specific liability (or combination of liabilities) as well as the problem of size and growth of an enterprise. The analysis of these decisions is based on the expected in flows and out flows of funds and their effects upon managerial objectives".

TYPES OF FINANCE
PUBLICE AND PRIVATE FINANCE

The public sector comprises of all the government owned organizations, all agencies and state offices. The private sector on the other hand refers to all the privately owned businesses, companies, partnerships and the profit and non-profit corporations.



What is Public Finance?

Public finance is the finance sector that deals with the allocation of resources to meet the set budgets for government entities. This branch of economics is responsible for the scrutiny of the meaning and effects of financial policies implemented by the government. This sector examines the effects and results of the application of taxation and the expenditures of all economic agents and the overall economy.

Richard Musgrave, a renown Economics professor, terms Public Finance as a complex of problems that are centered around the income and expenditure processes of the government. Public finance has several branches; public revenue, public expenditure, public debt, budget policy and the fiscal policy.

What is Private Finance?

Private Finance can be classified into two categories the personal finance and business finance. Personal finance deals with the process of optimizing finances by individuals such as people, families and single consumers. A great example is an individual financing his/her own car by mortgage. Personal finance involves financial planning at the lowest individual level. It includes savings accounts, insurance policies, consumer loans, stock market investments, retirement plans and credit cards.

Business Finance involves the process of optimizing finances by business organizations. It involves asset acquisition and proper allocation of funds to in a way that maximizes the achievement of set goals. Businesses can require finances on either of the three levels; short, medium or long term.

Differences between Public and Private Finance

Private: It deals with revenue and expenditure of private sector.

Public: It deals with revenue and expenditure of the government sector (public sector)

Time Period

Public finance is related to one-year time period whereas private finance is concerned with daily, weekly and monthly budget, etc.

Income vs Expenditure

In public, revenue follows expenditure. On the other hand, in private finance expenditure follows revenue.

Deficit Financing

In the case of the deficit budget, Govt. can issue new notes. On the other hand, the private sector has no authority to issue new notes.

Nature of Budget

In the public sector, the deficit budget is appreciable. In the private sector, the surplus budget is appreciable.

Compulsory Loans

The government can take compulsory loans from different financial institutions to meet its expenditure whereas the private sector cannot do it.

Secrecy

A government budget is no more secret, rather Govt. publicizes its budget through T.V, Radio, etc. On the other hand, the private budget is tried to be kept secret.

Nature of Projects

In public finance, Government has to complete long term projects. On the other hand, the private sector has a short terms project to complete.

Written Document

Public budget is a written document whereas the private budget is not a written document.

Audit System

Govt. revenue and expenditure is regularly checked by an audit system. On the other hand, there is no audit system in private finance.

Foreign Assistance

The Government can depend upon foreign assistance but in private finance, there is no chance of any foreign aid.

Direct or Indirect Source of Income

In public finance, the source of income is indirect i.e., various taxes whereas in private finance source of income is direct.

Prior Sanction

Govt. takes prior sanction from its cabinet, national assembly, senate, etc whereas, no prior sanction is required from any authority.

Future Planning

There is long term planning while in private finance short term planning is the motive.

Use of Financial Resources

In public, the main objective is the social welfare of the people whereas, in private resources are used just for maximum personal satisfaction.

Record of Finance

The private may or may not keep the record of its finance whereas Govt. keeps the permanent record of its finance.

NATURE OF FINANCIAL MANAGEMENT

Nature of financial management is concerned with its functions, its goals, trade-off with conflicting goals, its indispensability, its systems, its relation with other subsystems in the firm, its environment, its relationship with other disciplines, the procedural aspects and its equation with other divisions within the organisation.

1. Financial Management is an integral part of overall management. Financial considerations are involved in all business decisions. Hence, financial management is pervasive throughout the organisation.

2. The central focus of financial management is valuation of the firm. That is financial decisions are directed at increasing/maximization/optimizing the value of the firm.

3. Financial management essentially involves risk-return trade-off Decisions on investment involve choosing of types of assets which generate returns accompanied by risks. Generally higher

the risk, returns might be higher and vice versa. So, the financial manager has to decide the level of risk the firm can assume and satisfy with the accompanying return.

4. Financial management affects the survival, growth and vitality of the firm. Finance is said to be the life blood of business. It is to business, what blood is to us. The amount, type, sources, conditions and cost of finance squarely influence the functioning of the unit.

5. Finance functions, i.e., investment, rising of capital, distribution of profit, are performed in all firms - business or non-business, big or small, proprietary or corporate undertakings. Yes, financial management is a concern of every concern.

6. Financial management is a sub-system of the business system which has other subsystems like production, marketing, etc. In systems arrangement financial sub-system is to be well-coordinated with others and other sub-systems well matched with the financial subsystem.

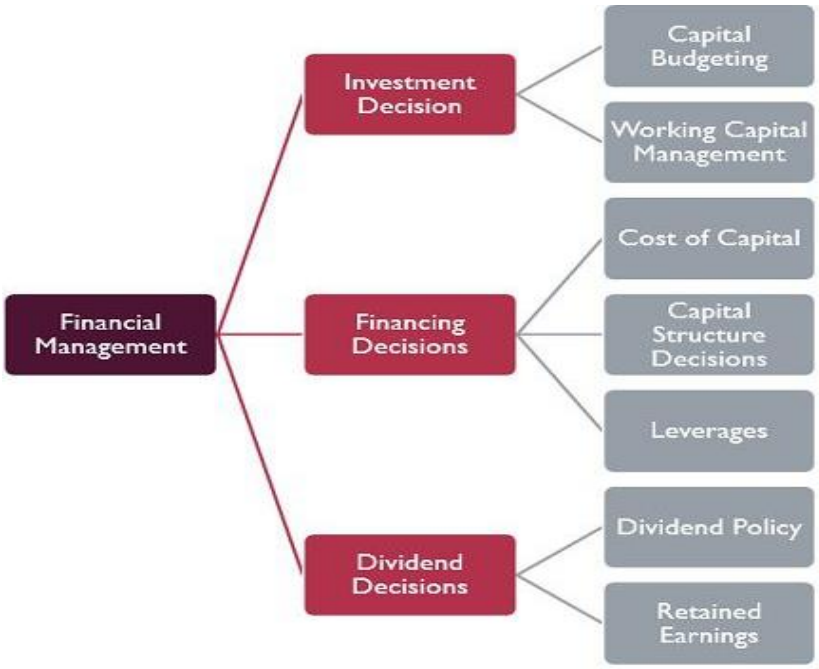
7. Finance is a field within economics that deals with the allocation of assets and liabilities over time under conditions of certainity and uncertainity.

8. Financial management can also be defined as the science of money management.

9. It is primarily based on accounting and economics

10. Secondarily based on production, marketing, HR, statistics, operations research, etc.

SCOPE/FUNCTIONS OF FINANCIAL MANAGEMENT



FUNCTIONAL AREAS OF FINANCIAL MANAGEMENT (OR) DUTIES AND RESPONSIBILITIES OF FINANCIAL MANAGER (OR) **FUNCTIONS OF FINANCIAL MANAGER (OR) ROLE OF FINANCIAL MANAGER. (OR) THREE IMPORTANT FINANCIAL DECISION**

A) Determining financial needs:-

One of the most important functions of the financial manager is to ensure the availability of adequate financing, financial needs have to be assessed for different purposes. Money may be required for initial promotional expenses, fixed capital and working capital needs. Promotional expenditure includes expenditure incurred in the process of company formation.

B) Determining sources of funds:-

The financial manager has to choose source of funds. He may issue different types of securities and debenture, may borrow form a number of finance institutional and the public. The financial manager must definitely know what he is doing, workout strategies to ensure good financial health of the firm.

C) Financial analysis:-

It is the evaluation & interpretation of a firm's financial position and operation and involves a comparison and interpretation of accounting data. The financial manager has to interpret different statements.

D) Optimal capital structure:-

The financial manager has to establish an optimum capital structure and ensure the maximum rate of return on investment and the liabilities carrying – fixed charges has to be defined.

E) Cost –volume profit analysis;-

This is popularly known as the CVP relationship for this purpose are fixed cost, variable cost and semi-variable cost have to be analyzed.

F) Profit planning and control:-

Profit planning and control have assumed great importance in the financial activities of modern business. Profit planning ensures the attainment of stability and growth. The break analysis and cost volume profit it analysis are important tools in profit planning and control of the firms.

G) Fixed assets management:- A firms fixed assets are land, building, machinery and equipment, furniture and such intangibles as patents, copy rights and goodwill. These fixed assets are justified to the extent of the utility or their production capacity.

H) Capital budgeting:-

It refers to the long-term planning for (1) investment in projects and fixed assets and (2) methods of financing the approved projects. It includes the methods of mobilization of long-terms funds and their deployments in profitable projects. Capital budgeting is considered as the process of making investment decisions on capital expenditure.

I) Dividend policies:-

The dividend policy of a firm determines the magnitude of the earnings distributed to share holders. The net operating profit or profit after tax (PAT) has to be intelligently apportioned between divided payments, and investments. The dividend policy determines the amount of dividend payment to be made to the share holders, the date of payments of dividends and the effect of the dividend policy on the value of the firm.

J) Acquisition and merger's:-

A merger is a transaction where two firms agree to integrate their operations on a relatively equal basis because they have resources and capabilities that together may create a stronger competitive advantage. Two or more companies combine to form either a new company or one of the combining companies survives, which is generally the acquirer.

OBJECTIVES OF FINANCIAL MANAGEMENT

- Profit Maximization Approach
- Wealth Maximization Approach

PROFIT MAXIMIZATION

The availability of funds depends upon the kind of commercial strategies adopted by a firm during a particular period of time. Maximization of profit is often considered to be a goal or an alternative goal of a firm.

(i) In favour of profit maximization:-

A) It is a parameter to measure the performance of a business

B) It ensures maximum welfare to the shareholders, employees and prompt payment to the creditors

C) Increase the confidence of management in expansion and diversification.

D) It indicates the efficient use of funds for different requirements.

ii) Against profit maximization

 It is not a clear term like accounting profit, before tax or after tax or net profit or gross profit.

 It encourage corrupt practices

 It does not consider the element of rise

 Time and fair picture of an organization is not reflected

 Attracts cut –throat competition

 Huge profits attracts government intervention

 It invites problem from workers.

 It disturbs the management morale of the customer.

 It affects the long run liquidity of a company.

 Estimating the exact amount of profit is difficult and practical tasks.

WEALTH MAXIMIZATION

Goals of financial management should be beneficial to the owner, customers, employees and management. This can be achieved by maximizing the value of the firm.

Advantages of wealth maximization:-

 It is a clear term

 Net effect of investment and benefits can be measured clearly.

 It considers the time value for money.

 It should be accepted universally

 It guides the management in framing a consistent strong dividend policy to reach maximum return to the equity holders.

Points against wealth maximization

- This concept is useful for equity shareholders not for debenture holders.
- The expectations of workers, consumers and various interest groups create a greater influence that must be respected to achieve long run wealth maximization and also for their survival.

FACTORS INFLUENCING FINANCIAL DECISIONS

1. Trading on Equity

Important Factors affecting capital structure of a company are trading on equity. Trading on equity are the arrangement made to the enterprise to use borrowed funds. These borrowed funds carrying a fixed rate of interest. They are planned in such a way to increase the rate of return on equity shares. Since the preference and debentures carry a fixed return, the companies will operate with a low equity base and borrow more funds, by the way, of external borrowings.

2. Desire to Retain Control

The **main** factors that are affecting capital structure of a company are desire to retain control. The promoters may desire to retain a substantial control over the management within the company. The promoters may seek more of debt financing rather than issuing shares to the public. The debt financing rather consists of debentures; preference shares as such shares do not have normal voting rights.

3. Size of Company

Factors influencing a capital structure of the company are size of the firm. Small companies depend more on owned funds rather borrowed funds. As it finds difficult to obtain long-term loans from financial institutions and banks due to lack of adequate security.

4. Nature of Business

Factors affecting capital structure of a company is nature of business. Companies which are assured of stability, and growth may go for borrowed capital funds as they can pay interest regularly. If the company is of cyclical in nature, then it may go for equity capital than debt financing.

5. Amount of Capital Required

Factors affecting capital structure of a company is the amount of capital required by the firm. If the amount of capital required is less, it can be collected from equity shareholders or by way of borrowed funds. However, if the funds required are large, then the company has to attract different types of investors.

6. Cost of Financing

Factors affecting capital structure of a company is the cost of financing. The company must collect funds at the lowest possible cost. Generally, the cost of collecting money through debentures and bonds is relatively less as compared to the cost of collecting funds by Equity.

7. Growth Rate

Factors affecting capital structure of a company are the growth rate of finance. The financial requirements of growing firms are high and cannot be met from internal sources. They have to depend heavily on external financing. Thus, such firms rely more on debt capital.

8. Period of Finance

Factors affecting capital structure of a company are the term of finance. If the funds are required for a short period, the company may rely on debentures and fixed deposits. However, if the funds are required for a long period, then the company can go for equity capital.

9. Flexibility

Factors affecting capital structure of a company are flexibility within the firm. If the firm has an ability to raise capital from any source, then it would be advisable to go for borrowed funds rather than more equity. However, the firm must be able to pay interest and installments on time.

10. Profitability

Factors affecting capital structure of a company are profitability to the firm. Firms which are highly profitable use little debt as their fund's requirement can be met from internally generated funds or by retained earnings.

11. Timing

Factors affecting capital structure of a company are timings. Capital Markets go through a cyclical pattern, i.e. boom, recession and recovery. During boom period, investors prefer equity. There are chances of collecting equity at a premium. During recession, investors are not inclined towards equity; they prefer debentures and fixed deposits.

12. Taxes

Factors affecting capital structure of a company are taxes laid on the firm.

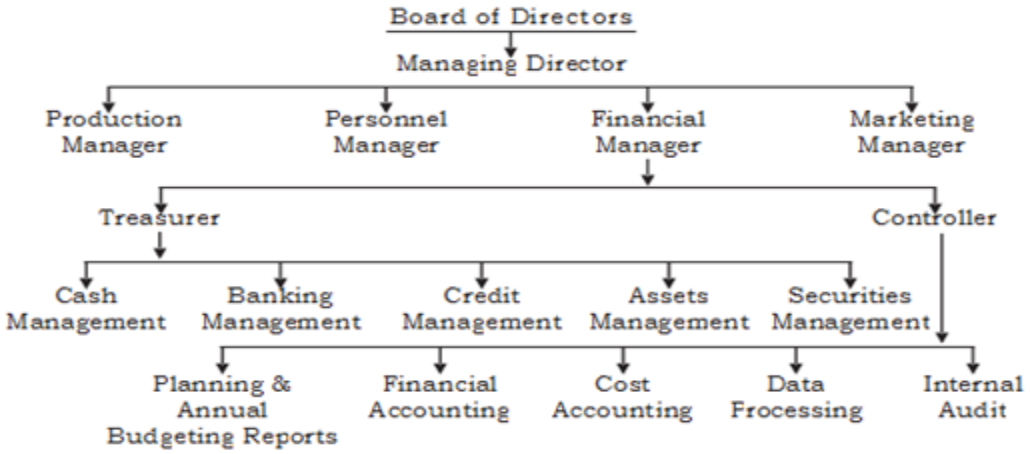
13. Attitude of Lenders

Factors affecting capital structure of a company are taxes laid on the firm. The interest on debt-capital is a tax-deductible expense, whereas dividend payment is not so. hence, higher the tax rate, greater the incentives to employ debt capital.

14. Purpose of Financing

Factors affecting capital structure of a company are the purpose of financing. If the funds are required for purchasing new machinery, then the company may raise money through debentures or term loans, as the company may be able to pay interest on debentures out of profits generated due to use of machinery.

ORGANISATION OF FINANCE FUNCTION



The size and importance of finance decision depends on size of the firm. In small firms, the accounting department generally performs the finance function. As the firm grows, a separate department reporting directly to the top management is created. In medium and large firms, the top financial executive will be either vice president of finance or chief financial officer. In large firms, finance and accounting functions are separated under two different departments

I. TREASURER

A finance treasurer administrator, most often simply called a treasurer, is a senior financial manager charged with managing the cash of a business. They monitor and analyze a company's financial history for the purpose of forecasting and developing future cash management strategies

1. CASH MANAGEMENT

Cash management is the corporate process of collecting and managing cash, as well as using it for short-term investing. It is a key component of a company's financial stability and solvency

2. BANKING MANAGEMENT

Banking Management is a financial institution that serves as a financial intermediary. Banking Management consists of various activities such as deposits, to provide credit, global financial markets, savings, etc

3. CREDIT MANAGEMENT

A credit manager is a person employed by an organization to manage the credit department and make decisions concerning credit limits, acceptable levels of risk, and terms of payment and enforcement actions with their customers.

4. ASSET MANAGEMENT

Asset management refers to systematic approach to the governance and realization of value from the things that a group or entity is responsible for, over their whole life cycles. It may apply both to tangible assets and to intangible assets

5. SECURITIES MANAGEMENT

Security management is the identification of an organization's assets (including people, buildings, machines, systems and information assets), followed by the development, documentation, and implementation of policies and procedures for protecting these assets.

II. CONTROLLER

Financial controllers are responsible for all of the day-to-day operations in the finance department, reporting directly to the finance director. This is a high-level position. Financial controller jobs are usually filled by those from a management or financial accounting background

1. PLANNING AND ANNUAL BUDGETING REPORTS

Annual budget for an organization is prepared for a year and is a comprehensive plan, a coordinated set of detailed financial statement of operating plans and schedule. It is the organization's formal plan of action for the budgeted period.

2. FINANCIAL ACCOUNTING

Financial accounting is a specialized branch of accounting that keeps track of a company's financial transactions. Using standardized guidelines, the transactions are recorded, summarized, and presented in a financial report or financial statement such as an income statement or a balance sheet.

3. COST ACCOUNTING

Cost accounting is the process of recording, classifying, analyzing, summarizing, and allocating costs associated with a process, and then developing various courses of action to control the costs

4. DATA PROCESSING

Data processing refers to the process of performing specific operations on a set of data or a database. A database is an organized collection of facts and information, such as records on employees, inventory, customers, and potential customers.

