M.I.E.T. ENGINEERING COLLEGE
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UG - CSE, EEE & MECH Programs Accredited by NBA, New Delhi
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An ISO 9001:2015 Certified Institution
Recognized by UGC under section 2(f) & 12(B) of UGC Act, 1956
Trichy – Pudukkottai Road, Tiruchirappalli – 620 007. Phone:0431-2660 303
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BA4202 FINANCIAL MANAGEMENT L T P 3 0 0

COURSE OBJECTIVES:

Facilitate student

- Understand the operational nuances of a Finance Manager.
- Comprehend the technique of making decisions related to finance functions.

UNIT I FOUNDATIONS OF FINANCE 9

Introduction to finance- Financial Management – Nature, scope and functions of Finance, organization of financial functions, objectives of Financial management, Major financial decisions – Time value of money
– features and valuation of shares and bonds – Concept of risk and return – single asset and of a portfolio.

UNIT II INVESTMENT DECISIONS 9

Capital Budgeting: Principles and techniques - Nature of capital budgeting- Identifying relevant cash flows
- Evaluation Techniques: Payback, Accounting rate of return, Net Present Value, Internal Rate of Return, Profitability Index - Comparison of DCF techniques - Concept and measurement of cost of capital - Specific cost and overall cost of capital.

UNIT III FINANCING AND DIVIDEND DECISION 9

Leverages - Operating and Financial leverage – measurement of leverages – degree of Operating &Financial leverage – Combined leverage, EBIT – EPS Analysis- Indifference point.
Capital structure – Theories – Net Income Approach, Net Operating Income Approach, MM Approach –Determinants of Capital structure.
Dividend decision- Issues in dividend decisions, Importance, Relevance & Irrelevance theories - Walter's
– Model, Gordon's model and MM model. – Factors determining dividend policy – Types of dividend policies – forms of dividend.

UNIT IV WORKING CAPITAL MANAGEMENT9

Principles of working capital: Concepts, Needs, Determinants, issues and estimation of working capital - Receivables Management - Inventory management – Cash management - Working capital finance : Commercial paper, Company deposit, Trade credit, Bank finance.

UNIT V LONG TERM SOURCES OF FINANCE 9

Indian capital market- New issues market- Secondary market - Long term finance: Shares, debenturesand term loans, lease, hire purchase, venture capital financing, Private Equity.

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UNIT 1 THE FINANCE FUNCTION

INTRODUCTION:

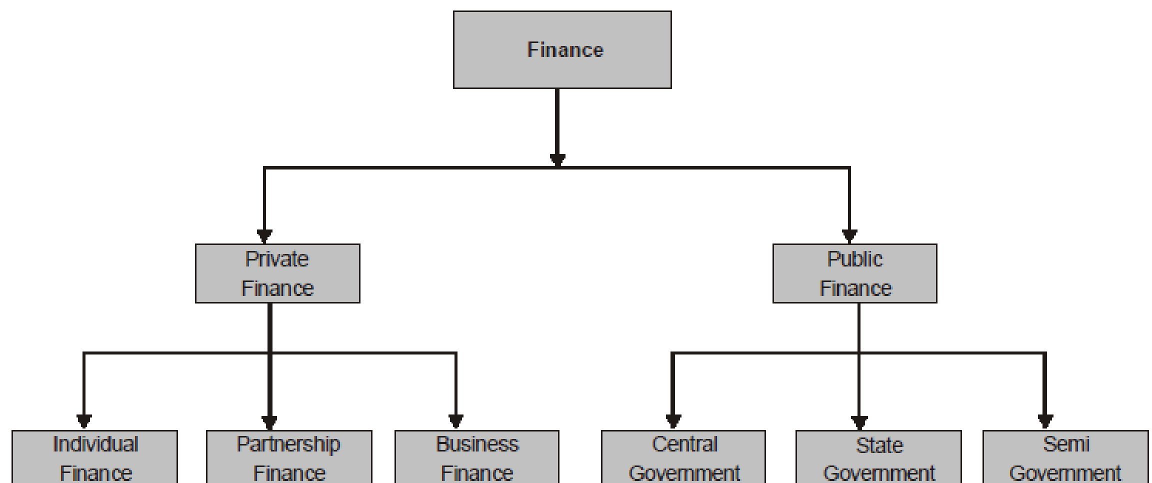
In our present day economy, Finance is defined as the provision of money at the time when it is required. Every enterprise, whether big, medium or small needs financeto carry on its operations and to achieve its targets. In fact, finance is so indispensable today that it is rightly said to be the life blood of an enterprise.

MEANING OF FINANCE

Finance may be defined as the art and science of managing money. It includes financial service and financial instruments. Finance also is referred as the provision of money at the time when it is needed. Finance function is the procurement of funds and their effective utilization in business concerns. The concept of finance includes capital, funds, money, and amount. But each word is having unique meaning. Studying and understanding the concept of finance become an important part of the business concern

TYPES OF FINANCE

Finance is one of the important and integral part of business concerns, hence, it plays a major role in every part of the business activities. It is used in all the area of the activities under the different names. Finance can



be classified into two major parts:

Private Finance, which includes the Individual, Firms, Business or Corporate Financial activities to meet the requirements. Public Finance which concerns with revenue and disbursement of Government such as Central Government, State Government and Semi-Government Financial matters.

Definition:Finance

may be defined as the provision of money at the time when it is required. Finance refers to the management of flow of money through an organization.According to WHEELER,

business finance may be defined as "that businessactivity which is concerned with the acquisition and conservation of capital

funds in meeting the financial needs and overall objectives of the businessenterprise."

- According to GUTHMANN and DOUGALL, business finance may be broadly defined as "the activity concerned with the planning, raising, controlling and administering the funds used in the business."

NATURE OF FINANCE FUNCTION:

The finance function is the process of acquiring and utilizing funds of a business.Finance functions are related to overall management of an organization. Finance function is concerned with the policy decisions such as like of business, size of firm,type of equipment used, use of debt, liquidity position. These policy decisions determine the size of the profitability and riskiness of the business of the firm. Prof.K.M.Upadhyay has outlined the nature of finance function as follows:

i) In most of the organizations, financial operations are centralized. This results in economies.
ii) Finance functions are performed in all business firms, irrespective of their sizes / legal forms of organization.
iii) They contribute to the survival and growth of the firm.
iv) Finance function is primarily involved with the data analysis for use in decision making.
v) Finance functions are concerned with the basic business activities of a firm, in addition to external environmental factors which affect basic business activities, namely,production and marketing.
vi) Finance functions comprise control functions also
vii) The central focus of finance function is valuation of the firm.

Finance is something different from Accounting as well as Economics but it uses information of accounting for making effective decisions. Accounting deals with recording, reporting and evaluating the business transactions, whereas Finance is termed as managerial or decision making process.

Economics deals with evaluating the allocation of resources in economy and alsorelated to costs and profits, demand and supply and production and consumption. Economics also consider those transactions which involve goods and services either in return of cash or not.

Economics is easy to understand when divided into two parts.

1. ***Micro Economics:***

It is also known as price theory or theory of the firm. Micro economics explains the behavior of rational persons in

making decisions related to pricing and production.

2. ***Macro Economics:***

Macro Economics is a broad concept as it takes into consideration overalleconomic situation of a nation. It uses gross national product (GNP) and useful in forecasting.

In order to manage problems related to money principles developed by financial managers, economics, accounting are used.

Hence, finance makes use of economic tools. From Micro economics it uses theories and assumptions. From Macro economics it uses forecasting models. Even though finance is concerned with individual firm and economics is concerned with forecasting of an industry.

SCOPE OF FINANCIAL MANAGEMENT:

The main objective of financial management is to arrange sufficient finance for meeting short term and long term needs. A financial manager will have to concentrate on the following areas of finance function.

1. Estimating financial requirements:

The first task of a financial manager is to estimate short term and long term financial requirements of his business. For that, he will prepare a financial plan for present as wellas for future. The amount required for purchasing fixed assets as well as needs for working capital will have to be ascertained.

2. Deciding capital structure:

Capital structure refers to kind and proportion of different securities for raising funds. After deciding the quantum of funds required it should be decided which type ofsecurities should be raised. It may be wise to finance fixed assets through long term debts. Even here if gestation period is longer than share capital may be the most suitable.Long term funds should be employed to finance working capital also, if not wholly then partially. Entirely depending on overdrafts and cash credits for meeting working capital needs may not be suitable. A decision about various sources for funds should be linkedto the cost of raising funds.

3. Selecting a source of finance:

An appropriate source of finance is selected after preparing a capital

structure which includes share capital, debentures, financial institutions, public deposits etc. If finance is needed for short term periods then banks, public deposits and financial institutions may be the appropriate. On the other hand, if long term finance is required then share capital and debentures may be the useful.

4. Selecting a pattern of investment:

When funds have been procured then a decision about investment pattern is to be taken. The selection of an investment pattern is related to the use of funds. A decision will haveto be taken as to which assets are to be purchased? The funds will have to be spent first on fixed assets and then an appropriate portion will be retained for working capital and for other requirements.

5. Proper cash management:

Cash management is an important task of finance manager. He has to assess variouscash needs at different times and then make arrangements for arranging cash. Cash may be required to purchase of raw materials, make payments to creditors, meet wage bills and meet day to day expenses. The idle cash with the business will mean that it is not properly used.

6. Implementing financial controls:

An efficient system of financial management necessitates the use of various control devices. They are ROI, break even analysis, cost control, ratio analysis, cost and internalaudit. ROI is the best control device in order to evaluate the performance of various financial policies.

7. Proper use of surpluses:

The utilization of profits or surpluses is also an important factor in financial management. A judicious use of surpluses is essential for expansion and diversification plans and also in protecting the interests of share holders. The ploughing back of profits is the best policy of further financing but it clashes with the interests of share holders. A balance should be struck in using funds for paying dividend and retaining earnings for financing expansion plans.

FINANCE FUNCTION – AIM

The objective of finance function is to arrange as much funds for the business as are required from time to time. This function has the following

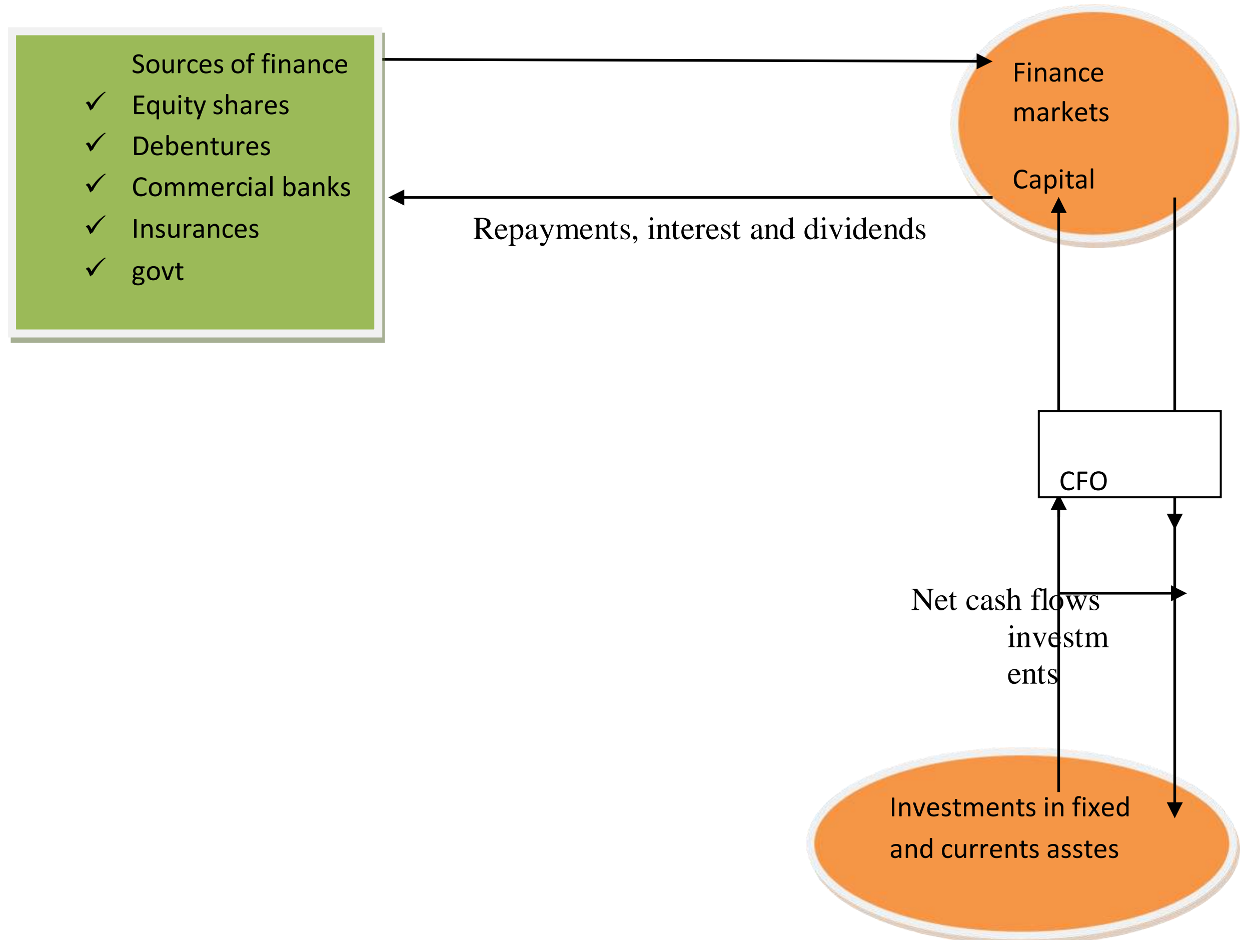
objectives.