5. INTERNAL AUDIT

"Internal audit is a dynamic profession involved in helping organisations achieve their objectives. It is concerned with evaluating and improving the effectiveness of risk management, control and governance processes in an organisation. ."

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SCHOOL OF MANAGEMENT STUDIES

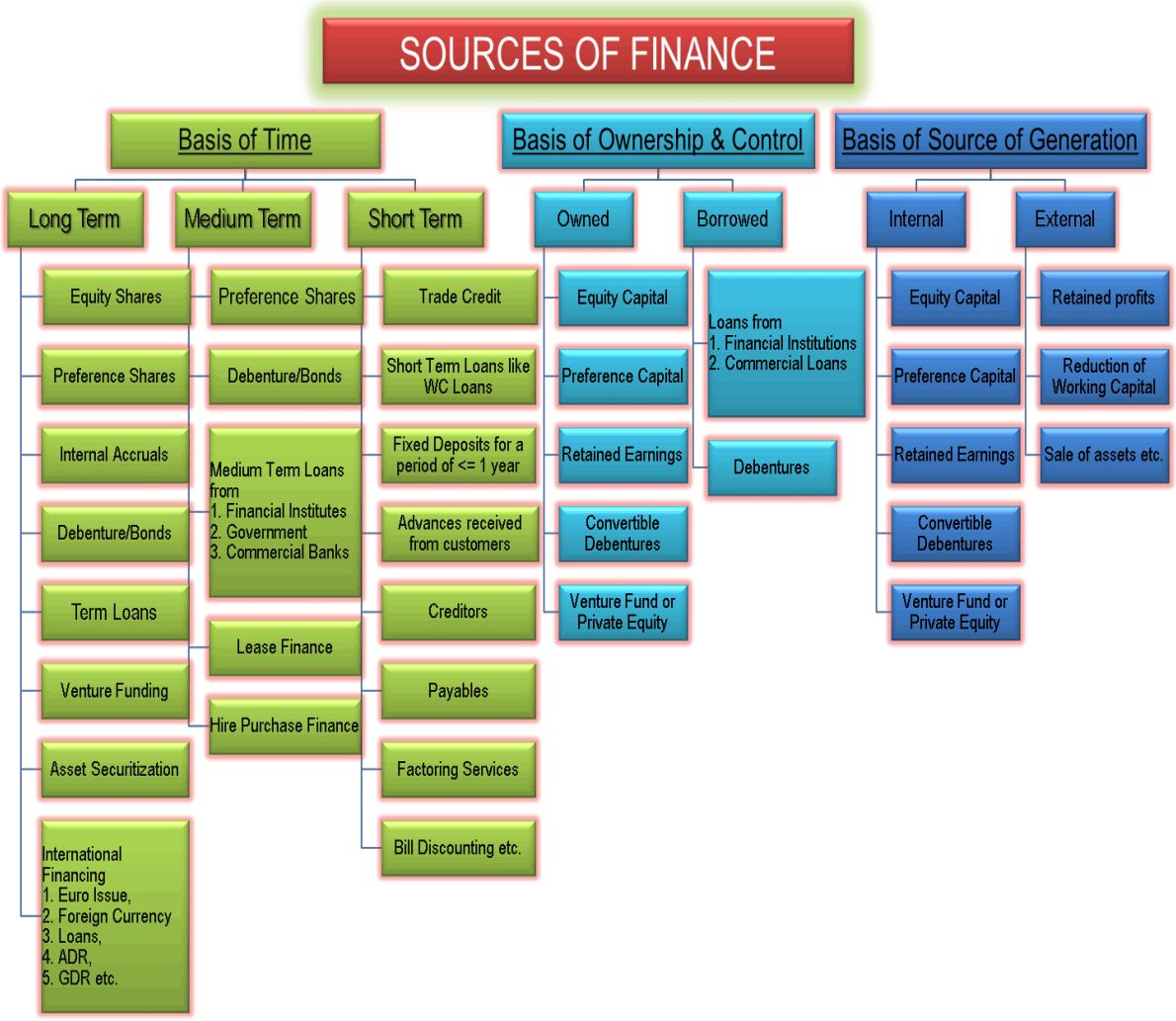
UNIT – II – Financial Management – SBA1106

II. SOURCES OF FINANCE

Ownership securities- Equity shares- Preference shares- Deferred shares- Creditorship securities Debentures- Bonds- Short term and Long term Sources.

MEANING AND DEFINITION

Finding the sources of business finance is the most important aspect when starting a business or a new venture. It needs the maximum effort and dedication. The sources of business finance are categorized based on ownership, time, period, and control, etc., evaluate, and used in different situations.



I. According to Time Period

Sources of financing a business are classified based on the time period for which the money is required. The time period is commonly classified into the following three:

LONG TERM SOURCES OF FINANCE / FUNDS	**MEDIUM TERM SOURCES OF FINANCE / FUNDS**	**SHORT TERM SOURCES OF FINANCE / FUNDS**
Share Capital or Equity Shares	Preference Capital or Preference Shares	Trade Credit
Preference Capital or Preference Shares	Debenture / Bonds	Factoring Services
Retained Earnings or Internal Accruals	Lease Finance	Bill Discounting etc.
Debenture / Bonds	Hire Purchase Finance	Advances received from customers
Term Loans from Financial Institutes, Government, and Commercial Banks	Medium Term Loans from Financial Institutes, Government, and Commercial Banks	Short Term Loans like Working Capital Loans from Commercial Banks
Venture Funding		Fixed Deposits (<1 Year)
Asset Securitization		Receivables and Payables
International Financing by way of Euro Issue, Foreign Currency Loans, ADR, GDR etc.		

1. Long-Term Sources of Finance

Long-term financing means capital requirements for a period of more than 5 years to 10, 15, 20 years or maybe more depending on other factors. Capital expenditures in fixed assets like plant and machinery, land and building, etc of business are funded using long-term sources of finance. Part of working capital which permanently stays with the business is also financed with long-term sources of funds. Long-term financing sources can be in the form of any of them:

- Share Capital or Equity Shares
- Preference Capital or Preference Shares
- Retained Earnings or Internal Accruals
- Debenture / Bonds
- Term Loans from Financial Institutes, Government, and Commercial Banks
- Venture Funding
- Asset Securitization
- International Financing by way of Euro Issue, Foreign Currency Loans, ADR, GDR, etc.

2. Medium Term Sources of Finance

Medium term financing means financing for a period of 3 to 5 years and is used generally for two reasons. One, when long-term capital is not available for the time being and second when deferred revenue expenditures like advertisements are made which are to be written off over a period of 3 to 5 years. Medium term financing sources can in the form of one of them:

- Preference Capital or Preference Shares
- Debenture / Bonds
- Medium Term Loans from
    - Financial Institutes
    - Government, and
    - Commercial Banks
- Lease Finance
- Hire Purchase Finance

3. Short Term Sources of Finance

Short term financing means financing for a period of less than 1 year. The need for short-term finance arises to finance the current assets of a business like an inventory of raw material and finished goods, debtors, minimum cash and bank balance etc. Short-term financing is also named as working capital financing. Short term finances are available in the form of:

- Trade Credit
- Short Term Loans like Working Capital Loans from Commercial Banks
- Fixed Deposits for a period of 1 year or less
- Advances received from customers
- Creditors
- Payables
- Factoring Services
- Bill Discounting etc.

II. According to Ownership and Control

Sources of finances are classified based on ownership and control over the business. These two parameters are an important consideration while selecting a source of funds for the business. Whenever we bring in capital, there are two types of costs – one is the interest and another is sharing ownership and control. Some entrepreneurs may not like to dilute their ownership rights in the business and others may believe in sharing the risk.

OWNED CAPITAL	**BORROWED CAPITAL**
Equity	Financial institutions,
Preference	Commercial banks or
Retained Earnings	The general public in case of debentures.
Convertible Debentures	
Venture Fund or Private Equity	

1. Owned Capital

Owned capital also refers to equity. It is sourced from promoters of the company or from the general public by issuing new equity shares. Promoters start the business by bringing in the required money for a startup. Following are the sources of Owned Capital:

- Equity
- Preference
- Retained Earnings
- Convertible Debentures
- Venture Fund or Private Equity

Further, when the business grows and internal accruals like profits of the company are not enough to satisfy financing requirements, the promoters have a choice of selecting ownership capital or non-ownership capital. This decision is up to the promoters. Still, to discuss, certain advantages of equity capital are as follows:

- It is a long-term capital which means it stays permanently with the business.
- There is no burden of paying interest or installments like borrowed capital. So, the risk of bankruptcy also reduces. Businesses in infancy stages prefer equity for this reason.

2. Borrowed Capital

Borrowed or debt capital is the finance arranged from outside sources. These sources of debt financing include the following:

- Financial institutions,
- Commercial banks or
- The general public in case of debentures

In this type of capital, the borrower has a charge on the assets of the business which means the company will pay the borrower by selling the assets in case of liquidation. Another feature of the borrowed fund is a regular payment of fixed interest and repayment of capital. Certain advantages of borrowing are as follows:

- There is no dilution in ownership and control of the business.
- The cost of borrowed funds is low since it is a deductible expense for taxation purpose which ends up saving on taxes for the company.
- It gives the business the benefit of leverage.

III. ACCORDING TO SOURCE OF GENERATION

Based on the source of generation, the following are the **internal and external sources of finance:**

INTERNAL SOURCES	EXTERNAL SOURCES
Retained profits	Equity
Reduction or controlling of working capital	Debt or Debt from Banks
Sale of assets etc.	All others except mentioned in Internal Sources

1. Internal Sources

The internal source of capital is the one which is generated internally by the business. These are as follows:

- Retained profits
- Reduction or controlling of working capital
- Sale of assets etc.

The internal source of funds has the same characteristics of owned capital. The best part of the internal sourcing of capital is that the business grows by itself and does not depend on outside parties. Disadvantages of both equity and debt are not present in this form of financing. Neither ownership dilutes nor fixed obligation/bankruptcy risk arises.

2. External Sources

An external source of finance is the capital generated from outside the business. Apart from the internal sources of funds, all the sources are external sources.

Deciding the right source of funds is a crucial business decision taken by top-level finance managers. The usage of the wrong source increases the cost of funds which in turn would have a direct impact on the feasibility of the project under concern. Improper match of the type of capital with business requirements may go against the smooth functioning of the business. For instance, if fixed assets, which derive benefits after 2 years, are financed through short-term finances will create cash flow mismatch after one year and the manager will again have to look for finances and pay the fee for raising capital again.

Detailed notes on various sources of finance is given below:

(1) Equity-Shares:

Equity Shares, also known as ordinary shares, represent the ownership capital in a company. The holders of these shares are the legal owners of the company. They have unrestricted claim on income and assets of the company and possess all the voting power in the company.

In fact, the foremost objective of a company is to maximise the value of its equity shares. Being the owners of the company, they bear the risk of ownership also. They are entitled to dividends after paying the preference dividends. The rate of dividend on these shares is not fixed and depends upon the availability of divisible profits and the intention of the directors.

They may be paid a higher rate of dividend in times of prosperity and also run the risk of no dividends in the period of adversity. Similarly, when the company is wound up, they can exercise their claim on those assets which are left after the payment of all other claims including that of preference shareholders.

Advantages of Equity / Ordinary Shares:

(A) Advantages to the Company:

Equity shares offer the following advantages to the company:

(i) Permanent Source of Funds – Equity capital is a permanent capital, and is available for use as long as the company continues. The management is free to utilise such capital and is not bound to refund it.

(ii) Increase in the Borrowing Capacity – The equity capital increases the company's shareholder's funds. Lenders normally lend in proportion to the amount of shareholder's funds. Higher amount of shareholder's funds provides higher safety to the lenders.

(iii) Not Bound to Pay Dividend – A company is not legally bound to pay dividend to its equity shareholders. The payment of dividend depends on the availability of divisible profits and the discretion of directors. A company can reinvest whole of its income, if it so desires.

(iv) No Need to Mortgage the Assets – The company need not mortgage its assets to secure equity capital. Hence, if the company desires to raise further finance from other sources, it can easily do so by mortgaging its assets.

(B) Advantages to Investors:

(i) Right to Control – Equity shareholders are the real owners of the company. They have the right to elect the directors as well as vote in the meetings of the company.

(ii) Increase in Rate of Dividends – In case of higher profits in the company, these shareholders are handsomely rewarded in the form of higher dividends.

(iii) Increase in Market Value – Usually a portion of the profits is ploughed back into the business which results in enhanced earning power of the company and increase in the market value of its shares.

(iv) Bonus Shares – Equity shareholders have a claim on the residual income of the company. This residual income is either directly distributed to them in the form of dividend or indirectly in the form of bonus shares.

(v) Right Shares – Equity shareholders are entitled to get right shares whenever the company issues new shares. The subscription price at which the right shares are offered to them is generally much below the share's current market price.

(vi) Easy to Sell – In comparison to investment in fixed properties, the investment in equity shares is much liquid because the shares can be sold in the market whenever needed.

Disadvantages of Equity Shares:

(A) Disadvantages to the Company:

(i) High Cost of Funds – Equity shares have a higher cost for two reasons. Firstly, as compared to interest, dividends cannot be deducted from the income of the company while calculating taxes. Dividends are paid out of post-tax profits. Secondly, equity shares have high floatation cost in terms of underwriting, brokerage and other issue expenses in comparison to other securities.

(ii) No Advantage of Trading on Equity – If a Company issues only equity shares, it will be deprived of the benefits of trading on equity. For availing the benefit of trading on equity, it is

essential to issue debentures or preference shares with fixed yields lower than the earning rate of the company.

(iii) Manipulation by a Group of Shareholders – Shares of a company can be purchased and sold in the stock market. Hence, a group of shareholders may control the company by purchasing shares and they may use such control for their personal advantage at the cost of company's interests.

(B) Disadvantages to Investors:

(i) Irregular Dividend – Dividend paid on equity shares is neither regular nor at a fixed rate. In case of lower profits, the company can reduce or suspend payment of dividend. In case of higher profits too, the company is not legally bound to distribute dividends. Entire profits may be ploughed back for expansion and development of the company.

(ii) Fall in the Market Value of Shares – If the company does not earn sufficient profits, the shareholders have to bear the loss because of fall in the market value of shares.

(iii) No Real Control over the Company – There are a number of shareholders and most of them are scattered and unorganised. Hence they are unable to exercise effective and real control over the company.

(iv) Ownership Dilution – If the new shares are issued to the public, it may dilute the ownership and control of the existing shareholders. The control of the company may change to new shareholders who may reap the benefits of the company's prosperity and progress.

(v) Loss on Liquidation – In case of liquidation, equity shareholders have to bear the maximum risk. Out of the realised value of assets, first the claims of creditors and then preference shareholders are satisfied, and the remaining balance, if any, is paid to equity shareholders. In most of the cases, equity shareholders do not get anything in case of liquidation.

To conclude, equity shares are the most convenient and popular source of long-term finance for a company. For new company recourse to equity share financing is most desirable because the management is under no legal obligation to pay dividends to shareholders and the management can retain its earnings entirely for their investment in the enterprise.

However, for obtaining further finance in case of any existing company, the management should, as far as possible, avoid issuing equity shares. From investor's point of view, equity shares are riskier as there is uncertainty regarding dividend and capital gains. Investors who desire to invest in safe securities with a regular and fixed income have no attraction for such shares. On the

contrary, the investors who are more ambitious and ready to bear risk in consideration of higher returns prefer these shares.

(2) Preference Shares:

Preference share capital is another source of long-term financing for a company. As the name suggests, these shares carry preferential rights over equity shares both regarding the payment of dividend and the return of capital. These shares carry a fixed rate of dividend and such dividend must be paid in full before the payment of any dividend on equity shares. Similarly, at the time of liquidation, the whole of preference capital must be paid before any payment is made to equity shareholders.

Preference shares give preferential rights to their holders in comparison to equity shares. These shares carry a fixed percent of dividend, which is lower than equity shareholders. The organization pays the dividend on preference shares before paving dividend to equity shareholders. Even during the winding up of the organization, the investment of preference shareholders is paid before equity shareholders.

The characteristics of preference shares are as follows:

i. Do not allow preference shareholders to act as real owners of the organization

ii. Make the repayment of preference shares possible during the existence of the organization

iii. Allow preference shareholders to receive dividends out of profit earned by the organization

iv. Do not bind an organization to offer any asset as security to preference shareholders

v. Carry less risk for investors as compared to equity shares

Following points discuss the different types of preference shares briefly:

i. Cumulative Preference Shares – Refer to the shares for which dividends get accumulated over a period of time. When the organization has sufficient profit, the accumulated dividend of these preference shares is paid.

ii. Non-Cumulative Preference Shares – Refer to the shares for which dividends are not accumulated over a period of time. The organization has to pay dividends on these preference shares at the end of financial year.

iii. Convertible Preference shares – Refer to the shares that can be converted into equity shares after a certain time-period. The holders of convertible preference shares have to pay conversion price at a given date for converting their shares into equity shares.

iv. Non-Convertible Preference Shares – Refer to the shares that cannot be converted into equity shares.

v. Redeemable Preference Shares – Refer to the shares that are repaid by the organization. These preference shares are issued for a fixed time-period and are paid during existence of the organization.

vi. Irredeemable Preference Shares – Refer to the shares that are not paid during the existence of the organization. These preference shares are only paid at the time of liquidation of the organization. At the time of liquidation, these shares are paid after paying all the liabilities.

The advantages of preference shares are as follows:

i. Help in raising more funds as they are less risky

ii. Release preference shareholders from any fixed liability at the time of liquidation of an organization

iii. Save an organization from unnecessary interference of preference shareholders as they do not enjoy any voting right

iv. Facilitate trading on equity

v. Prevent preference shareholders from claiming f or the assets of the organization

The disadvantages of preference shares are as follows:

i. Provide low returns to preference shareholders

ii. Characterize by fluctuations in returns

iii. Do not provide any voting rights to preference shareholders

iv. Do not allow an organization to show the dividend paid on these shares on the debit side of profit and loss account

(3) Ploughing Back of Profits:

A new company can raise finance only from external sources such as shares, debentures, loans etc. But, an existing company can also generate finance through its internal sources, i.e., retained earnings or ploughing back of profits. When a company does not distribute whole of its profits as dividend but reinvests a part of it in the business, it is known as ploughing back of profits or retention of earnings. This method of financing is also known as self-financing or internal financing.