1. **Assessing the Financial requirements.** The main objective of finance function is to assess the financial needs of an organization and then finding out suitable sources for raising them. The sources should be commensurate with the needs of the business. If funds are needed for longer periods then long-term sources like share capital, debentures, term loans may be explored.
2. **Proper Utilization of Funds:** Though raising of funds is important but their effective utilisation is more important. The funds should be used in such a way that maximum benefit is derived from them. The returns from their use should bemore than their cost. It should be ensured that funds do not remain idle at any point of time. The funds committed to various operations should be effectively utilised. Those projects should be preferred which are beneficial to the business.

3. **Increasing Profitability.** The planning and control of finance function aims at increasing profitability of the concern. It is true that money generates money. To increase profitability, sufficient funds will have to be invested. Finance Function should be so planned that the concern neither suffers from inadequacy of funds nor wastes more funds than required. A proper control should also be exercisedso that scarce resources are not frittered away on uneconomical operations. The cost of acquiring funds also influences profitability of the business.

4. **Maximizing Value of Firm**. Finance function also aims at maximizing the value of the firm. It is generally said that a concern's value is linked with its profitability.

ROLE OF FINANCIAL MANAGEMENT IN CONTEMPORARY SCENARIO:



Due to recent trends in business environment, financial managers are identifyingnew ways through which finance function can generate great value to their organization.

1. Current Business Environment: The progress in financial analytics is because of development of new business models, trends in role of traditional finance department, alternations in business processes and progress in technology.

Finance function in this vital environment emerged with enormous opportunities andchallenges.

2. New Business Model: At the time when internet was introduced, three new e- business models have evolved. They are business-to-business (B2B), business-to-

customer (B2C) and business-to-employees (B2E) future of financial analytics can be improved with the help of this new model of business.

Traditionally, financial analytical is emphasizing on utilization of tangible assets like cash, machinery etc, whereas some companies

are mainly focused on intangible assets which are not easy to evaluate and control. Hence financial analytics solved this problem by:

i) Recognizing the complete performance of organization.

ii) Determining the source through which value of intangible assets can beevaluated and increased.

iii) Predict the trends in market.

iv) The abilities of information system is encouraged.

v) Minimizes the operating costs and enterprise-wide investments are effectivelycontrolled and upgrade the business processes.

3. Changing Role of the Finance Department: The role of finance function has been changing simultaneously with the changes in economy. These changes are mainly due to Enterprise Resource Planning (ERP), shared services and alternations in its reporting role.

In the field of transaction processing, the role of financial staff has been widened up because of automated financial transactions. Now financial executives are not just processing and balancing transactions but they are focusing on decision- making processes.

International organizations are facilitating their customers by providing financial information and facility to update both finance and non-finance functions from any place around the world. It resulted in the department of decision support in the organization.

Finance professionals are held responsible for supplying suitable analytical tools and methods to decision makers.

i) Business Processes: With the evolution of business processes, queries regarding business are becoming more complicated. In order to solve, it requires analytics with high level of data integration and organizational collaboration. In the last few decades, organizations are replacing function based legacy systems with new methods like ERP, BRP etc., in order to get accurate and consistent financial and non- financial information.

In 1990's organizations were applying some modern systems like supply chain management, Customer Relationship Management (CRM) and many others to encourage their transactions. Overall organizations were building strong relations with customers.

ii) Technology: With the developments in technology, ERP, internet, data warehousing have also improved. Internet helps in increasing the sources of acquiring financial data, whereas ERP vendors are building their own financial analytics which helps I n evaluating the performance, planning and estimating, management and statutory reporting and financial consolidation.

Till now, data warehousing solutions used to emphasize on developing elements of analytical infrastructure such as data stores, data marts and reporting applications but in future these data ware housings provide advances analytical abilities to data stores.

iii) Integrated Analytics: To survive in this competitive environment, organizations must have advanced level of integrated financial analytics. Integrated financial analytics are useful for organizations to evaluate, combine and share information inside and outside the organization.

Hence, with the progress in role of finance function, the financial analytics are used in organizations effectively.

EVOLUTION OF FINANCE FUNCTION:

Financial management came into existence as a separate field of study from finance function in the early stages of 20th century. The evolution of financial management can be separated into three stages:

1. Traditional stage (Finance up to 1940): The traditional stage of financial management continued till four decades. Some of the important characteristics of this stage are:

i) In this stage, financial management mainly focuses on specific events like formation expansion, merger and liquidation of the firm.

ii) The techniques and methods used in financial management are mainly illustrated and in an organized manner.

iii) The essence of financial management was based on principles and policies used in capital market, equipments of financing and lawful matters of financial events.

iv) Financial management was observed mainly from the prospective of investment bankers, lenders and others.

2. Transactional stage (After 1940): The transactional stage started in the beginning years of 1940's and continued till the beginning of 1950's. The features of this stage were similar to the traditional stage. But this stage mainly focused on the routine problems of financial managers in the field of funds analysis, planning and control. In this stage, the essence of financial management was transferred to working capital

management.

3. **<u>Modern stage (After 1950):</u>** The modern stage started in the middle of 1950's and observed tremendous change in the development of financial management with the ideasfrom economic theory and implementation of quantitative methods of analysis. Some unique characteristics of modern stage are:

i) The main focus of financial management was on proper utilization of funds so thatwealth of current share holders can be maximized.

ii) The techniques and methods used in modern stage of financial management wereanalytical and quantitative.