Ploughing back of profits is made by transferring a part of after tax profits to various reserves such as General Reserve, Reserve Fund, Replacement Fund, Dividend Equalisation Fund etc. Such

retained earnings may be utilised to fulfil the long-term, medium-term and short-term financial requirements of the firm.

Advantages:

(i) Economical Method – It is very economical method of financing.

(ii) A Cushion to Absorb the Shocks of the Business – A concern with large reserves can easily absorb the shocks of trade cycles and the uncertainty of market.

(iii) Helpful in Following a Balanced Dividend Policy – Such a company can follow the policy of paying regular and balanced dividends because it can use retained earnings for paying dividends in the years when there are inadequate profits.

(iv) Helpful in Making the Company Self-Dependent – Ploughing back of profits makes the company self-dependent because it has not to depend upon outsiders such as banks, financial institutions, debentures etc.

(v) Increase in the Credit Worthiness of the Company – Since the company need not depend upon outside sources for its financial needs; it increases the credit worthiness of the company.

(vi) Helpful in the Repayment of Long-Term Liabilities – It enables the company to repay its long-term loans and debentures and thus relieves the company from the burden of fixed interest payments.

(B) Disadvantages or Dangers of Excessive Ploughing Back:

(i) Misuse of Retained Earnings – It is not necessary that the management may always use the retained earnings to the advantage of shareholders. They may invest the funds in unprofitable areas or may invest in other concerns under the same management, bringing little gain to the shareholders.

(ii) Over-Capitalisation – Retained earnings are used for the issue of bonus shares which may result to over-capitalisation without any corresponding increase in its earnings.

(iii) Creation of Monopolies – Continuous ploughing back of profits over a long time may lead a company to grow into a monopoly. This is more likely to occur when other companies find it difficult to procure finance from the market whereas an existing concern continues to grow through its retained earnings.

(iv) Manipulation in the Value of Shares – Ploughing back of profits provides the management an opportunity to manipulate the market value of its shares. In the name of ploughing back of profits, they may declare lower dividends and when the share values fall in the market, they may purchase

them at reduced prices. Later, they may increase the rate of dividend out of past profits and may sell their shares at a profit.

(v) Dissatisfaction among the Shareholders – Excessive ploughing back of profits may create dissatisfaction among the shareholders since the rate of dividend is quite low in relation to the earnings of the company.

(vi) Hindrance in the Free Flow of Capital – According to Prof. Pigou, "Excessive ploughing back entails social waste, because money is not made available to those who can use it to the best advantage of the community, but is retained by those who have earned it."

Despite the above disadvantages, the ploughing back of profits is a popular source of long-term finance and is widely used by most of the companies.

(4) Debentures:

A debenture is a form of financial instrument that provides long-term debt to an organization. In other words, a debenture is an agreement between a debenture holder and an organization, which acknowledges that the organization would repay the debt at a specified date to debenture holders. If an organization raises funds through issuing debentures, it needs to pay a fixed rate of interest at regular intervals. Debenture holders of an organization arc known as creditors.

Funds acquired by issue of debentures represent loans taken by the company and are also known as 'debt capital'. A debenture is a certificate issued by a company under its seal acknowledging a debt due by it to its holders. In USA there is a distinction between debentures and bonds. There, the term bond refers to an instrument which is secured on the assets of the company whereas the debentures refer to unsecured instruments.

But, in India no such distinction is made between bonds and debentures and the two terms are used as synonymous. According to Section 2 (30) of the Companies Act, 2013, "the term debenture includes debenture stock, bonds and any other securities of a company whether constituting a charge on the assets of the company or not."

The characteristics of debentures are as follows:

i. Provide no voting rights to debenture holders

ii. Allow debenture holders to receive fixed rate of interest

iii. Facilitate debenture holders to be paid back during the lifetime of an organization

iv. Allow the debenture holders of an organization to transfer bearer debentures to other individuals

v. Increase the liability of an organization

The advantages of debentures are as follows:

i. Involve less cost in raising funds than equity shares

ii. Help in raising funds from investors who are less likely to take risks

iii. Provide fixed returns to debenture holders even if there is no profit

iv. Allow debenture holders to receive payment before equity and preference shareholders even at the time of liquidation of an organization

The disadvantages of debentures are as follows:

i. Compel an organization to pay interest even if there is no profit or loss

ii. Make it difficult for an organization to provide security against debentures if an organization has insufficient fixed assets.

iii. Do not allow debenture holders to vote in the official meetings of the organization and influence the decision.

(5) Loans from Financial Institutions:

Financial Institutions are another important source of long-term finance. In India, a number of special financial institutions have been established by the Government at the national level and state level to provide medium-term and long-term loans to the industrial undertakings.

Financial institutions established at the national level include Industrial Development Bank of India (IDBI), Industrial Finance Corporation of India (IFCI), Industrial Credit and Investment Corporation of India (ICICI), Industrial Reconstruction Corporation of India (IRCI), Unit Trust of India (UTI), Life Insurance Corporation of India (LIC), General Insurance Corporation (GIC) etc.

Financial institutions established at the state level include State Financial Corporations (SFCs) and State Industrial Development Corporations (SIDCs). For example, In Haryana, Haryana State Financial Corporation (HFC) and Haryana State Industrial Development Corporation (HSIDC) have been established.

Characteristics of Loans from Financial Institutions:

(i) Maturity – Maturity period of term loans provided by Financial Institutions ranges between 6 to 10 years.

(ii) Direct Negotiation – Terms and conditions of such loans are directly negotiated between the borrower and the financial institution providing the loan.

(iii) Security – Such loans are always secured. While the assets financed by loans serve as primary security, all the present as well as the future immovable assets of the borrower constitute secondary security.

(iv) Restrictive Covenants – To protect their interests the financial institutions impose a number of restrictive terms and conditions. These are called covenants. These covenants may be in respect of maintaining a minimum current ratio, not to create further charge on assets, not to sell fixed assets without the lender's approval, restrain on taking additional loan, reduction in debt-equity ratio by issuing additional shares etc.

Financial Institutions may also restrict the payment of dividend, salaries and perks of managerial staff. Covenants may also include the appointment of nominee director by financial institutions to safeguard their interests.

(v) Convertibility – Financial institutions usually insist on the option of converting their loans into equity shares of the company,

(vi) Repayment Schedule – Such loans have to be repaid according to predetermined schedule. The common practice in India is the repayment of principal in equal instalments and payment of interest on the outstanding loan.

Advantages and Disadvantages of Loans from Financial Institutions:

Such loans offer all the advantages and disadvantages of debenture financing. An additional disadvantage from borrower's viewpoint is that the loan contracts contain certain restrictive covenants which restrict the managerial freedom. The right of lenders to appoint nominee directors on the board of the borrowing company may further restrict the managerial freedom.

(6) Lease Financing:

A famous quote by Donald B. Grant says, "Why own a cow when the milk is so cheap? All you really need is milk and not the cow." The concept of Lease is influenced by this quote. We can compare 'milk' with the 'rights to use an asset' and 'cow' with the 'asset' itself. Ultimately, a person who wants to manufacture a product using machinery can get to use that machinery under a leasing arrangement without owning it.

A lease can be defined as an arrangement between the lessor (owner of the asset) and the lessee (user of the asset) whereby the lessor purchases an asset for the lessee and allows him to use it in exchange for periodical payments called lease rentals or minimum lease payments (MLP). Leasing is beneficial to both the parties for availing tax benefits or doing tax planning.

Under the lease contract, the owner of the asset surrenders the right to use the asset to another party for an agreed period of time for an agreed consideration called the lease rental. The lessee pays a fixed rental to the lessor at the beginning or at the end of a month, quarter, half year, or year. At the end of the period of lease contract, the asset reverts back to the lessor, who is the legal owner of the asset.

Leasing is, thus, a device of long term source of finance. Lessee gets the right to use the asset without buying them. His position is akin to that of a person who uses the asset with borrowed money. The real position of lessor is not renting of asset but lending of finance and hence lease financing is, in effect, a contract of lending money. The lessee is free to choose the asset according to his requirements and the lessor is actually the financier.

Advantages of Leasing:

(A) Advantages to the Lessee:

(i) Additional Source of Finance – Leasing facilitates the use of assets without making any immediate payment. Thus the scarce financial resources of the business may be preserved for other purposes.

(ii) Simplicity – Borrowing from banks and financial institutions involve time consuming and complicated procedures whereas a leasing contract is simple to negotiate and free from cumbersome procedures.

(iii) Free from Restrictive Covenants – Lease financing is free from restrictive covenants whereas the financial institutions often put a number of restrictions on borrowers, such as, conversion of loan into equity, appoint nominee directors, restrictions on payment of dividend, and so on.

(iv) Flexibility in Fixing the Rentals – Lease rentals are fixed in such a way that the lessee is able to pay them from the cash flows generated from his business operations. Thus flexibility is not available in case of loans from financial institutions where the loans are repaid in instalments resulting in heavy burden in the earlier years of a project, whereas the project may actually generate substantial cash flows in later years.

(v) Safety from the Risk of Obsolescence – In a lease contract, the lessor being the owner of the leased asset bears the risk of obsolescence. Lessee is free to cancel the lease in case of change of technology.

(vi) Benefit of Maintenance – Lessee gets the benefit of maintenance and specialized services provided by the lessor. For example, computer manufacturers who lease out computers provide such services.

(vii) No Effect on Debt-Equity Ratio – Lease is considered a 'hidden form of debt' because neither the leased asset nor the lease liability is depicted on the balance sheet. Lease financing, therefore, does not affect the debt raising capacity of the enterprise.

(viii) Tax Benefits – Lease rentals can be adjusted in such a way that the lessee can reduce his tax liability.

(B) Advantages to the Lessor:

(i) Fully Secured – The lessor's interests are fully secured because he is the owner of the leased asset and can take possession of the asset in case the lessee defaults.

(ii) Tax Benefits – The lessor is entitled to claim the depreciation of leased asset and thus reduces his tax liability.

(iii) High Profitability – Leasing business is highly profitable to the lessor because the rate of return is more than what the lessor pays on his borrowings.

Limitations of Leasing:

(i) Costly Source of Finance – Lease financing is a costly source of finance for the lessee because lease rentals include a profit margin for the lessor as also the cost of risk of obsolescence.

(ii) Restrictions on the Use of Asset – Leasing contracts usually impose certain restrictions on the use of the asset or require compulsory insurance, and so on. In addition, the lessee is not free to make alterations to the leased asset.

(iii) Consequences of Default – Since the lessee is not the owner of the leased asset, the lessor may take over the possession of the same, in case of default in payment of lease rentals,

(iv) Excessive Penalties – Sometimes, lessee has to pay excessive penalties if he terminates the lease before the expiry of lease period,

(v) Not Entitled to Tax-Benefits – Lessee is not entitled to certain tax benefits like depreciation and investment allowance because he is not the owner of the asset.

7) Term Loans:

The terms loans represent a source of debt capital that is normally obtained by companies from term lending institutions. There are term lending institutions sponsored by governments or reputed banks. In India, financial institutions such as the Industrial Development Bank of India (IDBI), Industrial Finance Corporation of India (IFCI), Industrial Credit and Investment Corporation of India (ICICI) or any state level finance corporations like State Finance Corporation (SFC) and commercial banks provide term loans.

Term loans, also referred to as term finance, represent a source of debt finance, which is generally repayable in less than 10 years. They are employed to finance acquisition of fixed assets and working capital margin. Term loans differ from short-term loans which are employed to finance short-term working capital need and tend to be self-liquidating over a period of time usually less than a year.

Characteristics of Term Loans:

The basic characteristics of term loan have been discussed below:

(a) Security:

The term loans are secured loans. Assets which are financed through term loans serve as primary security and the other assets of the company serve as collateral security.

(b) Obligation:

The interest on term loans is a definite obligation that is payable irrespective of the financial condition of the firm. Generally, the financial institutions charge an interest rate that is related to the credit risk of the proposal, subject usually to a certain minimum prime lending rate (PLR) or floor rate. Financial institutions impose a penalty for defaults on the payment of installment of principal and/or interest.

(c) Interest:

The term loans carry a fixed rate of interest, but this rate is negotiated between the borrowers and lenders at the time of disbursing of loan.

(d) Maturity:

The maturity period of term loans is typically longer, in case of sanctions by financial institutions, in the range of 6-10 years in comparison to 3-5 years of bank advances. However, they may be rescheduled to enable corporate borrowers to tide over temporary financial exigencies.

(e) Restrictive Covenants:

Besides asset security, the lender of the term loans imposes other restrictive covenants to the borrower depending upon the nature of the project and the financial condition of the borrowing company. Restrictive covenants are binding legal obligations written in the loan agreement to safeguard the interest of the lender. The borrower may be asked to maintain a minimum asset base, not to raise additional loans or to repay existing loans, restricting the company to sell its key assets without prior approval of the lender, inclusion of the representative of the financial institution in the borrowing company and so on.

(f) Convertibility:

The term loans may be converted into equity at the option and according to the terms and conditions laid down by the financial institutions.

(g) Repayment or Amortization Schedule:

The borrowing company needs to follow a repayment schedule for paying back the term loan to the financial institution. A repayment schedule is a complete table of periodic loan payments that includes an interest amount computed on the unpaid balance of the loan plus a portion of the unpaid balance of the loan. The payment of a portion of the unpaid balance of the loan is called a payment of principal.

There are generally two types of loan repayment schedules:

(i) Equal principal payments and

(ii) Equal instalments.

(i) Equal Principal Payments:

In equal principal payment schedule, the size of the principal payment is the same for every payment. It is computed by dividing the amount of the original loan by the number of payments. For example, the Rs.12,000 loan may be divided by the 12 payment periods each resulting in a principal payment of Rs.1,000 per loan payment. Interest is computed on the amount of the unpaid balance of the loan at each payment period. Because the unpaid balance of the loan decreases with each principal payment, the size of the interest payment of each loan payment also decreases.

(ii) Equal Instalments:

An equal instalment schedule is comprised of a decreasing interest payment and an increasing principal payment. The decrease in the size of the interest payment is matched by an increase in

the size of the principal payment so that the size of the total loan payment remains constant over the maturity period of the loan.

Evaluating Term Loans:

Since, both debenture and term loan are a type of debt financing, they share basic characteristics of a debt and hence their pros and cons are also similar.

The advantages and disadvantages of term loans from the lender's and borrower's point of view are discussed below:

Advantages:

i. From Lender's Point of View:

(a) Term loans are provided by banks and other financial institutions against security because of which the term loans are secured.

(b) It is obligatory on the part of the borrower to pay the interest and repayment of principal irrespective of its financial position. As a result, the lender has a regular and steady income.

(c) Financial institutions may insist the borrower to convert the term loans into equity. Therefore, they can get the right to control the affairs of the company.

ii. From, Management's (Borrower's) Point of View:

(a) It is less costly as a source of finance.

(b) Interest payable on term loan is tax deductible expenditure and thus tax benefit becomes available on interest that renders the cost of debt cheap.

(c) The term loans are negotiable loans between the borrowers and lenders. The terms and conditions of such type of loans are not rigid and this provides some sort of flexibility.

(d) Since term loans do not represent debt financing, neither the control nor the profit sharing of the equity shareholders is diluted.

(e) Debt financing by term loan has fixed installments till the maturity of the loan. In a rising economy with increasing inflation, the effective cost of future installments decreases due to reduction in the value of the currency.

(f) The burden of periodic installments in term loans brings in a discipline in the management for better management of cash flows and other operations.

Disadvantages:

i. From Lender's Point of View:

(a) The terms and conditions of term loans are negotiable between borrowers and lenders and as a result, it may sometimes affect the interest of lenders.

(b) Like other sources of debt financing, the lenders of term loans do not have any right to have direct control over the affairs of the company.

ii. From Management's (Borrower's) Point of View:

(a) Yearly interest payment and repayment of principal is obligatory on the part of borrower. Failure to meet these payments raises a question mark on the liquidity position of the borrower and its existence may be at stake.

(b) Like any other form of debt financing, term loans also increase the financial risk of the company. Debt financing is beneficial only if the internal rate of return of the concern is greater than its cost of capital; otherwise it adversely affects the shareholders.

(c) In addition to collateral security, restrictive covenants are also imposed by the lenders which lead to unnecessary interference in the functioning of the business concern.

Special Types of Debt Instruments:

The ever growing financial requirements of the corporate sector have resulted in an intense competition between them to corner investors' funds. Investors have also become more aware, selective and demanding.

Therefore, it has become essential for the issuer to innovate and introduce new financial instruments to cater to the different needs of the issuers and investors. Most of the new instruments are simply old conventional instruments with some added features.

INTERNAL SOURCES OF FINANCING:

Internal finance is also known as self-financing by a company. Internal finance includes the funds generated within the corporate unit irrespective of the nature of source. These sources are particularly important for small businesses which may find it difficult to get external finance.

In other words, the extent of profitability after tax, the size of dividend payments and the amount of depreciation provided for along with the reserves and surplus all contribute to the sources of internal funds. These funds may be used to finance the cost of acquisition of fixed assets that are needed for expansion, modernization and diversification programmes of the company.

The internal accruals, like depreciation and retained earnings, have been discussed below:

i. Depreciation:

Depreciation means the decline in the value of fixed assets due to use and wear and tear. The objective of charging depreciation is to spread the cost of the fixed asset over its useful life for the purpose of ascertaining the result of operations as well as accumulation of funds for replacement of asset.

It is a source of internal financing which does not affect the working capital of the concern as it does not involve outflow of any cash like other expenses. It is recorded as expenditure in the accounting system of a firm. It is allowed to be deducted while arriving at the net profits of the firm subject to adherence of the percentages of allowable depreciation fixed under the tax laws.

Although depreciation is meant for replacement of particular assets but generally it creates a pool of funds which are available with a company to finance its working capital requirements and sometimes for acquisition of new assets including replacement of worn out plant and machinery.

Depreciation can be a very powerful accounting tool if it is applied with economic wisdom. As assets are depreciated, tax liability decreases. The saved taxes are allowed to accumulate as reserves. This is particularly important in the case of assets where the income tax laws provide for accelerated depreciation.

There exists a controversy whether depreciation should be taken as a source of finance. Whatever may be the outcome of such controversy, the fact remains that the depreciation is a sum that is set apart out of profits and retained within the business. Therefore, it can be used to finance the capital needs in the normal business routine, and as such depreciation in true academic sense can be deemed as a source of internal finance.

ii. Retained Earnings:

A company does not generally distribute all its earnings amongst its shareholders as dividends. A portion of the net profits may be retained in the business for use in the future. This is known as retained earnings. It is also referred to as ploughing back of profit. This is one of the important sources of internal financing used for fixed as well as working capital.

The profits available for ploughing back in an enterprise depend on factors like net profits, dividend policy and age of the organization. The total value of retained profits in a company can be seen in the “equity” section of the balance sheet. Also, the use of retained earnings does not

require compliance of any legal formalities. It just requires a resolution to be passed in the annual general meeting of the company.

The amount of earnings retained within the business has a direct impact on the amount of dividends. The profit reinvested as retained earnings is profit that could have been paid as a dividend. The dividend policy of the company is determined by the directors. From their standpoint, retained earnings are an attractive source of finance because investment projects can be undertaken without involving either the shareholders or any outsiders.

The main characteristics of retained profits are that there is no compulsory maturity like term loans and debentures and they are not characterized by fixed burden of interest or installment payments like borrowed capital.

Evaluating Internal Sources of Finance:

The advantage of having internal accruals like depreciation and retained earnings is clearly seen in their characteristics. **These are discussed below:**

(a) They are cheap although they have an opportunity cost, that is, the return they could have obtained elsewhere. However, the use of internal accruals as opposed to new shares or debentures avoids costs that are associated with fresh issues.

(b) They are very flexible as the management has complete control over how they are reinvested and what proportion is kept rather than paid as dividends.

(c) They do not dilute the ownership of the company. The less the firm relies on external sources of funding, more is the retention of the ownership of the firm. For example, if an expansion or acquisition is allowed with venture capital, the investor might demand part ownership of the firm, rather than simply a share in the profits, including a say in management.

If the firm finds an asset-based lender, who owns those assets which are required by the firm, then upon a default, the lender as part of the agreement may acquire control of the firm in lieu of seizing the assets and causing a shutdown. Dilution of control is an inherent characteristic of financing through issue of equity shares.

(d) Sometimes internal accruals as a source of finance are preferred over the other sources due to the financial and taxation position of the company's shareholders. The capital profits emerging out of retained earnings may be preferred because of taxation considerations. A capital profit is taxed when shares are sold, rather than receiving the profits as dividends, which becomes a part of current taxable income.

(e) They strengthen the financial position of a company and appreciate the capital, which ultimately increases the market value of shares and the wealth of shareholders in case of a growing firm.

(f) The less debt the company has, the more attractive it is to potential investors and buyers. Lower debt improves a company's debt capacity and creditworthiness, as well.

However, there are certain disadvantages of using internal accruals as a source of finance.

These are as follows:

(a) The directors of quoted companies occasionally get criticized for restricting the value of dividends and for hoarding too much cash in the business. If retained profits do not result in higher profits then there is an argument that shareholders could make better returns by having the cash for themselves.

(b) If the purpose for utilization of retained earnings is not clearly stated, it may lead to careless spending of funds.

(c) Sometimes, a conservative dividend policy leads to huge accumulation of retained earnings leading to over-capitalization.

Companies can also raise internal finance by selling off assets for cash. This can include real estate, patents, works of art, and other assets controlled by the company. Sale of assets must be made with care to avoid taking losses or exposing the company to the risk of future losses. When companies are considering new investments, they may compare available sources of finance to determine which would be most appropriate for a new endeavor.

Internal finance can be appealing for certain types of investments, while in other cases, it may be advantageous to tap external financing. The firms that choose to finance through the external sources can retain internal funds to cover the company in an emergency. The board members vote on whether or not new investments should be pursued and the type of financing the company should use.

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UNIT – III – Financial Management – SBA1106

UNIT III CAPITAL STRUCTURE

Capital Structure: Meaning and Determinants of Capital Structure – Need for Optimum Capital Structure- Theories of Capital Structure- Net Income Approach- Net Operating Income Approach- Traditional approach – Capital Structure and EPS

MEANING AND DEFINITION

Capital structure is the permanent financing of the company represented primarily by long- term debt and shareholder's funds but excluding all short-term credit. The term capital structure differs from financial structure.

Financial structure refers to the way the firm's assets are financed. In other words, it includes both, long-term as well as short-term sourced of funds. Thus a company's capital structure is only a part of its financial structure.

Gerstenberg defines capital structure is the combination of debt and equity in the financial statement of a company to remain its market value of the shares unchanged.

James C. Van Horne, "The mix of a firm's permanent long-term financing represented by debt, preferred stock, and common stock equity".

PATTERNS OF CAPITAL STRUCTURE

In case of new company, the capital structure may be of any of the following four patterns:

(1) Capital structure with equity shares only.
(2) Capital structure with both equity and preference shares.
(3) Capital structure with equity shares and debentures.
(4) Capital structure with equity shares, preference shares and debentures

FACTORS AFFECTING CAPITAL STRUCTURE OF THE FIRM

1. Trading on Equity

Important Factors affecting capital structure of a company are trading on equity. Trading on equity are the arrangement made to the enterprise to use borrowed funds. These borrowed funds carrying a fixed rate of interest. They are planned in such a way to increase the rate of return on equity shares. Since the preference and debentures carry a fixed return, the companies will operate with a low equity base and borrow more funds, by the way, of external borrowings.

2. Desire to Retain Control

The main factors that are affecting capital structure of a company are desire to retain control. The promoters may desire to retain a substantial control over the management within the company. The promoters may seek more of debt financing rather than issuing shares to the public. The debt financing rather consists of debentures, preference shares as such shares do not have normal voting rights.

3. Size of Company

Factors influencing a capital structure of the company are size of the firm. Small companies depend more on owned funds rather borrowed funds. As it finds difficult to obtain long-term loans from financial institutions and banks due to lack of adequate security.

4. Nature of Business

Factors affecting capital structure of a company is nature of business. Companies which are assured of stability, and growth may go for borrowed capital funds as they can pay interest regularly. If the company is of cyclical in nature, then it may go for equity capital than debt financing.

5. Amount of Capital Required

Factors affecting capital structure of a company is the amount of capital required by the firm. If the amount of capital required is less, it can be collected from equity shareholders or by way of borrowed funds. However, if the funds required are large, then the company has to attract different types of investors.

6. Cost of Financing

Factors affecting capital structure of a company is the cost of financing. The company must collect funds at the lowest possible cost. Generally, the cost of collecting money through debentures and bonds is relatively less as compared to the cost of collecting funds by Equity.

7. Growth Rate

Factors affecting capital structure of a company are the growth rate of finance. The financial requirements of growing firms are high and cannot be met from internal sources. They have to depend heavily on external financing. Thus, such firms rely more on debt capital.

8. Period of Finance

Factors affecting capital structure of a company are the term of finance. If the funds are required for a short period, the company may rely on debentures and fixed deposits. However, if the funds are required for a long period, then the company can go for equity capital.

9. Flexibility

Factors affecting capital structure of a company are flexibility within the firm. If the firm has an ability to raise capital from any source, then it would be advisable to go for borrowed funds rather than more equity. However, the firm must be able to pay interest and installments on time.

10. Profitability

Factors affecting capital structure of a company are profitability to the firm. Firms which are highly profitable use little debt as their fund's requirement can be met from internally generated funds or by retained earnings.

11. Timing

Factors affecting capital structure of a company are timings. Capital Markets go through a cyclical pattern, i.e. boom, recession and recovery. During boom period, investors prefer equity. There are chances of collecting equity at a premium. During recession, investors are not inclined towards equity; they prefer debentures and fixed deposits.

12. Taxes

Factors affecting capital structure of a company are taxes laid on the firm.

13. Attitude of Lenders

Factors affecting capital structure of a company are taxes laid on the firm. The interest on debt-capital is a tax-deductible expense, whereas dividend payment is not so. hence, higher the tax rate, greater the incentives to employ debt capital.

14. Purpose of Financing

Factors affecting capital structure of a company are the purpose of financing. If the funds are required for purchasing new machinery, then the company may raise money through debentures or term loans, as the company may be able to pay interest on debentures out of profits generated due to use of machinery.

FEATURES OF AN IDEAL CAPTIAL STRUCTURE

1. SIMPLICITY

A complicated capital structure may not be understood by all; on the contrary it may raise suspicions and create confusion. A capital structure must be as simple as possible.

2. PROFITABILITY

The structure should be most profitable to the company. It should minimize the cost of financing and maximize earnings in the company.

3. SOLVENCY

If debt is used in excess, it may lead to affect the solvency of the company. In a sound capital structure debt shall only be a reasonable proportion of the total capital employed in the business.

4. FLEXIBILITY

A sound capital structure shall keep room for expansion or reduction of capital. Usually the increase in capital is not a problem but reduction of capital is very difficult. Equity capital cannot be reduced except in accordance with the provision of companies Act, flexibility can be introduced into capital structure by opting preference shares or debentures as one of the securities to be issued for raising finance.

5. INTENSIVE USE OF FUNDS

A sound capital structure shall provide the concern with sufficient funds needed for operations. It shall not cause surplus or scarcity of capital as both have adversely effect on the profitability.

6. CONSERVATISM

The capital structure shall be conservative in the sense that the debt raising capacity of the concern shall not be exceeded. Capital structure shall generate sufficient cash for future requirements but shall not lead to excessive cash.

7. PROVISION FOR MEETING FUTURE

In periods of depression, it will be difficult to raise funds. Such future contingencies shall be anticipated and capital structure shall make provision for such contingencies. It means keeping less risky securities received for future issues.

8. CONTROL

A sound capital structure ensures that the control over the company remains in the hands of equity shareholders.

9. ECONOMY

The total cost of maintaining the different securities issued shall be kept to minimum. Subject to other constraints, the capital structure selected shall be the most economical.

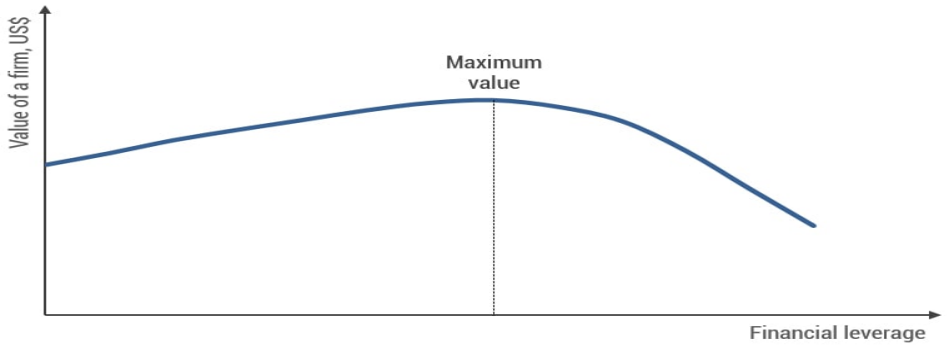
OPTIMUM CAPITAL STRUCTURE

A firm should try to maintain an optimum capital structure with a view to maintain financial stability. This optimum capital structure is obtained when the market value per equity share is the maximum.

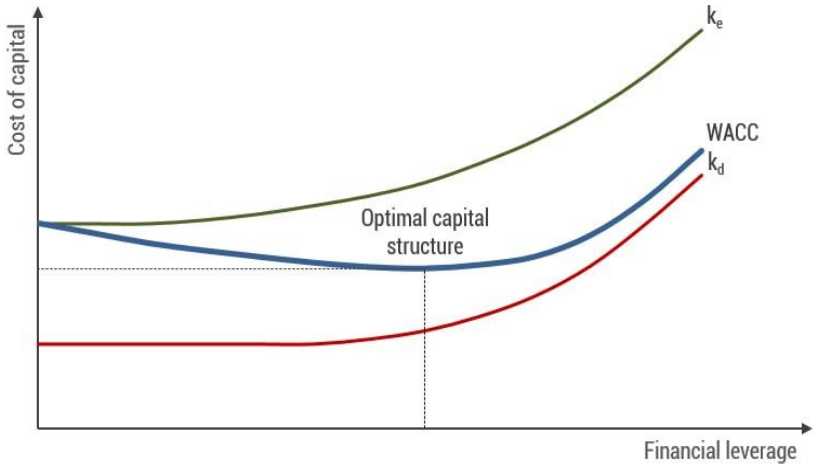
It may, therefore, be defined as that relationship of debt and equity securities which maximizes the value of a company's share in the stock exchange. In case a company borrows and this borrowing helps in increasing the value of the company's shares in the stock exchanges, it can be said that the

borrowing has helped the company in moving towards its optimum capital structure. In case, the borrowing results in fall in market value of the company equity shares, it can be said that the borrowing has moved the company away from its optimum capital structure.

Optimum capital structure is defined as that relationship of debt and equity shares which maximize the Value of the company's share in the market and minimizes the Overall Cost of Capital of the firm. The objective of the firm should therefore be to select a financing or debt equity mix, which will lead to maximum value of the firm and minimum overall cost of capital of the firm.



Value of the firm



Overall Cost of Capital

Need for Optimum Capital Structure

a) Minimized Cost: The primary objective of a company is to maximize the shareholder's wealth through minimization of cost. A well-advised capital structure enables a company to raise the requisite funds from various sources at the lowest possible cost in terms of market rate of interest earning rate expected by prospective investors, expense of issue etc. this maximize the return to the equity shareholders as well as the market value of shares held by them.

b) Maximized Return: The primary objective of every corporation is to promote the shareholders interest. A balanced capital structure enables company to provide maximum return to the equity shareholders of the company by raising the requesting capital funds at the minimum cost.

c) Minimize Risks: A sound capital structure serves as an insurance against various business risks, such as interest in costs, interest rates, taxes and reduction in prices. These risks are minimized by making suitable adjustments in the components of capital structure. A balanced capital structure enables the company to meet the business risks by employing its retained earnings for the smooth business operations.

d) Controlled: Though the management of a company is apparently in the hands of the directors, indirectly, a company is controlled by equity shareholders carry limited voting rights and debentures holders do not have any voting right, a well-devised capital structure ensures the retention of control over the affairs of the company with in the hands of the existing equity shareholders by maintaining a proper balance between voting right and non-moving right capital

e) Liquid: An object of a balanced capital structure is to maintain proper liquidity which is necessary for the solvency of the company. A sound capital structure enables a company to maintain a proper balance between fixed and liquid assets and avoid the various financial and managerial difficulties.

f) Optimum Utilization - Optimum utilization of the available financial resources is an important objective of a balanced financial structure. An ideal financial structure enables the company to make full utilization of available capital by establishing a proper co-ordination between the quantum of capital and the financial requirements of the business. A balanced capital structure helps a company to estimate both the states of overcapitalization and under-capitalization which are harmful to financial interests of the company.

g) Simple: A balanced capital structure is aimed at limiting the number of issues and types of securities, thus, making the capital structure as simple as possible.

h) Flexible: Flexibility or capital structure enables the company to raise additional capital at the time of need, or redeem the surplus capital. it not only helps is fuller utilization of the available capital but also eliminates the two undesirable states of over-capitalization and under - capitalization.

CAPITAL STRUCTURE THEORIES

In order to achieve the goal of identifying an optimum debt-equity mix, it is necessary for the finance manager to be conversant with the basic theories underlying the capital structure of corporate enterprises.

There are the four major theories approaches explaining the relationship between capital structures cost of capital and value of the firm.

1. Net Income (NI) Approach,
2. Net Operating income (NOI) approach,
3. Modigliani-miller (MM) approach,
4. Traditional approach.

Assumptions:

The following are the assumptions in order to present the analysis in a simple and intelligible manner:

(i) The firm employs only the two types of the capital-debt and equity. There are also no preference shares.

(ii) There are no corporate taxes. This assumption has been removed later.

(iii) The firm pays 100% of its earning as dividend. Thus, there are no retained earnings.

(iv) The firm's total assets are given and do not change. In other words, the investment decision are to assumed to be constant.

(v) The firm's total financing remains constant. The firm can change its capital structure either by redeeming the debentures by issue of share or by raising more debt and reduce the equity share capital.

(vi) The Operating Earnings (EBIT) are not expected to grow.

(vii) The business risk remains constant and is independent of capital structure and financial risks.

(viii) All investor have the same subjective probability distribution of the future expected operating earnings (EBIT) for a given firm.

(ix) The firm has a perpetual life.

1. Net Income (NI) approach (Suggested by Durand)

According to this approach, capital structures decision is relevant to the valuation of the firm. In other words, a change in the capital structure causes a corresponding change in the overall cost of the capital as well as the total value of the firm.

Higher debt content in the capital structure (i.e. High financial leverage) will result in the overall or weighted average cost of the capital. This will cause increase in the value of the firm and consequently increase in the value of equity share of the company. Reverse will happen in a converse situation.

Assumptions:

(i) There are no corporate taxes.

(ii) The cost of the debt is less than cost of equity or equity capitalization rate.

(iii) The debt content does not change the risk perception of the investors.

Value of the firm:

The value of the firm on the basis of NI approach can be ascertained as follows: -

V = S + B where:

V = Value of firm;

S = Market value of equity;

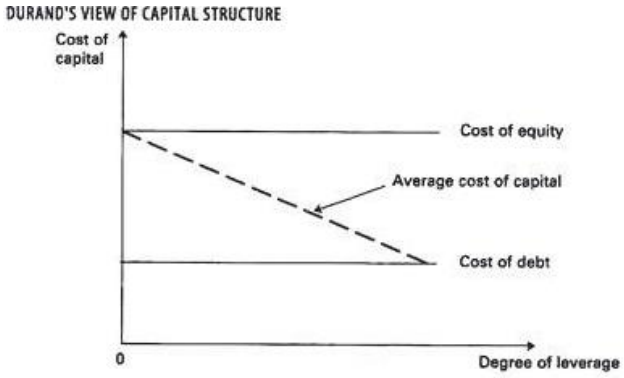
B = Market value of debt.

Market value of Equity can be ascertained as follow S=EATES / K_e * 100

Where: S = Market value of equity

EATES = Earnings available for equity shareholders;

K_e = Equity capitalization Rate.