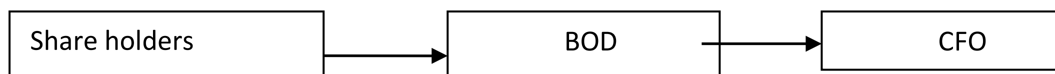
Since the starting of modern stage of financial management many important developments took place. Some of them are in the fields of capital budgeting, valuation models, dividend policy, option pricing theory, behavioral finance etc.

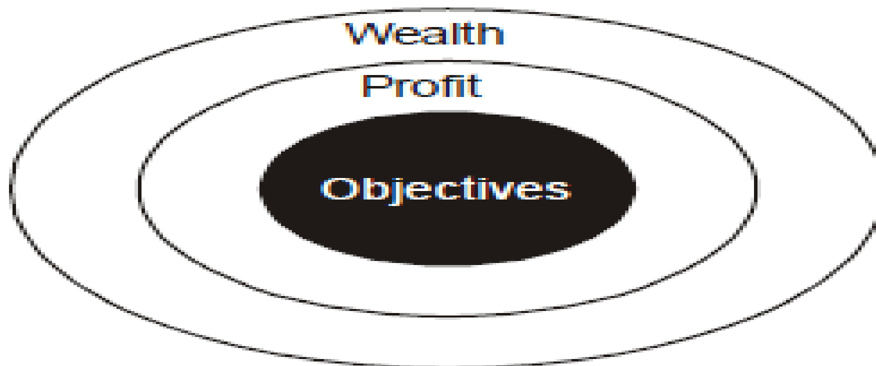
GOALS OF FINANCE FUNCTION

Effective procurement and efficient use of finance lead to proper utilization of thefinance by the business concern. It is the essential part of the financial manager. Hence, the financial manager must determine the basic objectives of the financial management. Objectives of Financial Management may be broadly divided into two parts such as:

1. Profit maximization

2. Wealth maximization.





Profit Maximization

Main aim of any kind of economic activity is earning profit. A business concern is also functioning mainly for the purpose of earning profit. Profit is the measuring techniques.

to understand the business efficiency of the concern. Profit maximization is also the traditional and narrow approach, which aims at, maximizes the profit of the concern. Profit maximization consists of the following important features.

1. Profit maximization is also called as cashing per share maximization. It leads to maximize the business operation for profit maximization.

2. Ultimate aim of the business concern is earning profit, hence, it considers all the possible ways to increase the profitability of the concern.

3. Profit is the parameter of measuring the efficiency of the business concern. So it shows the entire position of the business concern.

4. Profit maximization objectives help to reduce the risk of the business.

Favorable Arguments for Profit Maximization

The following important points are in support of the profit maximization objectives of the business concern:

(i) Main aim is earning profit.

(ii) Profit is the parameter of the business operation.

(iii) Profit reduces risk of the business concern.

(iv) Profit is the main source of finance.

(v) Profitability meets the social needs also.

Unfavorable Arguments for Profit Maximization

The following important points are against the objectives of profit maximization:

(i) Profit maximization leads to exploiting workers and consumers.

(ii) Profit maximization creates immoral practices such as corrupt practice, unfair trade practice, etc.

(iii) Profit maximization objectives leads to inequalities among the sake holders such as customers, suppliers, public shareholders, etc.

Drawbacks of Profit Maximization

Profit maximization objective consists of certain drawback also:

(i) It is vague: In this objective, profit is not defined precisely or correctly. It creates some unnecessary opinion regarding earning habits of the business concern.

(ii) It ignores the time value of money: Profit maximization does not consider the time value of money or the net present value of the cash inflow. It leads certain differences between the actual cash inflow and net present cash flow during a particular period.

(iii) It ignores risk: Profit maximization does not consider risk of the business concern. Risks may be internal or external which will affect the overall operation of the business concern.

2. Wealth Maximization

Wealth maximization is one of the modern approaches, which involves latest innovations and improvements in the field of the business concern. The term wealth means shareholder wealth or the wealth of the persons those who are involved in the business concern. Wealth maximization is also known as value maximization or net present worth maximization. This objective is an universally accepted concept in the field of business

Favorable Arguments for Wealth Maximization

(i) Wealth maximization is superior to the profit maximization because the main aim of the business concern under this concept is to improve the value or wealth of the shareholders.

(ii) Wealth maximization considers the comparison of the value to cost associated with the business concern. Total value detected from the total cost incurred for the business operation. It provides extract value of the business concern.

(iii) Wealth maximization considers both time and risk of the business concern.

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Wealth maximization provides efficient allocation of resources. ***Unfavorable Arguments for Wealth Maximization***

(i) Wealth maximization leads to prescriptive idea of the business concern but it may notbe suitable to present day business activities.

(ii) Wealth maximization is nothing, it is also profit maximization, it is the indirect nameof the profit maximization.

(iii) Wealth maximization creates ownership-management controversy.

(iv) Management alone enjoy certain benefits.

(v) The ultimate aim of the wealth maximization objectives is to maximize the profit.

(vi) Wealth maximization can be activated only with the help of the profitable positionof the business concern.

S.NO.	PROFITMAXIMIZATION	WEALTH MAXIMIZATION	WELFARE MAXIMIZATION
1)	Profits are earned maximized, so that firmcan over-come future risks which are uncertain.	Wealth is maximized, so that wealth of share-holders can be maximized.	Welfare maximization is done with the help of micro economic techniques to examine a locative distribution.
2)	Profit maximization is a yards stick for calculating efficiency and economic prosperity of the concern.	In wealth maximization stockholders current wealth is evaluated in order to maximize the value of shares in themarket.	In welfare maximization, social welfare is evaluated by calculating economic activities of individuals in the society.

(iv) It ensures the economic interest of the society.

3)	Profit is measured in terms of efficiency of the firm.	Wealth is measured in terms of market price of shares.	Welfare can be measured in two ways, either by pare to efficiency or in units or dollars.
4)	Profit maximization involvesproblemof uncertainty because profits are uncertain.	Wealth maximization involves problems related to maximizing shareholder'swealth or wealth of the firm	Wealth maximization involves problem of combining the utilities of different people.

PROFIT VS. WEALTH VS.