Proof Problem 1:
From the following capital structure, prove NI Theory:

Particulars	Situation I	Situation II
EBIT	RS.1,000	RS.1,000
Debts	RS.1,000	RS.3,000
Cost of Debts (k_d)	15%	15%
Cost of equity (k_e)	20%	20%

PROOF:

Particulars	Situation 1	Situation II
EBIT	1,000	1,000
(-) Interest 15%	150	450
EATES	850	550
Value of Equity Shares (S) EATES/K_e	4,250	2,750

Value of Debentures (B)	1,000	3,000
Value of the firm (V) = B + S	5,250	5,750
Over all cost of capital K_o = EBIT/V * 100	1,000 / 5,250	1,000 / 5,750
Ko	19%	17%

Thus increase in debts increase the value of the firm and decrease the overall cost of capital. Hence NI theory is proved.

Proof Problem 2:

ABC Ltd. Earned a profit of Rs. 20 lakhs before providing for interest and tax. The company's capital structure is as follows:

(i) 4,00,000 Equity shares of Rs. 10 each and its market capitalisation rate is 16%.

(ii) 25,000 14% Secured redeemable debentures of Rs. 150 each.

Case 1: You are required to calculate the value of the firm under 'Net Income Approach'. Also calculate the overall cost of capital of the firm.

Case 2: When debentures increases from 25,000 to 35,000 by redeeming equity shares, find V and Ko.

Case 1 Solution:

Value of the Firm **(V) = S + B**

B = Market value of debt

B = 25,000* Rs.150 = Rs. 37,50,000

Market Value of Equity (S)

Particulars	Rs.
Earnings Before Interest and Tax	20,00,000
Less: Interest @14%	5,25,000
Earnings available to equity shareholders	14,75,000

S = EATES / K_e

Where, EATES = Rs. 14,75,000 K_e = 16%

S = Rs. 14,75,000/0.16 = = Rs. 92,18,750

Now, we can Calculate ***the Value of the Firm V = S+B***

= Rs. 92,18,750 + Rs. 37,50,000 = **Rs. 1,29,68,750**

Calculation of Overall Cost of Capital

Ko = EBIT/V = Rs. 20,00,000/Rs. 1.29.68.750 x 100 = 15.42%

Case 2 Solution:

Value of the Firm (V) = S + B

B = Market value of debt

B = 35,000* Rs.150 = Rs. 52,50,000

Market Value of Equity (S)

Particulars	Rs.
Profit Before Interest and Tax	20,00,000
Less: Debenture @14%	7,35,000
Earnings available to equity shares	12,65,000

S = EATES/ Ke

Where

Earnings Available to Equity Shareholders Rs. 12,65,000

Ke, = Equity capitalisation rate 16% or 0.16

S = Rs. 12,65,000 /0.16 = = Rs. 79,06,250

Now, we can Calculate ***the Value of the Firm V = S+B***

= Rs. 79,06,250 + Rs. 52,50,000 = **Rs. 1,31,56,250**

Calculation of Overall Cost of Capital

Ko= EBIT/V = Rs. 20,00,000/Rs. 1,31,56,250 x 100 = **15.2%**

Thus increase in debt, increases the value of the firm and decreases the overall cost of capital. Hence NI theory is proved

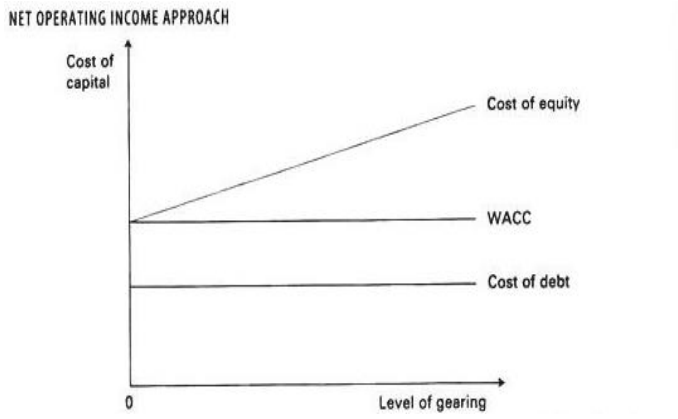
2. NET OPERATING INCOME (NOI) APPROACH. (Suggested by Durand)

Theory Statement

The NOI approach believes that changes in capital structure has no effect on the overall cost of capital and the value of the firm. Hence there is no optimum capital structure. Every capital structure is optional. The substance of the theory is that the shareholders perceive risk as debt increased and therefore they demand more returns which pushes the cost of equity.

Assumptions:

- There are no corporate taxes.
- The cost of debt remains constant.
- The overall cost of capital remains constant.
- Cost of Equity increases when Debt increases, vice versa.



Proof Problem 1:

Consider a fictitious company with below figures, Calculate Value of the firm and Overall Cost of Capital of the firm and prove NOI approach:

Earnings before Interest Tax (EBIT)	Rs. 1,00,000
Debentures	Rs. 3,00,000
Cost of Bonds issued (Debt)	10%
Cost of Equity	14%

Solution:

Value of the Firm (V) = S + B

B = Market value of debt

B = Rs. 3,00,000

Market Value of Equity (S)

Particulars	Rs.
Earnings Before Interest and Tax	1,00,000
Less: Interest @10%	30,000
Earnings available to equity shareholders	70,000

$S = EATES / K_e$

Where, EATES = Rs. 70,000 K_e = 14%

S = Rs. 70,000/0.14 = = Rs. 5,00,000

Now, we can Calculate ***the Value of the Firm V = S+B***

= Rs. 5,00,000 + Rs. 3,00,000 = **Rs. 8,00,000**

Calculation of Overall Cost of Capital

Ko = EBIT/V = Rs. 1,00,000/Rs. 8,00,000 x 100 = 12.5%

Problem 2:

Consider the same previous problem, assume that the proportion of debt increases from Rs.300,000 to Rs.400,000 and cost of equity increases to 15%, everything else remains same. Now find V and Ko.

Solution:

Value of the Firm (V) = S + B

B = Market value of debt

B = Rs. 4,00,000

Market Value of Equity (S)

Particulars	Rs.
Earnings Before Interest and Tax	1,00,000
Less: Interest @10%	40,000
Earnings available to equity shareholders	60,000

$S = EATES / K_e$

Where, EATES = Rs. 60,000 K_e = 14%

S = Rs. 60,000/0.15 = = Rs. 4,00,000

Now, we can Calculate ***the Value of the Firm V = S+B***

= Rs. 4,00,000 + Rs. 4,00,000 = **Rs. 8,00,000**

Calculation of Overall Cost of Capital

Ko = EBIT/V = Rs. 1,00,000/Rs. 8,00,000 x 100 = 12.5%

As observed, in the case of Net Operating Income approach, with the increase in debt proportion, the total market value of the company remains unchanged and Overall Cost of Capital remains constant.

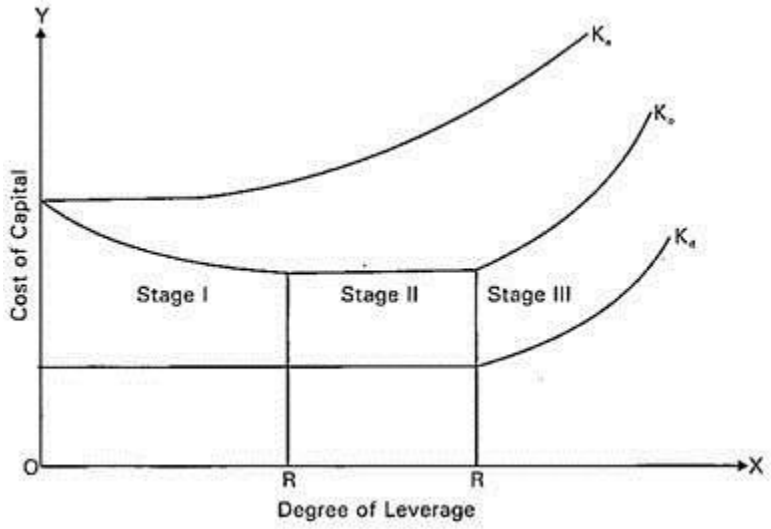
DIFFRENCES BETWEEN NI AND NOI APPROACH THEORY

	NI theory	NOI theory
Changes in capital structure	Affects the value of the firm	Does not affects the value of the firm
Cost of Equity	Assumed that cost of equity remains constant	cost of equity will increase if the debts are increasing
Value of the firm	If debt increase, the value of the firm also increases	Although debt increasing the value of the firm remains Constant
Increase in Debts	leads to decrease of COC	COC remains constant
Cost of Capital	Overall cost of capital will come down when debt increases vice versa	Overall cost of capital remains Constant

TRADITONAL THEORY(approach)

Net income and Net operating income theories are two extremes in the area of capital structure theories. Net income approach says that debt is always preferable and there is optimum capital structure. Net operating income theory says that including debt is irrelevant because it has no effect either on overall cost of capital or over the value of the firm. Traditional theory takes the middle of the road position between NI and NOI. The following is the essence of Traditional Theory.

- Up to a certain level of increase in leverage (debt), overall cost of capital comes down and value of the firm increases.
- Beyond a certain level, increase in leverage increases risk of equity shareholders and consequently ke, which results in increase in overall cost of capital and decrease in value of the firm.
- There is an optimum capital structure.



MODI GILIANI AND MILLER APPROACH (MM APPROACH)

The Modigiliani-Miller approach is similar to the net operating income (NOI) approach. In other words, according to this approach, the value of a firm is independent of its capital structure. However, there is a basic difference between the two. The NOI approach is purely conceptual. It does not provide operational justification for irrelevance of the capital structure in the valuation of

the firm. While MM approach supports the NOI approach provides justification for the independence of the total valuation and cost of capital of the firm from its capital structure. In other words, MM approach maintains that the overall cost of capital does not change in the debt equity mix or capital structure of the firm.

Assumptions:

(i) Capital markets are perfect. This means
   (a) Investors are free to buy and sell securities.
   (b) The investors can borrow without restriction on the same terms on which the firm can borrow;
   (c) The investors are well informed;
   (d) The investors behave rationally; and
   (e) There are no transaction costs.

(ii) The firms can be classified into homogeneous risk classes all firms within the same class will have the same degree of business risk.

(iii) All investors have the same expectation of a firms net operating income (EBIT) with which to evaluate the value of any firm.

(iv) The dividend payout ratio is 100%. In other words, there are no retained earnings.

(v) There are no corporate taxes. However, this assumption has been removed later.

(vi) Arbitrage process

The arbitrage process is the operational justification of MM hypothesis. The term "Arbitrage' refers to an act of buying an asset or security in one market having lower price and selling it in another market at a higher price. The consequence of such action is that the market price of the securities of the two firms exactly similar in all respects except in their capital structures cannot for long remain different in different markets. Thus, arbitrage process restores equilibrium in value of securities.

vii) **Home Made Leverage**

An investor may like to shift from one firm to the other firm due to economic benefits. In case the investor wants to maintain secured ownership but runs with short of funds, it is assumed that the investor would borrow money and invest in the company which is more secured and beneficial.

Basic propositions:

The following are the three basic propositions of the MM approach.

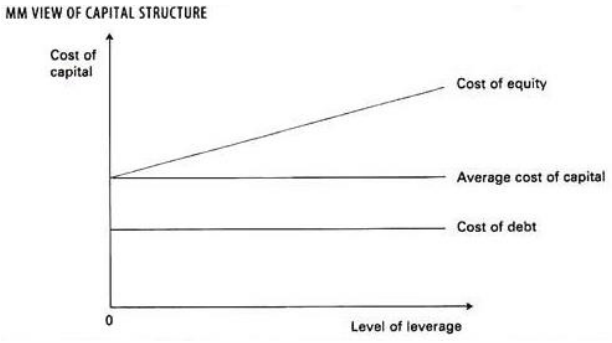
1. The overall cost of capital (k) and the value of the firm (V) are independent of the capital structure. In other words k and V are constant for all levels of debt-equity mix. The total market value of the firm is given by capitalizing the expected net operating income (NOI) by the rate appropriate for that risk class.

2. The cost of equity is equal to capitalization rate of a pure equity stream plus a premium for the financial risk. The financial risk increases with more debt content in the capital structure. As a result, ke increases in a manner to off set exactly the use of a less expensive source of funds represented by debt.

3. The cut-off rate for investment purposes is completely independent of the way in which an investment is financed.

"MM hypothesis based on the idea that no matter how you divide up the capital structure of a firm among debt, equity and other claims, there is a conservation of investment value".

That is, because the total investment value if corporation depends upon its underlying profitability and risk. It is invariant with respect to relative changes in the firm's financial capitalization. So, regardless of the financing mix, the total value of the firm remains the same.



THEORY STATEMENT

Changes in capital structure will not affect the value of the firm.

PROOF PROBLEM:

Assume that there are two firms L (levered firm - with debentures) and UL (Un levered firm - without debentures).

Particulars	Firm L	Firm UL
EBIT	Rs.1,00,000	Rs.1,00,000
Debentures @10%	Rs.5,00,000	-
Cost of equity	16%	12.5%

SOLUTION

Particulars	Firm L	Firm UL
EBIT	1,00,000	1,00,000
- Interest	50,000	-
EATES	50,000	1,00,000
Value of Equity Shares (S) EATES/K_e	Rs.3,12,500	Rs.8,00,000
Value of Debentures (B)	Rs.5,00,000	-
Value of the firm (V) = B + S	Rs.8,12,500	Rs.8,00,000
Over all cost of capital K_o = EBIT/V	1,00,000 / 8,12,500	1,00,000 / 8,00,000
K_o	.123	.125

According to MM approach if two companies under the same business environment have the same EBIT but have different capital structure (one may be levered and un levered) yet the value of the two firms will be equal. But if there is a small difference in the value, it will be for a temporary period only.

The investors will analyse the investment and returns they get in two different companies. They would find some economic benefits if they shift from high value firm to low value firm. The process of shifting from one firm to the other is called arbitrage process.

Due to this arbitrage process, demand of shares for higher value firm will decreases. And also its value and price will decrease. On other hand the value and price of the lower firm will increase. So because of arbitrage process the value of both the firms become equal. Hence the changes in capital structure does not affect the value of the firm.

Analyse of Economic Benefits:

Let us the assume X owns 10% of the equity of firm L (the same example)

Investment made (10 % of 3,12,500)	31,250
Income (10% of 50,000) i.e. for making investment X will get Rs.5,000 as return.	5,000
If X wishes to invest 10% of investment in UL:	
10% of investment in Ul (10% on 8,00,000)	Rs.80,000
For make investment money required was	Rs.80,000

But X is having only Rs.31,250 in his hand for remaining Rs. 48,750 he arranged a loan with interest rate of 10%

Income from Firm UL for 10% investment(100000 * 10%)	Rs.10,000
Less: Interest paid for loan	Rs.4875
Net Income	Rs.5,125

Here X will get return of Rs.5,125 from Firm UL by making own investment of Rs.31,250. But in L firm he invests 31,250 and had 5,000 whereas in firm UL he will get Rs.5,125. He will be getting Rs.125 more for investment in firm UL. In such circumstances all the investors like X will prefer the Firm UL (lower value firm). As a result, the demand and value of higher value firm will come down and the demand and value of the lower value firm will increase

The investors will analyse the investment and returns they get in two different companies. They would find some economic benefits, they shift from high value firm to low value firm. The process of shifting from one firm to the other is called arbitrage process.

Due to this arbitrage process, demand of shares for higher value firm will decreases. And also its value and price will decrease. On other hand the value and price of the lower firm will increase. So because of arbitrage process the value of both the firms become equal. Hence the changes in capital structure does not affect the value of the firm.

LIMITATIONS OF MM APPROACH:

1. Perfect market conditions need not exist:
    - All investors are not rational.
    - Complete information may not be available to all investors
    - Transaction cost will exist
    - Flotation cost will exist.
2. Investors may not like to borrow money for making investment on securities.
3. In practice the investors borrow money for the interest rate which wad definitely more than the company' s borrowing rate.
4. There need not be only equity and debentures for financing. Preference shares will also exists.
5. Taxes may exist.
6. The total financing need not be constant.

Limitations of mm hypothesis:

1. Rates of interest are not the same for the individuals and the firms:

The assumption made under the MM hypothesis that the firms and individual can borrow and lend at the same rate of interest does not hold good in actual practice. This is because firms have the higher credit standing as compared to the individuals on account of firms holding substantial fixed assets.

2. Homemade leverage is not perfect substitute for corporate leverage:

The risk to which an investor is exposed is not identical when the investor is exposed is not identical when the investor himself borrows. As a matter of fact, the risk exposure to the investor is greater in the former case as compared to the latter. When the firms borrows, the liability of the investor is limited only to the extent of his proportionate share holding, in case the company is forced to go for its liquidation.

3. Transaction costs involved:

Buying and selling of securities involves transaction costs. It would therefore become necessary for investor to invest a larger amount in the shares of the unlevered / levered firms than his prevent investment to earn the same return.

4. Institutional restrictions:

The switching option form unlevered to levered firm and vice-versa is not available to All investors particularly, institutional investors life insurance corporation of India, unit trust of India, Commercial banks etc. Thus, the institutional restrictions stand in the way of smooth operation of the arbitrage process.

5. Corporate taxes frustrate MM hypothesis:

On account of corporate taxes, it is a known fact that the cost of borrowing funds to the firm is less than the contractual rate of interest. As a result, the total return to the shareholders of an unleveled firm is always less than that of the levered firm. Thus, the total market value of levered firm tends to exceed that of the unlevered firm on account of this very reason.

Corporate taxes

The MM hypothesis that the value of a firm and its cost of capital will remain constant with leverage does not hold good when there are corporate taxes. Since corporate taxes do exist, in 1963 MM agreed that the value of the firm will increase or the cost of capital will decline, if corporate taxes are introduced in the exercise. This is because interest is a deductible expense for tax purposes and therefore the effective cost if debt is less than the contractual rate of interest. A levered firm should have, therefore, a greater market value as compared to an unlevered firm. The value of the levered firm would exceed that of the unlevered firm by an amount equal to the levered firm's debt multiplied by the tax rate. This can be put in the form of the following formula:

$V_L = V_{UL} + B(1-t)$

Where

V_L = value of levered firm;

V_U = value of an unlevered firm; B = amount of debt; and

t = tax rate

The market value of an unlevered firm will be equal to the market value of its shares.