WELFARE AGENCY

RELATIONSHIP AND COST:

The relationship that exists in an organization between share holders and management known as agency relationship. Agency relationship results when a principalhires an agent to perform part of his duties. In this type of relationship there is a chance of conflicts to occur between the principal and the agent. This conflict is termed as agency problem. The costs incurred by stockholders in order to minimize agency problem and maximize the owner's wealth are called agency costs.

The two primary agency relationship exists in a business concern are:

1) Shareholders Vs Bondholders

2) Manager Vs Share holders

1) <u>Agency conflict-I (Shareholders Vs Bondholders):</u> Shareholders are the real owners of the concern, they pay fixed and agreed amount of interest to bondholders till the duration of bond is finished but bondholders have a proceeding claim over the assets of the company. Since equity investors are the owners of the company they possess a residual claim on the cash flows of the company. Bondholders are the only sufferers if decisions of the company are not appropriate.

When a company invest in project by taking amount from bondholders and if the project is successful, fixed amount is paid to bondholders and rest of the profits are for shareholders and suppose if project fails then sufferers will be the bondholders as their money have been invested.

2) <u>Agency conflict-II (Managers Vs Shareholders):</u> Profits generated from investments in projects can be utilized for reinvestment or provided back to shareholdersas dividends. If dividends are increased, it may leads to decrease in the resources which are under the manager's control and also strict its growth. As managers are evaluated on the basis of growth they might go for unproductive projects which cannot generate appropriate returns, which make the shareholders feel shocked. This is the main cause ofconflicts between managers and shareholders.

THE NEW DEBATE ON MAXIMIZING VS SATISFYING:

A principal agent relationship exists between management and owners of the company. The real owners of the company are shareholders and whereas management engaged for making decisions on behalf of share holders. Conflicts are common in every relationship, they arise when objectives of agents does not match with objectives of principal.

Sometimes, managers are considered to be the satisfiers rather than

maximizer's of share holder's wealth, when managers satisfy the objectives of shareholders considerably and also satisfies their own objectives. Such a behavior of management is well in short term but it is not suitable in long, medium term for some companies. It giverise to two critical conditions:

1) The competitive market for the shareholder's funds

2) The competitive market for management jobs

The share holders of the company which is listed in stock exchange can evaluate the performance of management by comparing the share price performance of similar companies. If share price performance is not good, then it is clear that management is only satisfying and not working for maximizing shareholders wealth. It leads to the situation in which share holders sell off their shares and purchase shares of maximizing companies. It ultimately leads to the undesirable takeover.

Hence, the competitive market for shareholder's funds ensures support to the maximizing objective.

Another way for managers to continue his objectives are possible with job promotions. It is believed by managers that performing their duties well leads to promotion and applies; it is a competitive market for managerial jobs. Hence, satisfying managers are replaced with maximizing managers.

Because of above conditions, satisfying behavior of management is not suitable in long and medium term. It is difficult for companies which are not listed in stock exchange to evaluate share price performance.

MAXIMIZING VS SATISFYING

As share holders are the real owners of the organization, they appoint managers to take important decisions with the objective of maximizing share holder's wealth. Though organizations have many more objectives, but maximizing stock price is considered to be an important objective of all for many firms.

1) Stock price maximization and social welfare: It is advantageous for society, if firm maximize its stock price. But, firm must not have any intentions of forming monopolistic market, creating pollution and avoiding safety measures. When stockprices are maximized, it benefits society by:

i) To greater extent the owners of stock are society*:* In past, ownership of stock was with wealthy people in society. But now, with the tremendous growth of pension funds, life insurance companies and mutual funds, large group of people in society have ownership of stock either directly or

indirectly. Hence, when stock price is increased, it ultimately improves the quality of life for many people in society.

ii) Consumers benefit: It is necessary to have effective low-cost businesses which manufacture good quality of goods and services at the cheapest cost possible to maximize stock price. Companies which are interested in maximizing stock price must satisfy all requirements of customers, provide good services and innovate new products finally; it must increase its sales by creating value for customers. Some people believe that firms increase the prices of goods while maximizing stock price. But it is not true;in order to survive in competitive market firms does not increase prices otherwise they may lose their market share.

iii) Employees benefit: In past years, it was an exception that decreases in level of employees lead to increase in stock price, but now a successful company which can increase stock price can develop and recruit more employees which ultimately benefits the society. Successful companies take advantage of skilled employees and motivated employees are an important source of corporate success.

2) Managerial Actions to Maximize Shareholder's Wealth: In order to identify the steps taken by managers to maximize shareholder's wealth, the ability of the organization to generate cash must be known. Cash flows can be determined in three ways, they are:

i) Unit Sales: In first determinant, managers can increase the level of their sales eitherby satisfying customers or by luck, but which will not continue in long run.

ii) After Tax Operating Margins: In second determinant, managers can generate cash flows by increasing operating profit which is not possible in competitive environment orby decreasing direct expenses.

iii) Capital Requirements: In third determinant, managers can increase cash flows by decreasing assets requirements which ultimately results in increase of stock price.

Investment and financing decisions have an impact on level, timing and risk of the cash flow of firm and finally on stock price. It is necessary for manager to make decisions which can maximize the stock price of the firm.

3) Maximizing Earnings Per Share is Beneficent or Not: In order to maximize stock price, many analyst focus on cash flows by evaluating the performance of the company and also focus of EPS as an accounting measure. Along with cash flow, EPS also plays an important role in

identifying stockholder's value.

RISK RETURN TRADE-OFF

The Risk-Return Trade-Off is an essential concept in finance theory. Riskimplies the changes in expected return like sales, profits or cash flow and it also includesprobability that problem.

Risk analysis is a procedure of calculating and examining the risk which isrelated to financial and investment decision of the company.

Finance managers must focus on expected rate of return by comparing the level of risks involved in investment decision. When it is expected that rate of return will be high then it involves high level of risk and vice versa.

1) Capital Budgeting Decisions: Capital budgeting decision is important, as it involves proper allocation of funds. These decisions are made considerably for long period of time in order to get benefits in future. While taking capital budgeting decision, finance manager needs to evaluate the cost of capital and risk involved in it. Finance manager must have complete knowledge about the techniques used for evaluating such as Net Present Value (NPV), IRR, discounted cash flow, etc. Finance manager must have the capability of combining risk with returns in order to evaluate the potential of investment appropriately.

2) Capital Structure Decisions: Capital structure decisions play an important role in designing the capital structure which is suitable for the company. It is the duty of finance manager to develop an optimum capital structure which involves less amount of cost of capital, less amount of risk but which can generate huge amount of returns.While developing capital structure, finance managers must also consider the financial and operating leverages of the firm.

3) Dividend Decisions: Dividend decision is also important for organization to design the dividend policy. Dividend policy involves the amount of profits to paid as dividend to shareholders or reinvested in the organizations. Shareholders emphasize on getting higher amount of dividend, whereas management of company tries to maintain profits toface uncertainties in future. The dividend policy of the firm mainly depends of profitability.

4) Working Capital Decisions: Working capital management is an addition of fixed capital investment. Working capital management is an important element of every organization, as it helps in continuing the business processes. Decisions related to working capital are known as working capital decisions. The essential elements ofworking capital are

cash, accounts receivable and inventory. Each element of working capital involves some kind of risk in it.

Hence, it is clear that each every decision related to finance involves risk-return trade-off. So, it is the responsibility of finance managers to consider both risk and return,while making these decisions.

PROFIT MAXIMIZATION VS WEALTH

MAXIMIZATIONPROFIT MAXIMIZATION

Profit earning is the main aim of every economic activity. A business being an economic institution must earn profit to cover its costs and provide funds for growth.No business can survive without earning profit. Profit is a measure of efficiency of a business enterprise. Profits also serve as a protection against risks which cannot be ensured. The accumulated profits enable a business to face risks like fall in prices, competition from other units, adverse government policies etc.

(i) When profit-earning is the aim of business then profit maximization should bethe obvious objective.

(ii) Profitability is a barometer for measuring efficiency and economic prosperityof a business enterprise, thus, profit maximization if justified on the grounds of rationality.

(iii) Economic and business conditions do not remain same at all the times. There may be adverse business conditions like recession, depression, severe competitionetc. A business will be able to survive under unfavorable situation, only if it has some past earnings to rely upon. Therefore, a business should try to earn more and more whensituations favorable.

(iv) Profits are the main sources of finance for the growth of a business. So, abusiness should aim at maximization of profits for enabling its growth and development.

(v) Profitability is essential for fulfilling social goals also. A firm by pursuingthe objective of profit maximization also maximizes socio-economic welfare.

WEALTH MAXIMIZATION

Wealth maximization is the appropriate objective of an enterprise. Financial theory asserts that wealth maximization is the single substitute for a stockholder'sutility. When the firm maximizes the stockholder's wealth, the individual stockholder can use this wealth to maximize his individual utility. It means that by maximizing stockholder's wealth the firm is operating consistently towards maximizing stockholder's utility.

Stockholder's current wealth in a firm = (Number of shares owned) x (Current Stock Price Share)

$$W \quad NP$$

DIFFERENCE BETWEEN PROFIT AND WEALTH MAXIMIZATION

Goal	Objective	Advantages	Disadvantages
Profit maximization	Large amount of profits	-Easy to calculate profits. -Easy to determine the link between financial decisions and profits.	-Emphasizes the short term. -Ignores risk or uncertainty. -Ignores the timing of returns. -Requires immediate resources.
Stockholder wealth maximization	Highest market value of common stock	-Emphasizes the long term. -Recognizes risk or uncertainty. -Consider stockholders return.	-Offers no clear relationship between financial decisions and stock price. -Can lead to management anxiety and frustration.

UNIT 2 THE INVESTMENT DECISION (CAPITAL BUDGETING)

INTRODUCTION

The word Capital refers to be the total investment of a company of firm in money, tangible and intangible assets. Whereas budgeting defined by the "**Rowland** and **William**" it may be said to be the art of building budgets. Budgets are a blue print of a plan and action expressed in quantities and manners. Investment decision is the process of making investment decisions in capital expenditure. A capital expenditure may be defined as an expenditure the benefits of which are expected to be received over period of time exceeding one year. The main characteristic of a capital expenditure is that the expenditure is incurred at one point of time whereas benefits of the expenditure are realized at different points of time in future. The examples of capital expenditure:

1. Purchase of fixed assets such as land and building, plant and machinery, good will,etc.

2. The expenditure relating to addition, expansion, improvement and alteration to thefixed assets.

3. The replacement of fixed assets.

4. Research and development project.

MEANING

The process through which different projects are evaluated is known as capital budgeting. Capital budgeting is defined "as the firm's formal process for the acquisition and investment of capital. It involves firm's decisions to invest its current funds for addition, disposition, modification and replacement of fixed assets".

DEFINITION

Capital budgeting (investment decision) as, "Capital budgeting is long termplanning for making and financing proposed capital outlays." -- Charles T.Horngreen

"Capital budgeting consists in planning development of available capital for the purpose of maximizing the long term profitability of the concern" – Lynch

"Capital budgeting is concerned with the allocation of the firm source financial resources among the available opportunities. The consideration

of investment opportunities involves the comparison of the expected future streams of earnings from a project with the immediate and subsequent streams of earning from a project, with the immediate and subsequent streams of expenditure". **G.C. Philippatos**

NEED AND IMPORTANCE OF CAPITAL BUDGETING

1. Huge investments: Capital budgeting requires huge investments of funds, but the available funds are limited, therefore the firm before investing projects, plan are control its capital expenditure.