$V_U = S$

Where V_U = market value of an unlevered firm S = market value of equity;

S = Earnings available for equity shareholder's / Equity capitalization rate

In other words, the value of Vu can be determined by the following equation:

Vu = EBT(1-t)/Ke

Where;

EBT = earnings before tax, T = tax rate. Ke = equity capitalization rate.

Since in case of unlevered firm there is no debt content, earning before tax (EBT) means earnings before interest and tax (EBIT).

Tax rate 40%

Particulars	Firm L	Firm UL
EBIT	1,00,000	1,00,000
- Interest	50,000	-
EBT	50,000	1,00,000

Vu = EBT(1-t)/Ke

= 1,00,000(1-.4)/.125

= Rs.4,80,000

V_L = V_{UL} + B(1-t)

= 4,80,000 + 5,00,000(1-.4)

= Rs.7,80,000

V_L > Vu

Rs.7,80,000 > Rs.4,80,000

Thus it is proved.

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SCHOOL OF MANAGEMENT STUDIES

UNIT – IV – Financial Management – SBA1106

IV. MANAGEMENT OF WORKING CAPITAL

Meaning of working capital- Types of working capital- Working capital cycle- Determinants of working capital- Estimation of working capital- Short term funds, Management of cash: cash Budget- practical issues, Bank Finance for Working Capital: Tandon Committee & Chore Committee- Observations and Recommendations.

MEANING AND DEFINITION

The uses of funds of a concern can be divided into two parts namely long-term funds and short-term funds. The long – term investment may be termed as 'fixed investment.' A major part of the long-term funds is invested in the fixed assets. These fixed assets are retained in the business to earn profits during the life of the fixed assets. To run the business operations short– term assets are also required.

The term working capital is commonly used for the capital required for day-to-day working in a business concern, such as for purchasing raw material, for meeting day-to-day expenditure on salaries, wages, rents rates, advertising etc. But there is much disagreement among various financial authorities (Financiers, accountants, businessmen and economists) as to the exact meaning of the term working capital.

DEFINITION OF WORKING CAPITAL

Working capital refers to the circulating capital required to meet the day to day operations of a business firm. Working capital may be defined as follows: According to Weston & Brigham - "Working capital refers to a firm's investment in short term assets, such as cash amounts receivables, inventories etc.

Concepts of working capital

1. **Gross Working Capital**: It refers to the firm's investment in total current or circulating assets.
2. **Net Working Capital**: The term "Net Working Capital" has been defined in two different ways:

i. It is the excess of current assets over current liabilities. This is, as a matter of fact, the most commonly accepted definition. Some people define it as only the difference between current assets and current liabilities. The former seems to be a better definition as compared to the latter.

ii. ii. It is that portion of a firm's current assets which is financed by long-term funds.

CLASSIFICATION OF WORKING CAPITAL

Permanent Working Capital: This refers to that minimum amount of investment in all current assets which is required at all times to carry out minimum level of business activities. In other words, it represents the current assets required on a continuing basis over the entire year.

1. Amount of permanent working capital remains in the business in one form or another. This is particularly important from the point of view of financing. The suppliers of such working capital should not expect its return during the life-time of the firm.
2. It also grows with the size of the business. In other words, greater the size of the business, greater is the amount of such working capital and vice versa Permanent working capital is permanently needed for the business and therefore it should be financed out of long-term funds.

Temporary Working Capital: The amount of such working capital keeps on fluctuating from time to time on the basis of business activities. In other words, it represents additional current assets required at different times during the operating year. For example, extra inventory has to be maintained to support sales during peak sales period. Similarly, receivable also increase and must be financed during period of high sales. On the other hand, investment in inventories, receivables, etc., will decrease in periods of depression.

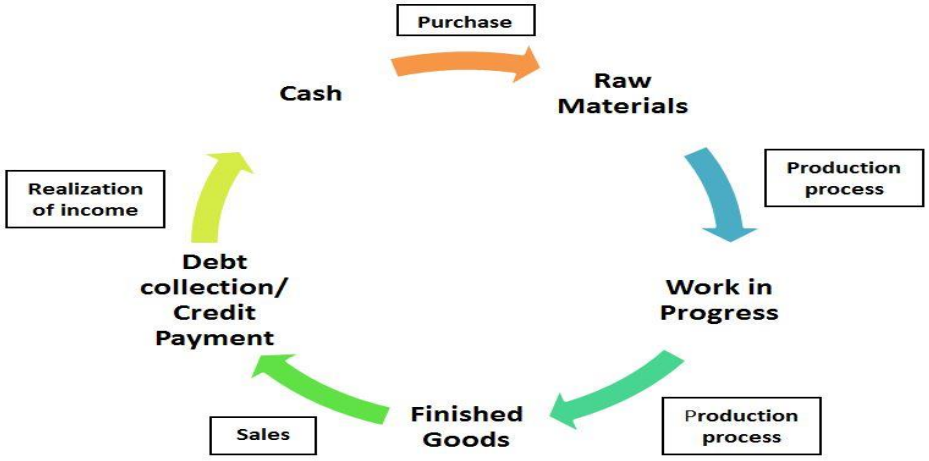
Suppliers of temporary working capital can expect its return during off season when it is not required by the firm. Hence, temporary working capital is generally financed from short- term sources of finance such as bank credit.

LIST OF CURRENT ASSETS AND CURRENT LIABILITIES

Current Assets	Current Liabilities
Cash, Bank, Short-Term securities, Debtors, Bill Receivable, Stock (Inventory—R/M, WIP, F/G), Prepaid expenses, etc.	Creditors Outstanding expenses, Bills Payable, Bank Overdraft, etc.

FOUR COMPONENTS OF CASH CYCLE

a. Conversion of cash into inventory.
b. Conversion of Inventory into Finished Goods.
c. Conversion of Finished goods into account receivable
d. Conversion of Account Receivable into cash.



Operating Cycle of a Business

DETERMINANTS OF WORKING CAPITAL

The factors influencing the working capital decisions of a firm may be classified as two groups, such as

- internal factors and
- external factors.

The internal factors include, nature of business size of business, firm's product policy, credit policy, dividend policy, and access to money and capital markets, growth and expansion of business etc. The external factors include business fluctuations, changes in the technology, infrastructural facilities, import policy and the taxation policy etc. These factors are discussed in brief in the following lines.

Internal factors

1. Nature and size of the business: The working capital requirements of a firm are basically influenced by the nature and size of the business. Size may be measured in terms of the scale of operations. A firm with larger scale of operations will need more working capital than a small firm. Similarly, the nature of the business - influence the working capital decisions. Trading and financial firms have less investment in fixed assets. But require a large sum of money to be invested in working capital. Retail stores, business units require larger amount of working capital, whereas, public utilities need less working capital and more funds to invest in fixed assets.

2. Firm's production policy: The firm's production policy (manufacturing cycle) is an important factor to decide the working capital requirement of a firm. The production cycle starts with the purchase and use of raw material and completes with the production of finished goods. On the otherhand production policy is uniform production policy or seasonal production policy etc., also influences the working capital decisions. Larger the manufacturing cycle and uniform production policy – larger will be the requirement of working capital. The working capital requirement will be higher with varying production schedules in accordance with the changing demand.

3. Firm's credit policy: The credit policy of a firm influences credit policy of working capital. A firm following liberal credit policy to all customers requires funds. On the other hand, the firm adopting strict credit policy and grant credit facilities to few potential customers will require less amount of working capital.

4. Availability of credit: The working capital requirements of a firm are also affected by credit terms granted by its suppliers – i.e. creditors. A firm will need less working capital if liberal credit terms are available to it. Similarly, the availability of credit from banks also influences the working capital needs of the firm. A firm, which can get bank credit easily on favorable conditions, will be operated with less working capital than a firm without such a facility.

5. Growth and expansion of business: Working capital requirement of a business firm tend to increase in correspondence with growth in sales volume and fixed assets. A growing firm may need funds to invest in fixed assets in order to sustain its growing production and sales. This will, in turn, increase investment in current assets to support increased scale of operations. Thus, a growing firm needs additional funds continuously.

6. Profit margin and dividend policy: The magnitude of working capital in a firm is dependent upon its profit margin and dividend policy. A high net profit margin contributes towards the working capital pool. To the extent the net profit has been earned in cash, it becomes a source of working capital. This depends upon the dividend policy of the firm. Distribution of high proportion of profits in the form of cash dividends results in a drain on cash resources and thus reduces company's working capital to that extent. The working capital position of the firm is strengthened if the management follows conservative dividend policy and vice versa.

7. Operating efficiency of the firm: Operating efficiency means the optimum utilisation of a firm's resources at minimum cost. If a firm successfully controls operating cost, it will be able to improve net profit margin which, will, in turn, release greater funds for working capital purposes.

8. Co-ordinating activities in firm: The working capital requirements of a firm are depend upon the co-ordination between production and distribution activities. The greater and effective the co- ordinations, the pressure on the working capital will be minimized. In the absence of co-ordination, demand for working capital is reduced.

External factors

1. **Business fluctuations**: Most firms experience fluctuations in demand for their products and services. These business variations affect the working capital requirements. When there is an upward swing in the economy, sales will increase, correspondingly, the firm's investment in inventories and book debts will also increase. Under boom, additional investment in fixed assets may be made by some firms to increase their productive capacity. This act of the firm will require additional funds. On the other hand, when, there is a decline in economy, sales will come down and consequently the conditions, the firm try to reduce their short-term borrowings. Similarly, the seasonal fluctuations may also affect the requirement of working capital of a firm.

2. **Changes in the technology**: The technological changes and developments in the area of production can have immediate effects on the need for working capital. If the firm wish to install a new machine in the place of old system, the new system can utilise less expensive raw materials, the inventory needs may be reduced there by working capital needs.

3. **Import policy**: Import policy of the Government may also affect the levels of working capital of a firm since they have to arrange funds for importing goods at specified times.

4. **Infrastructural facilities**: The firms may require additional funds to maintain the levels of inventory and other current assets, when there is a good infrastructural facility in the company like transportation and communications.

5. **Taxation policy**: The tax policies of the Government will influence the working capital decisions. If the Government follows regressive taxation policy, i.e. imposing heavy tax burdens on business firms, they are left with very little profits for distribution and retention purpose. Consequently, the firm has to borrow additional funds to meet their increased working capital needs. When there is a liberalized tax policy, the pressure on working capital requirement is minimized. Thus the working capital requirements of a firm are influenced by the internal and external factors.

IMPORTANCE OR ADVANTAGES OF ADEQUATE WORKING CAPITAL

Working capital is the life blood and nerve center of a business. Just as circulation of blood is essential in the human body for maintaining life, working capital is very essential to maintain the smooth running of a business. No business can run successfully without an adequate amount of working capital. The main advantages of maintaining adequate amount of working capital are:

1. **Solvency of the business**: Adequate working capital helps in maintaining solvency of the business by providing uninterrupted flow of production.

2. **Goodwill**: Sufficient working capital enables a business concern to make prompt payments and hence helps in creating and maintaining goodwill.

3. **Easy loans**: A concern having adequate working capital, high solvency and good credit standing can arrange loans from banks and other on easy and favourable terms.

4. **Cash discounts**: Adequate working capital also enables a concern to avail cash discounts on the purchases and hence it reduces costs.

5. **Regular supply of raw materials**: Sufficient working capital ensures regular supply of raw materials and continuous production.

6. **Regular payment of salaries, wages and other day-to-day commitments**: A company which has ample working capital can make regular payment of salaries, wages and other day- to-day commitments which raises the morale of its employees, increases their efficiency, reduces wastages and costs and enhances production and profits.

7. **Exploitation of favourable market conditions**: Only concerns with adequate working capital can exploit favourable market conditions such as purchasing its requirements in bulk when the prices are lower and by holding its inventories for higher prices.

8. **Ability to face crisis**: Adequate working capital enables a concern to face business crisis in emergencies such as depression because during such periods, generally, there is much pressure on working capital.

9. **Quick and regular return on investments**: Every Investor wants a quick and regular return on his investments. Sufficiency of working capital enables a concern to pay quick and regular dividends to its investors as there may not be much pressure to plough back profits. This gains the confidence of its investors and creates a favourable market to raise additional funds i.e., the future.

10. **High morale**: Adequacy of working capital creates an environment of security, confidence, and high morale and creates overall efficiency in a business.

DISADVANTAGES OF REDUNDANT OR EXCESSIVE WORKING CAPITAL

1. Excessive Working Capital means ideal funds which earn no profits for the business and hence the business cannot earn a proper rate of return on its investments.
2. When there is a redundant working capital, it may lead to unnecessary purchasing and accumulation of inventories causing more chances of theft, waste and losses.
3. Excessive working capital implies excessive debtors and defective credit policy which may cause higher incidence of bad debts.
4. It may result into overall inefficiency in the organization.
5. When there is excessive working capital, relations with banks and other financial institutions may not be maintained.
6. Due to low rate of return on investments, the value of shares may also fall.
7. The redundant working capital gives rise to speculative transactions.

DISADVANTAGES OR DANGERS OF INADEQUATE WORKING CAPITAL

1. A concern which has inadequate working capital cannot pay its short-term liabilities in time. Thus, it will lose its reputation and shall not be able to get good credit facilities.
2. It cannot buy its requirements in bulk and cannot avail of discounts, etc.

3. It becomes difficult for the firm to exploit favourable market conditions and undertake profitable projects due to lack of working capital.
4. The firm cannot pay day-to-day expenses of its operations and it creates inefficiencies, increases costs and reduces the profits of the business.
5. It becomes impossible to utilize efficiently the fixed assets due to non-availability of liquid funds.
6. The rate of return on investments also falls with the shortage of working capital.

ESTIMATION OF WORKING CAPITAL REQUIREMENTS

Format for calculation of Net Working Capital

Particulars	**Amount Rs.**	**Total Rs.**
A. Current Assets:		
1. Cash in Hand/at Bank	xxx	
2. Raw Materials	**xxx**	
3. Work-In-Progress:	**xxx xxx xxx xxx**	
i. Raw Materials	**xxx xxx**	
ii. Direct Labour	**xxx**	xxx
iii. Overhead		
4. Finished Goods		
5. Debtors		
6. Prepaid Expenses		
7. Others		
Total Current Assets (TCA)		xxx
B. Current Liabilities:		
1. Creditors	xxx	
2. Accounts Payables	xxx	
3. Advance Income	xxx	Xxx
Total Current Liabilities (TCL)		Xxx
Net Working Capital (A-B)(TCA-TCL)		Xxx

Problem No: 1

The board of Directors of XYZ Co requests to prepare statement showing the working capital management for a level of activity at 1,56,000 units of production, The following information is available for your calculation:

Details	**Per Unit (Rs)**
Raw Materials	90
Direct Labour	40
Overhead	75
Total	**205**
Profit	60
Selling price	**265**

i) Raw material are stock on average for 1 month

ii) Materials are in process WIP, which is 50% completed on average for 4 weeks.

iii) Finished goods are in stock, on average, for 1 month.

iv) Time lag in payment from debtors is 2 months.

v) Credit allowed by Suppliers is 1 month.

vi) Average lag in payment of wages is 1.5 weeks.

vii) Average lag in payment of overhead is 1 month.

Assume that all the sales are credit sales. Cash is hand and in Bank is expected to be Rs. 60,000. It is to be assumed that production is carried on evenly throughout the year, wages & overhead accrue similarly. Add 10% for contingency.

Solution:

Particulars	**Amount (Rs)**	**Total (Rs)**
A. Current Assets:		
Stock		
Raw materials (156000 x 90 x 1/2)	**70,20,000**	
WIP (156000 x 205 x 4/52 x 0.5)	**12,30,000**	

Finished goods (156000 x 205 x 1/12)	**26,65,000**	
Sundry Debtors (156000 x 205 x 2/12)	**53,30,000**	
Cash at Bank	**60,000**	16,30,5000
Total Current Assets (TCA)		**16,30,5000**

B. Current Liabilities:		
Creditors (156000 x 90 x 1/2)	70,20,000	
Outstanding salaries (156000 x 40 x 1.5/52)	1,80,000	
Outstanding expenses (156000 x 75 x 1/12)	9,75000	81,75,000
Total Current Liabilities (TCL)		**81,75,000**
Net Working Capital (A-B)(TCA-TCL)		**81,30,000**
Add: 10% for contingency		**8,13,000**
Working Capital Required		**89,43,000**

SOURCES OF WORKING CAPITAL

The current assets which are used in running daily operation of a business is called working capital. Working Capital may be classified as Fixed working capital and Variable working capital. Both types of working capital help in running firm's daily operation. Fixed working capital should be financed from long-term sources & variable working capital from short term source. So variable from the following sources are as financed:

1. **Short term Bank Loan (STBC):** t is a big source of w. cap. Usually firms finance through STBL to meet the need of variable WC and need in excess of FWC. Commercial banks give bank O/D, cash credit etc.
2. **Non Bank short term loan**: Relatives, Bankers, Govt. Institute are the non bank S.T. Loan
3. **Internal Source**: One of the main sources w. Cap for a firm in Internal sources. This is also
4. called Self-financing.
5. **Long Term Sources (LTS):** Sometimes W. Cap is financed through LTS. Usually fixed

working capital are share, debenture LT loan etc.

6. **Money Lenders**: When firms can't finance short-term need of w.cap from anywhere, they take loan form moneylenders.
7. **Trade Credit**: When firms purchase on credit & pay the money according to credit term, it is called Trade Credit. Normally Trade credit is used as a source of variable working capital.
8. **Selling out Excess of Fixed asset**: If any fixed asset is considered as extra than need, then that idle fixed asset is sold for working capital.
9. Other than the above sources, a firm finances their working capital though paying debts in late (as much as possible) & Accrual etc.
10. Collect money/Receivable in the earliest time, pay as late as possible.

MANAGEMENT OF CASH

Management of cash is concerned with providing sufficient cash for meeting cash needs of a business as when needed. On other hand, if undertaking maintains excessive cash, it will remain idle in the business, contributing nothing towards the wealth of the firm. If heavy amounts are blocked, the company will not be in a position to carry on its day-to-day working efficiently. Therefore, the aim of the cash management is to maintain sound cash position to keep the firm sufficiently liquid and to use the excessive cash if any in same profitable manner.