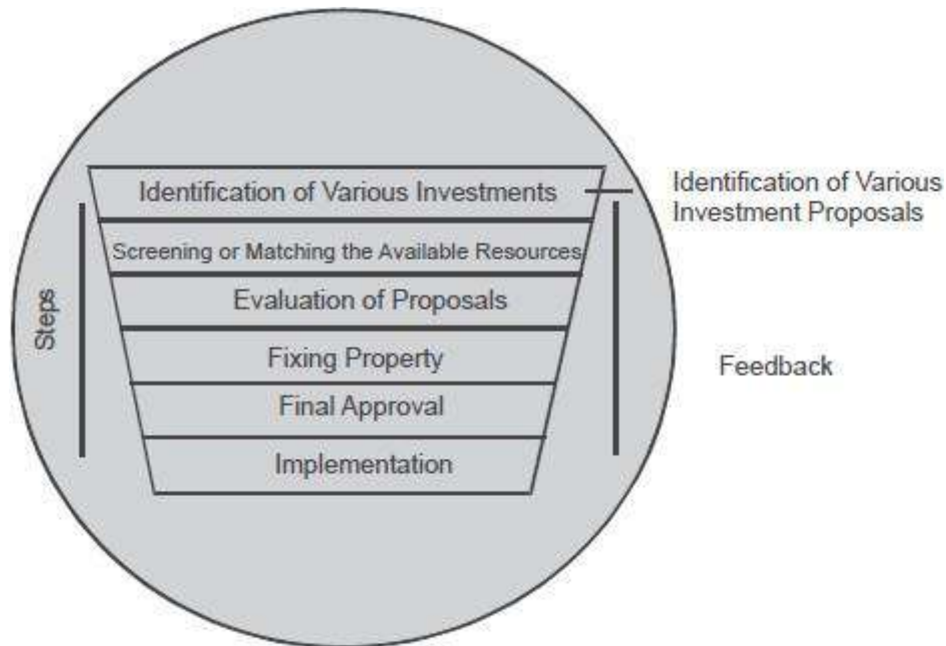
2. Long-term: Capital expenditure is long-term in nature or permanent in nature. Therefore financial risks involved in the investment decision are more. If higher risks are involved, it needs careful planning of capital budgeting.

3. Irreversible: The capital investment decisions are irreversible, are not changed back. Once the decision is taken for purchasing a permanent asset, it is very difficult todispose of those assets without involving huge losses.

4. Long-term effect: Capital budgeting not only reduces the cost but also increases the revenue in long-term and will bring significant changes in the profit of the company by avoiding over or more investment or under investment. Over investments leads to be unable to utilize assets or over utilization of fixed assets. Therefore before making the investment, it is required carefully planning and analysis of the project thoroughly.

CAPITAL BUDGETING PROCESS

Capital budgeting is a complex process as it involves decisions relating to the investment of current funds for the benefit to the achieved in future and the future. always uncertain. However the following procedure may be adopted in the process of capital budgeting:



Step 1 and 2 = Project generation,

Step3 = Project evaluation

Step4 and 5 =project selection

Step 6 = project execution.

PROJECT GENERATION

1. Identification of Investment Proposals:

The capital budgeting process begins with the identification of investment proposals. The proposal or the idea about potential investment opportunities mayoriginate from the top management or may come from the rank and file worker of any department or from any officer of the organization. The departmental head analyses thevarious proposals in the light of the corporate strategies and submits the suitable proposals to the capital expenditure planning committee in case of large organizations orto the officers concerned with the process of long-term decisions.

2. Screening the Proposals:

The expenditure planning committee screens the various proposals received fromdifferent departments. The committee views these proposals from various angels to ensure that these are in accordance with the corporate strategies or a selection criterion'sof the firm and also do not

lead to departmental imbalances.

PROJECT EVALUATION

3. Evaluation of Various Proposals:

The next step in the capital budgeting process is to evaluate the profitability of various proposals. There are many methods which may be used for this purpose such as payback period method, rate of return method, net present value method, internal rate of return method etc. All these methods of evaluating profitability of capital investment proposals have been discussed in detail separately in the following pages of this chapter.

It should, however, be noted that the various proposals to the evaluated may be classified as:

(I) Independent proposals

(ii) Contingent or dependent proposals and

(iii) Mutually exclusive proposals.

Independent proposals are those which do not compete with one another and the same may be either accepted or rejected on the basis of a minimum return on investment required. The contingent proposals are those whose acceptance depends upon theacceptance of one or more other proposals, eg., further investment in building or machineries may have to be undertaken as a result of expansion programmed. Mutually exclusive proposals are those which compete with each other and one of those may have to be selected at the cost of the other.

PROJECT SELECTION

1. Fixing Priorities:

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

2. Final Approval and Preparation of Capital Expenditure Budget:

Proposals meeting the evaluation and other criteria are finally

approved to be included in the Capital expenditure budget. However, proposals involving smallerinvestment may be decided at the lower levels for expeditious action. The capital expenditure budget lays down the amount of estimated expenditure to be incurred on fixed assets during the budget period.

PROJECT EXECUTION

3. Implementing Proposal:

Preparation of a capital expenditure budgeting and incorporation of a particular proposal in the budget does not itself authorize to go ahead with the implementation of the project. A request for authority to spend the amount should further be made to the Capital Expenditure Committee which may like to review the profitability of the project in the changed circumstances.

Further, while implementing the project, it is better to assign responsibilities for completing the project within the given time frame and cost limit so as to avoid unnecessary delays and cost over runs. Network techniques used in the project management such as PERT and CPM can also be applied to control and monitor the implementation of the projects.

4. Performance Review:

The last stage in the process of capital budgeting is the evaluation of the performance of the project. The evaluation is made through post completion audit by way of comparison of actual expenditure of the project with the budgeted one, and also by comparing the actual return from the investment with the anticipated return. The

unfavorable variances, if any should be looked into and the causes of the same areidentified so that corrective action may be taken in future.

DEVOLOPING CAH FLOW DATA (cash inflow and cash outflow)

Before we can compute a project's value, we must estimate the cash flows both current and future associated with it. We therefore begin by discussing cash flow estimation, which is the most important and perhaps the most difficult, step in the analysis of a capital project. The process of cash flow estimation is problematic becauseit is difficult to accurately forecast the costs and revenues associated with large, complex projects that are expected to affect operations for long periods of time.

Calculation of cash inflow

Sales	xxxx	
Less: Cash expenses	xxxx	
PBDT	xxxx	
Less: Depreciation	xxxx	
PBT	xxxx	
less: Tax	xxxx	
PAT	xxxx	
Add: Depreciation	xxxx	
Cash inflow p.a		**xxxx**

Calculation of cash outflow

Cost of project/asset	xxxx	
Transportation/installation charges	xxxx	
Working capital	xxxx	
Cash outflow		**xxxx**

PROJECT EVALUATION TECHNIQUES (OR) CAPITAL BUDGE TINGTECHNIQUES

At each point of time a business firm has a number of proposals regarding various projects in which it can invest funds. But the funds available with the firm are always limited and it is not possible to invest funds in all the proposals at a time. Hence, it is very essential to select from amongst the various competing proposals, those which give the highest benefits. The crux of the capital budgeting is the allocation of available resources to various proposals.

There are many methods of evaluating profitability of capital investment proposals. The various commonly used methods are as follows:

(A) Traditional methods:

(1) Pay-back Period Method or Pay out or Pay off Method.