A firm that has sufficient cash balance can get the following **importance** in business.

Maintenance of Goodwill: The goodwill of a firm depends to a large extent on this fact that the firm repay all the obligations as and when they mature. It can be possible only when the firm maintains a good cash balance.

Cash discount can be availed: If a firm has sufficient cash, it can avail cash discounts offered by the suppliers. It will lower down the cost of material and finally cost of production.

Good bank relations: Commercial banks like to maintain good relations with such firms having high liquidity in funds.

Exploitation of good business opportunities: Firms having food cash position can exploit the business opportunities very well. They can take risk of entering into new ventures.
Increase in efficiency: Sufficient cash funds ensuring continuity in production that results in high morale, increased productivity, lowering of costs etc.

Overcoming abnormal situations: Firms having sufficient cash are always in a position to overcome the abnormal financial conditions with ease and without causing much loss to the interest of existing shareholders.

PRINCIPAL MOTIVES FOR HOLDING CASH

Every firm undertaking desires to keep minimum balance of cash for its unforeseen obligations. What should be that minimum amount of cash is early a problem for the financial management to solve. Even cash is a non-productive assets, the firm needs to hold cash to meet the following motives:

THE TRANSACTION MOTIVE

The transaction motive is the need for cash to meet day to day requirements such as purchase of materials payment of wages and salaries etc. The cash funds to be kept depend on cash outflows of funds and inflow of funds. If both inflow and outflow of funds are equal, there will not be any need to hold cash. But inflow and outflow are not perfectly coinciding. For this purpose, firm should maintain some cash payment.

PRECAUTIONARY MOTIVE

The precautionary motive is the need to hold cash to meet contingencies in future. The precaution for any amount of cash depends upon the predictability of cash flows. If it is correctly predicted, less cash will be maintained for an emergency. The precautionary cash

is also influenced by the firm's ability to borrow at short notice when the need arises. The precautionary balance may be kept in less cash and more in high-liquid and low risk marketable securities.

SPECULATIVE MOTIVE

Speculative motive relates to the holding of cash for investing in profit making opportunities as and when they arise. If cash is available to exploit such opportunities, there is a chance of making profits on investment of cash in such opportunities. Most of such opportunities are:

- Purchase of raw materials at a reduced price on immediate cash payment
- Speculate on interest rate movement by buying securities when interest rates are expected to decline and
- Delay in purchases of raw materials on the expectation of decline in prices.

COMPENSATION MOTIVE

Bank provides various services to the firm on commission basis, while for some other services they require to maintain a minimum cash balance at the bank. This balance is known as compensation balances, from the firms, view point this amount is dead money. The quantum of compensation balance varies with banks. The balance with bank depends upon the supply of money in money market.

FACTORS AFFECTING THE SIZE OF CASH REQUIREMENT

Major non-recurring expenditures

This includes expenditure for purchase of long term assets for promotion of new project or diversification of business. Generally, such expenditures are planned once or a few times. Therefore, the firm has sufficient time to raise finance for these expenditure.

Repayment of major loans

It involves large cash out flows, for this firms may go for new issue of shares and debentures to raise enough cash. If not possible by sale of securities, it may sell some of its assets.

Expected cash receipts and cash payments

This determines the size of net cash flows. Management of the firm may decide to maintain a particular level of net cash flows to guard against technical insolvency. There are two factors affecting cash flows a) level of sales and b) The stage in the life cycle of the firm, depending upon its policies with regard to management of non-cash assets and financing arrangements, the level of sales and the stage in the life cycle of the firm are inter related and interdependent.

Possible fluctuations in expected cash inflows and outflows

Short-term variations in cash flows are natural. These fluctuations determine the risk associated with liquidity. Shorter the period of forecast, precise will be the estimates for cash flows. However, there is always some degree of uncertainty that actual cash flows will occur as per estimated cash flows.

Firm's capacity to borrow emergency

Higher the capacities to borrow at a very short period smaller are the cash balances required for transaction and precautionary needs. The credit worthiness of firm, relationship of the firm with its banks and prevailing money market conditions are some of the factors which may influence the borrowing capacity of a firm.

The attitude and policy of the firm’s management towards running out of cash

Cash balances of a firm also depend upon the management policies and attitudes as regards to liquidity preference, sales on credit, investment in inventory and sales volume. If a management gives more importance to profitability, they would tend to minimize cash balances and maximize investment of available cash to the extent possible.

The degree of efficiency in managing flows of cash

Overall efficiency of cash management depends upon collection and disbursement policies and methods. These policies and methods aim at speeding up of the collections and delaying the payments, without having adverse impacts.

HOW COLLECTIONS CAN BE PROMPTED & PAYMENTS DELAYED……

Controlling inflow of cash is a very important and serious problem for every financial executive. Accordingly, every firm is to ensure that there is no unnecessary diversion of cash receipts and cash paid by the parties is immediately collected without any delay. An efficient financial manager will attempt to reduce the firms deposit float by speeding up the mailing processing and collection times. Normally, by the following way the firm can collect its cash without much delay.

The principal methods of establishing a decentralized collection are explained below:

PRE AUTHORISED SYSTEM

CONCENTRATION BANKING

In concentration banking system large number of collection center are established by the firm indifferent geographical areas. The purpose of this system is to minimise the log between the mailing time from customers to the firm and the time when the firm can make use of the funds. The collection centers collect cheques from their customers and deposit them in the local bank account. Instructions are given to the local collection center to transfer funds daily by telex, or fax or electronic mail to bank at the head office.

Advantages:

- Time gap between the cheques sent by the customers and received by the firm is reduced.
- If firm's branches is allowed to send bills; the mailing time is less than if they are mailed from the head office.
- It accelerates the over all cash collections.
- It reduces the size of float\float is the difference between the amount of deposits and the amount of usable funds.

LOCK BOX SYSTEM

This is another method of prompt collections. This system helps the firm to eliminate the time between the receipts of cheques and their deposits in the bank. In this system the firm establishes number of collection centres. At each centre, the firm hires a post office box and

instructed its customers to mail their remittance to the box. The firm's local bank has been given the authority to collect the remittances directly from the local box. The bank clears the mail several times a day and deposits the cheque in the firms account. At the conclusion of each day all photo copies, invoices, deposits slips and other documents included with the remittances are mailed to the firm.

Advantages:

- The time lock for converting receivables is reduced.
- The bank takes over the task receiving, endorsing, totalling and depositing
- cheques. With less handling of receipts by employee's better audit control is achieved and the chance of documents becoming lost is reduced.
- If customer's cheque is uncollectable, it is returned by special instructions to the firm.
- This system is useful and economical when average remittance is large.

This system is an improvement the concentration bank system. In lock box system the banker clears the remittances from post boxes, instead of remittance being sent to branch offices and branch offices sending the cheques and bills to the bankers for collection. Thus one more intermediary step is skipped to speed up the collection.

ZERO BALANCE ACCOUNTING SYSTEM

In this system a centralised control over each disbursement is effected. Large companies having branches at the national level uses this system. These branches as usual have accounts will the banks and draw money for day to day expenses. Under the existing rules each branch is maintaining the branches may not properly use several lakhs of rupees with bank without earning interest and the amounts. Under these circumstances, the zero balance accounting is boon to these orgnisations.

In this system, branches draw their cheques on their individual accounts. When a cheque is paid to a third party these cheques get cleared through the banking system in the usual way. As and when these cheques are honoured, the bank will debit or else the negative balance will build in the account.

At the close of the day, all the negative balance will be brought to the zero level once again by means of funds transferred from the concentration bank account. Every morning on electronic report is forwarded to the head office with details as to the balances in the master

account and also the details of the previous day's transaction with zero balance account. On receipt of the report from the bank, the financial manager may take action, to convert the cash into Marketable Securities or The marketable securities into cash.

Advantages:

- The idle cash in the branch bank accounts are fully used.
- The minimum cash balances to be maintained by each branch are reduced.
- Centralised control over disbursement is exercised.
- Adjustments are done at bank level and it saves a lot of time for the management.
- Quick clearance of cheques is possible.

PREAUTHORISED SYSTEM

This system helps to convert the receivable cash into working cash with in short time. This system is useful only if companies receive a fixed amount from number or customers over a period of time at fixed intervals. The difference between this system and other is that it does not contain the signature of the drawer. Thus without the signature of drawer the cheques are paid by the banks to the companies with the customers legal authorisations. This type of cash management is good and rise to insurance companies and leasing companies.

Advantages:

- The company may predict the cash flows more accurately.
- There is no postal delay, no process delay and the cost of processing is also less.
- The customer need not worry about the payment and he is free from writing the cheques and sending the same.
- In case of urgency the company may get the preauthorised cheques system discounted with the bank.

PAYMENT PRACTICES

- Controlling of cash is an important as controlling inflow of cash. In order to control

the outflow of cash most of the companies follow centralised cash payment system. Under this system, all payments are transferred from branch office to the central office and it pays the creditor bill direct to the parties. A transaction delay is quite possible as advantage to the firm.

- There may be other methods of delaying payments without losing its credit. Such methods, other than centralised cash payments are explained below:
- Avoid early payments - because it will have no special advantage for paying early except earning cash discounts which is very nominal.
- Use cheque payments- that will take extra time for collection.

- Making delay to make payments - i.e. if the outstanding can not affect the firm in any way means, the firm can make the payment with quite delay.

CASH BUDGET

This is a sum total of the requirements of cash in respect of various functional budgets as well as anticipated cash receipts. It is prepared by the chief accountant. It shows the cash available and need from time to meet the capital requirements of the organisation. The budget is prepared in two parts – one showing an estimate of receipts and the other showing an estimate of payments. It is prepared for the following purpose:

(i) To indicate when additional finance is required and how much

(ii) To find out whether surplus funds are available for outside investment, etc.

Cash Budget Format

Particulars	**Month1**	**Month2**
Opening Cash Balance	xxx	xxx
+ Receipts	xxx	xxx
- Payments	xxx	xxx
Closing Cash Balance	xxx	xxx

1. Prepare a cash Budget for July, Aug and Sep. 2006.

Month	Sales	Purchases	Expenses
May 06	3,00,000	1,00,000	20,000
June 06	4,00,000	2,00,000	30,000
July 06	5,00,000	2,50,000	40,000
Aug 06	6,00,000	3,00,000	50,000
Sep 06	7,00,000	4,00,000	70,000

Additional Information:

(i) Opening cash balance Rs. 20,000.

(ii) Payment of Tax is expected to pay in July 06 Rs. 25,000.

(iii) 50% of sales are in cash and rest on credit which is recovered in next two subsequent months.

(iv) An instalment of Rs. 1,00,000 to be paid in the month of July.

(v) Dividend of Rs. 20,000 is receivable in the month of Sep. 2006.

Solution **CASH BUDGET**

Particulars	**July**	**August**	**September**
Opening Cash Balance	**20,000**	**30,000**	**2,05,000**
+ Receipts: (I)			
Cash Sales	2,50,000	3,00,000	3,50,000
Credit Sales (2 months)	75,000	1,00,000	1,25,000
(1 month)	1,00,000	1,25,000	1,50,000
Dividend			20,000
(I)	**4,45,000**	**5,55,000**	**8,50,000**
- Payments: (II)			
Purchases	2,50,000	3,00,000	4,00,000
Expenses	40,000	50,000	70,000
Tax	25,000		
Installment	1,00,000		
(II)	**4,15,000**	**3,50,000**	**4,70,000**
Closing Cash Balance	**30,000**	**2,05,000**	**3,80,000**

BANK FINANCE FOR WORKING CAPITAL

1. Tandon Committee Report

Reserve Bank of India set up a committee under the chairmanship of Shri P.L. Tandon in July 1974. The terms of reference of the Committee were:

The terms of reference of the Committee were:

1. To suggest guidelines for commercial banks to follow up and supervise credit from the point of view of ensuring proper end use of funds and keeping a watch on the safety of advances;
2. To suggest the type of operational data and other Information that may be obtained by banks periodically from the borrowers and by the Reserve Bank of India from the leading banks;
3. To make suggestions for prescribing inventory norms for the different industries, both in the private and public sectors and indicate the broad criteria for deviating from these norms ;
4. To make recommendations regarding resources for financing the minimum working capital requirements
5. To suggest criteria regarding satisfactory' capital structure and sound financial basis in relation to borrowings
6. To make recommendations as to whether the existing pattern of financing working capital requirements by cash credit/overdraft system etc., requires to be modified, if so, to suggest suitable modifications

Recommendations

- Norms of current asset.
- Maximum permissible bank finance.
- Emphasis on loan systems.
- Periodic information and reporting system.

Norms for current assets.

They defined the norms (15 industries) for • Raw materials • Stock in progress • Finished goods • Receivables

Maximum permissible bank finance (MPBF) Three methods for determining MPBF

- Method 1: MPBF=0.75(CA-CL)
- Method 2: MPBF=0.75(CA)-CL
- Method 3: MPBF=0.75(CA-CCA)-CL CA- current asset, CL- current liabilities, CCA- core current assets (permanent component of working capital).

Emphasis on loan system

Only a portion of MPBF must be cash credit component and the balance must be in the form of working capital demand loan.

Periodic information and report system.

- quarterly information system-form I – Estimate production and sale for current and ensuring quarter. – The estimate of current asset and liabilities for the ensuing quarter.

Quarterly information system-form II – Production and sales during current year and for the latest completed year. – Asset and liabilities for the latest completed year.

- Half yearly operating statements- form III – Actual and estimated operating performance for the half year ended.
- Half yearly operating statements- form IIIB – Actual and estimated sources and uses of funds for the half year ended.

2. Chore Committee Report

The Reserve Bank of India in March, 1979 appointed another committee under the chairmanship of Shri K.B. Chore to review the working of cash credit system in recent years with particular reference to the gap between sanctioned limits and the extent of their utilization and also to suggest alternative type of credit facilities which should ensure greater credit discipline.

The important **recommendations of the Committee** are as follows:

(i) The banks should obtain quarterly statements in the prescribed format from all borrowers having working capital credit limits of Rs 50 lacs and above.

(ii) The banks should undertake a periodical review of limits of Rs 10 lacs and above.

(iii) The banks should not bifurcate cash credit accounts into demand loan and cash credit components.

(iv) If a borrower does not submit the quarterly returns in time the banks may charge penal interest of one per cent on the total amount outstanding for the period of default.

(v) Banks should discourage sanction of temporary limits by charging additional one per cent interest over the normal rate on these limits.

(vi) The banks should fix separate credit limits for peak level and non-peak level, wherever possible.

(vii) Banks should take steps to convert cash credit limits into bill limits for financing sales.

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SCHOOL OF MANAGEMENT STUDIES

UNIT – V – Financial Management – SBA1106

UNIT V MANAGEMENT OF LONG TERM CAPITAL

Sources of long term funds- Cost of Capital- Computation Cost of Capital for Each Source and Weighted Average Cost- Capital Structure- Computation of Indifference Point- Financial Leverage- Operating Leverage- Combined Leverage and its significance- Financial Information System (FIS) – Basics of Management Control System- Corporate Governance

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SOURCES OF LONG TERM FUNDS

Refer Unit II material

COST OF CAPITAL

Cost of capital for a firm may be defined as the cost of obtaining funds i.e.; The average rate of return that the investors in a firm would expect for supplying funds to the firm. According to Soloman Ezva," cost of capital to the minimum required rate of earnings or the cut- off rate of capital expenditure.

USES OF COST OF CAPITAL IN FINANCIAL DECISION MAKING:

1. **CAPITAL BUDGETING DECISION:**

In various methods of capital budgeting, cost of capital is the key factor in deciding the project out of various proposals pending before the management.

2. **DESIGNING OF CAPITAL MIX:**

The mix of debt and equity increased the rate of return on equity capital, other things remaining the same. But use of debt increases, the financial risks also. The situation results in a higher cost of capital for the firm. Thus cost of capital affects the capital structure.

3**. DECIDING ABOUT THE METHOD OF FINANCING:**

Whenever additional finance requires, he may have a better choice of the source of finance, which bears he minimum cost of capital.

4. **PERFORMANCE OF TOP MANAGEMENT:**

The performance of top management should be evaluated by comparing actual profitability of projects, with (a) the projected overall cost of capital and (b) the actual costs of funds raised to finance the projects.

5. **OTHER AREAS:**

The concept of cost of capital is also important in many other areas of decision making, such as dividend decision and working capital policy.

SPECIFIC COST AND WEIGHTED COST

Specific cost refers to the cost which is associated with the particular sources of capital. E.g.- Cost of Equity Weighted/ Composite cost is the combined cost of different sources of capital taken together. E.g.- Cost of debt, cost of equity & Cost of preference shares.

MEASUREMENT OF SPECIFIC COST OF DIFFERENT SOURCES

I. **COST OF DEBT: (Kd)**

The cost of debt is defined in terms of the required rate of return that the debt investment must yield to protect the shareholders interest.

Cost of **Irredeemable** Debentures **Before Tax** – Issued at Par, Premium or Discount

$$K_i = I/NP \times 100$$

Cost of **Irredeemable** Debentures **After Tax** – Issued at Par, Premium or Discount

$$K_d = I/NP \times 100(1-t) \text{ or } K_d = r\,(1-t)$$

Cost of **Redeemable** Debentures **Before Tax** – Issued at Par, Premium or Discount

$$K_i = \frac{I + 1/n\,(P-NP)}{1/2(P + NP)}$$

Cost of **Redeemable** Debentures **After Tax** – Issued at Par, Premium or Discount

$$K_d = \left[\frac{I + 1/n\,(P-NP)}{1/2(P + NP)}\right] \times (1-t)$$

I = Interest

NP = Net Proceeds

n = Number of years for maturity

P = Redeemable value of debentures

II. **COST OF PREFERENCE SHARES (Kp)**:

Cost of preference shares are the fixed cost bearing securities. The dividend rate is fixed well in advance at the time of their issue

Irredeemable Preference Shares	$K_p = D/NP$
Redeemable Preference Shares	$K_p = \frac{D + 1/n\ (P-NP)}{½(P+NP)}$

D = *Dividend for preference share holder*

NP = *Net Proceeds per share = Face value + Premium – Discount – Cost of issue (if any)*

n = *Number of years for maturity*

P = *Redeemable value of Preference shares*

III. COST OF EQUITY SHARES (Ke):

The cost of equity capital is the minimum rate of return that the firm must earn on the equity financed portion of an investment project in order to leave unchanged the market price of the stock.

(a)Dividend / Price Approach:

According to this approach the value of an equity share is equivalent to the present value of future dividends plus the present value of the price expected to be realized.

Ke = D/NP or D/MP

D = *Dividend Per share*

NP = *Net Proceeds per share = Face value + Premium – Discount – Cost of issue (if any)*

MP = *Market Price Per Share*

(b) Dividend / Price + growth rate Approach:

This approach takes into account dividend as well as rate of growth in the dividend, which is assumed to be equal to the growth rate in earnings per share and market price per share.

Ke = D/NP + G

D = *Dividend Per share*

NP = *Net Proceeds per share = Face value + Premium – Discount – Cost of issue (if any)*

MP = *Market Price Per Share*

G = *Growth Rate of Dividends*

(c) Earnings Price ratio Approach:

This ratio establishes the relationship between earnings and market price of the shares. Shareholders capitalize a stream of unchanged earnings by the capitalization ratio of E / P in order to evaluate their holdings.

Ke = E / NP or MP

NP = Net Proceeds per share = Face value + Premium – Discount – Cost of issue (if any)

MP = Market Price Per Share

E = Earnings Per Share

(d) **Realised Yield Approach:**

This approach is based on the rate of return actually realized for a period of time by investors in a company. Under this approach, the realized yield is discounted at the present value factor and then compared with the value of investment.

Ke= E /NP or MP

IV. COST OF RETAINED EARNINGS

Retained earnings also have opportunity cost. Opportunity cost of retained earnings is other rate of return which they can get by investing the after tax dividends in other alternative opportunities. It can be expressed as:

Kr= Ke (I-T) (1-B)

T = tax rate

B = Brokerage rate

WEIGHTED AVERAGE COST OF CAPTIAL

Weighted average is an average of the costs of specific sources of capital employed in a business, properly weighted by the proportion, they hold in the firm's capital structure.

BOOK VALUE WEIGHTS AND MARKET VALUE WEIGHTS

The weighted cost of capital can be computed by using the book value or the market value weights. Book value weight will be understated it the market value of the share is higher than the book value and vice-versa.

Steps involved in computation of WACC

• Calculate the cost of each of the sources of finance is ascertained.

• Assigning weights to specific costs.

• Multiplying the cost of each source by the appropriate weights.

• Dividing the total weighted cost by the total weights.

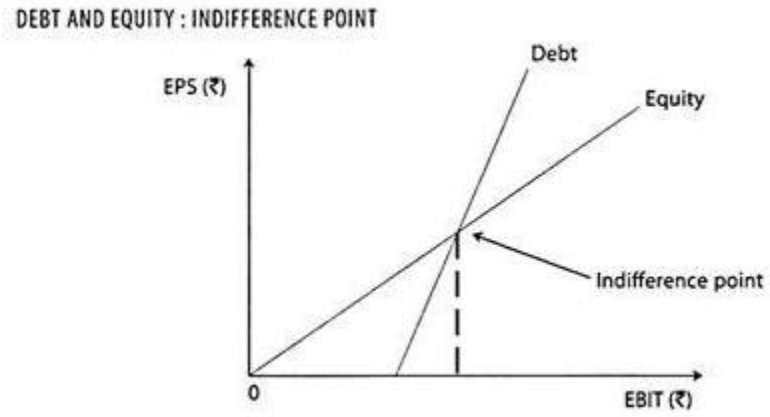
CAPITAL STRUCTURE

Refer Unit III material

FINANCIAL INDIFFERENCE POINT

Indifference point is the point of EBIT, where EPS for any two financial plan is same. The indifference point may be defined as the level of EBIT beyond which the benefits of financial leverage begins to operate with respect to earnings per share.

When two alternative financial plans do produce the level of EBIT where EPS is the same, this situation is referred to as 'indifference point'. In case, the expected level of EBIT exceeds the indifference point, the use of debt financing would be advantageous to maximize the EPS.



The indifference point between the two financing alternatives can be ascertained as follows:

EPS1 = EPS2

$$\frac{(EBIT-I_1)(1-t)}{N_1} = \frac{(EBIT-I_2)(1-t)}{N_2}$$

Where,

EPS1 = Earnings Per Share of alternative 1

EPS2 = Earnings Per Share of alternative 2

EBIT = Earnings before interest and taxes

t = Corporate rate of tax

I_1 = Interest charges in Financing alternative 1

N_1 = Number of equity shares in Financing alternative 1

I_2 = Interest charges in Financing alternative 2

N_2 = Number of equity shares in Financing alternative 2

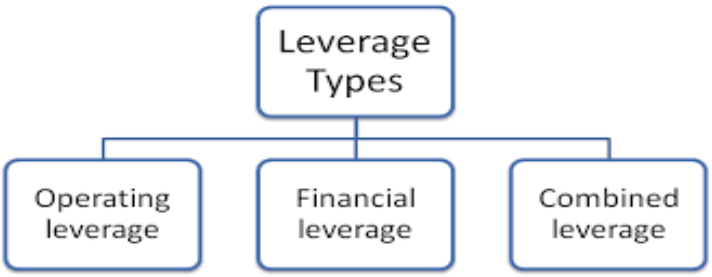
LEVERAGE

In general, leverage means to use something that you already have in order to achieve something new or better. In financial terms leverage means influence of one financial variable over the other financial variable.

James Horne has defined leverage as "the employment of funds which the firm has to pay a fixed cost or fixed return". If a firm is not required to pay fixed cost or fixed return there will be no leverage. The use of various financial instruments or borrowed capital, to increase the potential return of an investment is known as leverage.

- Leverage refers to the use of debt (borrowed funds) to amplify returns from an investment or project.
- Leverage is an investment strategy of using borrowed money specifically, the use of various financial instruments or borrowed capital to increase the potential return of an investment.
- Leverage is the use of debt (borrowed capital) in order to undertake investment or project. The result is to multiply the potential returns from a project.
- At the same time, leverage will also multiply the potential downside risk in case the investment does not get adequate returns.
- The company has to pay fixed cost (interest) which could still decline the company's profit. In other words increasing leverage increases the size of the return and increases the risk

TYPES OF LEVERAGE



1. OPERATING LEVERAGE

Operating leverage arises from the existence of fixed operating expenses. So the degree of operating leverage depends upon the amount of fixed costs. If fixed costs are high even a small decline in sales can lead to a large decline in operating income. Operating leverage may be defined as the firm's ability to use fixed operating costs to magnify the effects of changes in Sales on its EBIT. Operating leverage is related with Investment activities. Operating leverage can be determined by means of cost volume analysis.

Significance of Operating Leverage:

1. It measures the sensitivity of EBIT to change in sales.
2. It is a measure of business risk.
3. It helps in studying the cost, volume and profit relationship.

Formula:

Operating leverage $= \frac{Contribution}{EBIT}$

Operating leverage also be defined as % of change in profits resulting from % change in sales.

Degree of Operating leverage $= \frac{\%\text{ of change in EBIT}}{\%\text{ of change in sales}}$

When Fixed and variable cost could not have apportioned. The above formula could be used. This is a more practical formula

2. FINANCIAL LEVERAGE

Financial leverage refers to the use of funds obtained by fixed cost or fixed return securities (preference and debentures) in the hope of increasing the return to equity shareholders. It may be defined as % return on equity to the percentage on capitalization. Financial leverage may be defined as the firm's ability to use fixed financial costs to magnify the effects of changes in EBIT on its EPS.

Significance of Financial Leverage:

1. It measures the sensitivity of EPS to change in EBIT.
2. It is a measure of financial risk.
3. It helps in studying the relationship between operating profit and earnings per share of the firm.

Formula:

1. If Preference Share dividend does not exist:

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

2. If Preference Share dividend exists:

Financial Leverage = $\frac{EBIT(1-T)}{\text{EBIT}-\text{I (l}-\text{Tax)} - \text{Dp}}$

Financial leverage also can be defined as % of change in EPS resulting from % change in EBIT.

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

Trading on Equity

Trading on Equity is a financial process that involves taking more debt to boost the return of the shareholders. Trading on Equity occurs when a company takes new debt, in the form of bonds, preferred stock, or loans etc. The company uses those funds to acquire assets to generate a return greater than the interest cost of new debt. Trading on equity is also known as financial leverage is considered successful if the company generates a profit and a higher return on investment for the shareholders.

Benefits of Financial Leverage

The financial leverage has various advantages to the company, management, investors and financial companies. The following are some such benefits:

- **Economies of Scale**: The financial leverage helps the organizations to expand its production unit and manufacture goods on a large scale, reducing the fixed cost drastically.
- **Improves Credit Rating**: If the company take debts and can pay off these debts on time by generating a good profit from the funds availed, it secures a high credit rating and considered reliable by the lenders.
- **Favourable Cash Flow Position**: This additional capital provides an opportunity to increase the earning power of the company and hence to improve the cash flow position of the company.
- **Increases Shareholders' Profitability**: As the company expands its business through financial leverage, the scope for profitability also increases.
- **Tax Relaxation**: When the debts and liabilities burden the company, the government allows tax exemptions and benefits to it.
- **Expansion of Business Ventures**: The need for financial leverage arises when the company plans for growth and development, which is a positive step.

Limitations of Financial Leverage

There are certain drawbacks of the financial leverage which are mainly related to borrowings through debts. These are as follows:

- **High Risk**: There is always a risk of loss or failure in generating the expected returns along with the burden of paying interest on debts.
- **Adverse Results**: The outcome of such borrowings may be harmful at times if the business plan goes wrong.
- **Restrictions from Financial Institutions**: The lending financial institution usually restricts and controls the business operations to some extent.
- **High Rate of Interest**: The interest rates on the borrowed sum is generally high, which creates a burden on the company.
- **Benefits Limited to Stable Companies**: The financial leverage is a suitable option for only those companies which are stable and possess a sound financial position.
- **May Lead to Bankruptcy**: In case of unexpected loss or poor returns and huge debts or liabilities, the company may face the situation of bankruptcy.

A company must be careful while analyzing its financial leverage position because high leverage means high debts. Also, giving ownership may prove to be hazardous for the organization and even result in huge loss and business failure.

3. COMPOSITE LEVERAGE OR COMBINED LEVERAGE

Combined leverage thus expresses the relationship between revenue on account Of sales and the taxable income. It helps in finding out the resulting percentage change in taxable income on account of percentage change in sales.

Formula:

Composite leverage = Operating leverage * Financial leverage (or) $\frac{Contribution}{EBT}$

(or) Combined Leverage = $\frac{Contribution}{\text{EBIT}-\text{I (l}-\text{Tax)} - \text{Dp}}$

(or) Combined Leverage = $\frac{Contribution(1-T)}{EBIT(1-T)Dp}$

(or) Degree of Combined Leverage = $\frac{\%\text{ of change in EPS}}{\%\text{ of change in sales}}$

Significance of Combined Leverage:

1. It measures the sensitivity of EPS to change in sales.
2. It is a measure of both business and financial risk.
3. It helps in studying the relationship between EPS and Sales of the firm.

Favourable and Unfavourable Leverage:

When Sales minus (-) Variable Cost exceeds Contribution (or) EBIT exceeds Fixed cost bearing funds requirement, it is referred as Favorable leverage, When they do not, it is referred as Unfavorable leverage.

BUSINESS RISK AND FINANCIAL RISK

Operating or Business Risk

Risk that a business will not be able to cover its operating costs.

Operating risk is the risk associated with the operation of the firm. It refers to the chance a business's cash flows are not enough to cover its operating expenses like cost of goods sold, rent and wages. Operating cost is composed of fixed costs and variable costs. Existence of excessive fixed cost is disadvantageous to the firm. If the total revenue of a firm having a high fixed cost declines for any reason, the operating profit will reduce proportionately more.

Operating leverage refers to the percentage of fixed costs that a company has. If a business firm has more fixed costs as compared to variable costs, then the firm is said to have high operating leverage. Incurrence of fixed operating costs in the firm's income stream increases the business risk or operating risk. If a firm has high operating leverage, a small change in sales volume results in a large change in returns.

Financial Risk

Risk that business will not be able to cover its financial costs/financial obligations. Financial risk is the risk associated with financing decisions of the firm i.e. how a company finances its operations. The presence of debt in the capital structure creates fixed payments in the form of interest, which is a compulsory payment to be made whether the firm makes a profit or not. It increases the variability of the returns to the shareholders

When debt is used by the firm, the rate of return on equity increases because debt capital is generally cheaper. Therefore use of the debt capital has a magnifying effect on the earnings of the equity shareholders but it also adds financial risk. The variability in earnings of the equity

shareholders due to presence of debt in the capital structure of a company is referred to as financial risk. The higher the amount of leverage a company has, the higher the financial risk which exists to stockholders of the company.

FINANCIAL INFORMATION SYSTEM

Financial information system is a channel and carrying and providing information to the management. The efficiency of an organisation is to ascertain extent governed by the regularity of the information provided to those who perform the functions of management. An effective system of FIS collects financial data from the financial records and transactions. The information is properly processed and stored for use in future. The need and purpose of FIS is outlined under:

1. The primary aim of FIS is to provide information for sound judgment on the basis of operating results.
2. To provide understanding and acceptance of the judgement by the people engaged in various aspects of the organisation.
3. To provide information to top management to help them in planning and organisation.

USES FINANCIAL INFORMATION SYSTEM

Planning and control:

FIS is to establish, coordinate and administer and act as integral part of management. FIS is useful for planning, programmes for capital investing and financing. In addition, it helps in sales forecasting, expense budgets and cost standards.

Reporting and interpreting:

FIS device is a useful tool for compare performance and operating plans and standards and to report and interpret the results of operations at all levels of management.

Evaluating and advising:

FIS is to evaluate the effectiveness of policies, organizational structure and procedures in attaining the business objectives.

Tax administration:

FIS helps in administration of tax policies and procedures FIS assists in supervising all matters relating to tax accounting.

Government reporting:

FIS is a tool for supervise and coordinate the preparation of reports to government agencies. FIS helps in submission of periodical statements to Government in appropriate time.

Apart from weekly and fortnightly journals, there are some monthly publications like 'Reserve Bank of India Bulletin', Dun's Review and The Chartered Accountant Institute Journal are also available to provide sources of financial information in India

BASICS OF MANAGEMENT CONTROL SYSTEM

Management Control System is a set of formal and informal systems to assist management in the coordination of various activities / functions of an organization and to steer the entire organization toward the achievement of overall goals and objectives.

• A control system is so designed to bring unity out of the diverse activities of an organization to fulfill overall objectives.

Factors influencing Management Control System

• Size and spread of the enterprise

• Nature of operations and divisibility

• Type of responsibility centres

• People and their perceptions

Types of management control systems

- Formal Control
- Informal Control

FORMAL CONTROL SYSTEM

• The controls are laid down by the management in writing to influence the behaviour of employees in achieving organization's goals.

• Examples:

- Rules and regulations

- Procedures

- Work plan / work instructions.

• Formal Control System (FCS) establishes well defined organizational structure, policies and procedures to be followed by the members of the organization. FCS can be classified into three types:

- Input Control
- Process Control
- Output Control

INFORMAL CONTROL SYSTEM

• These are unwritten, people initiated mechanisms that influence the behaviour of individuals or groups in business units.

Example:

- Group behaviour
- Work culture
- Organizational norms and beliefs

There are three types of Informal Control:

- Self-Control
- Social Control
- Cultural Control

LEVELS OF CONTROLS IN AN ORGANIZATION

- Top Mgt. (Strategic Control)
- Middle Mgt. (Management Control)
- Lower level (Operational Control)

Strategic control

• It is the function of the top management.

• It involves strategy formulation for the entire organization, identifying goals, strategies and policies for the entire organization.

• It is long term in nature.

Management control

• It deals with the effective utilization of resources made available by the top-management for the accomplishment of organization's objectives.

• It is exercised by the middle management through interaction with the top management and lower level management.

• It is medium term in nature.

Operational control

• It is exercised by the lower level / shop floor level management.

• It is short term in nature, the benchmarks are well defined and the outcomes are tangible and easily measurable.

CORPORATE GOVERNANCE

Corporate Governance refers to the way a corporation is governed. It is the technique by which companies are directed and managed. It means carrying the business as per the stakeholders' desires. It is actually conducted by the board of Directors and the concerned committees for the company's stakeholder's benefit. It is all about balancing individual and societal goals, as well as, economic and social goals.

Corporate Governance is the interaction between various participants (shareholders, board of directors, and company's management) in shaping corporation's performance and the way it is proceeding towards. The relationship between the owners and the managers in an organization must be healthy and there should be no conflict between the two. The owners must see that individual's actual performance is according to the standard performance. These dimensions of corporate governance should not be overlooked.

Corporate Governance deals with the manner the providers of finance guarantee themselves of getting a fair return on their investment. Corporate Governance clearly distinguishes between the owners and the managers. The managers are the deciding authority. In modern corporations, the functions/ tasks of owners and managers should be clearly defined, rather, harmonizing.

Corporate Governance deals with determining ways to take effective strategic decisions. It gives ultimate authority and complete responsibility to the Board of Directors. In today's market-oriented economy, the need for corporate governance arises. Also, efficiency as well as globalization are significant factors urging corporate governance. Corporate Governance is essential to develop added value to the stakeholders.

Corporate Governance ensures transparency which ensures strong and balanced economic development. This also ensures that the interests of all shareholders (majority as well as minority

shareholders) are safeguarded. It ensures that all shareholders fully exercise their rights and that the organization fully recognizes their rights.

Corporate Governance has a broad scope. It includes both social and institutional aspects. Corporate Governance encourages a trustworthy, moral, as well as ethical environment.

Benefits of Corporate Governance

1. Good corporate governance ensures corporate success and economic growth.
2. Strong corporate governance maintains investors' confidence, as a result of which, company can raise capital efficiently and effectively.
3. It lowers the capital cost.
4. There is a positive impact on the share price.
5. It provides proper inducement to the owners as well as managers to achieve objectives that are in interests of the shareholders and the organization.
6. Good corporate governance also minimizes wastages, corruption, risks and mismanagement.
7. It helps in brand formation and development.
8. It ensures organization in managed in a manner that fits the best interests of all.