(2) Improvement of Traditional Approach to pay back Period Method.(postpayback method)

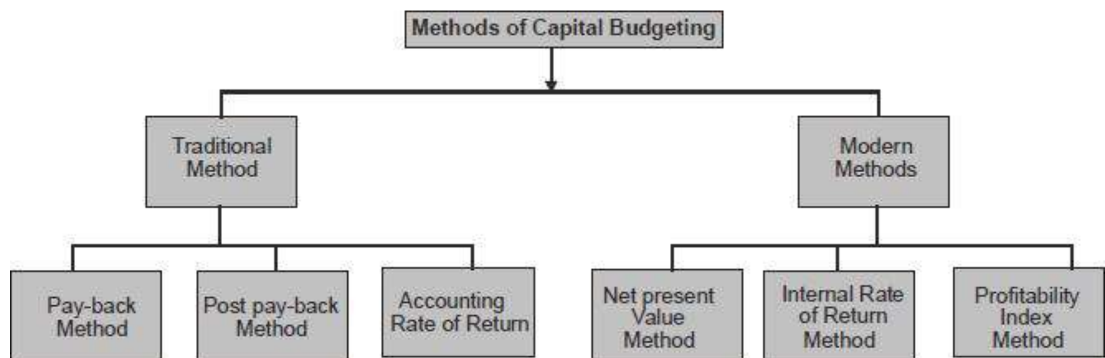
(3) Accounting or Average Rate of Return Method.

(B) Time-adjusted method or discounted methods:

(4) Net Present Value Method.

(5) Internal Rate of Return Method.

(6) Profitability Index Method.



(A) TRADITIONAL METHODS:

1. PAY-BACK PERIOD METHOD

The 'pay back' sometimes called as pay out or pay off period method represents the period in which the total investment in permanent assets pays back itself. This method is based on the principle that every capital expenditure pays itself back within a certain period out of the additional earnings generated from the capital assets.

Under this method, various investments are ranked according to the length of their payback period in such a manner that the investment within a shorter payback period is preferred to the one which has longer pay back period. (It is one of the non- discounted cash flow methods of capital budgeting).

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

MERITS

The following are the important merits of the pay-back method:

1. It is easy to calculate and simple to understand.

2. Pay-back method provides further improvement over the accounting rate return.

3. Pay-back method reduces the possibility of loss on account of obsolescence.

DEMERITS

1. It ignores the time value of money.

2. It ignores all cash inflows after the pay-back period.

3. It is one of the misleading evaluations of capital budgeting.

ACCEPT /REJECT CRITERIA

If the actual pay-back period is less than the predetermined pay-back period, the projectwould be accepted. If not, it would be rejected.

2. POST PAY-BACK PROFITABILITY METHOD:

One of the serious limitations of Pay-back period method is that it does not take into account the cash inflows earned after pay-back period and hence the true profitability of the project cannot be assessed. Hence, an, improvement over thismethod can be made by taking into account the return receivable beyond the pay-back period.

Post pay-back profitability =Cash inflow (Estimated life – Pay-back period) Post pay-back profitability index= Post pay-back profitability/original investment

3. AVERAGE RATE OF RETURN:

This method takes into account the earnings expected from the investment over their whole life. It is known as accounting rate of return method for the reason that under thismethod, the Accounting concept of profit (net profit after tax and depreciation) is used rather than cash inflows. According to this method, various projects are ranked in order of the rate of earnings or rate of return. The project with the higher rate of return is selected as compared to the one with lower rate of return. This method can also be used

to make decision as to accepting or rejecting a proposal. Average rate of return meansthe average rate of return or profit taken for considering

(a) Average Rate of Return Method (ARR):

Under this method average profit after tax and depreciation is calculated and then it is divided by the total capital outlay or total investment in the project. The project evaluation. This method is one of the traditional methods for evaluating

The project proposals

ARR = (Total profits (after dep & taxes))/ (Net Investment in the project X No. of yearsof profits) x 100

OR

ARR = (Average Annual profits)/ (Net investment in the project) x 100

(b) Average Return on Average Investment Method:

This is the most appropriate method of rate of return on investment Under this method, average profit after depreciation and taxes is divided by the average amount of investment; thus:

Average Return on Average Investment = (Average Annual Profit after depreciation andtaxes)/ (Average Investment) x 100

Merits

1. It is easy to calculate and simple to understand.

2. It is based on the accounting information rather than cash inflow.

3. It is not based on the time value of money.

4. It considers the total benefits associated with the project.

Demerits

1. It ignores the time value of money.

2. It ignores the reinvestment potential of a project.

3. Different methods are used for accounting profit. So, it leads to some difficulties inthe calculation of the project.

Accept/Reject criteria

If the actual accounting rate of return is more than the predetermined required rate ofreturn, the project would be accepted. If not it would be rejected.

(B) TIME – ADJUSTED OR DISCOUNTED CASH FLOW

METHODS: orMODERN METHOD

The traditional methods of capital budgeting i.e. pay-back method as well as accounting rate of return method, suffer from the serious limitations that give equal weight to present and future flow of incomes. These methods do not take into consideration the time value of money, the fact that a rupee earned today has more valuethan a rupee earned after five years.

1. NET PRESENT VALUE

Net present value method is one of the modern methods for evaluating the project proposals. In this method cash inflows are considered with the time value of the money. Net present value describes as the summation of the present value of cash inflow and present value of cash outflow. Net present value is the difference between the total present values of future cash inflows and the total present value of future cash outflows.

NPV = Total Present value of cash inflows – Net Investment

If offered an investment that costs $5,000 today and promises to pay you $7,000 two years from today and if your opportunity cost for projects of similar risk is 10%, would you make this investment? You

Need to compare your $5,000 investment with the $7,000 cash flow you expect in two years. Because you feel that a discount rate of 10% reflects the degree of uncertainty associated with the $7,000 expected in two years, today it is worth:

Present value of $7,000 to be received in two years

$$= \frac{\$7{,}000}{(1 + 0.10)^2} = \$5{,}785.12$$

By investing $5,000 today, you are getting in return a promise of a cash flow in the future that is worth $5,785.12 today. You increase your wealth by $785.12 when you make this investment.

Merits

1. It recognizes the time value of money.

2. It considers the total benefits arising out of the proposal.

3. It is the best method for the selection of mutually exclusive projects.

It helps to achieve the maximization of shareholders' wealth ***Demerits***

1. It is difficult to understand and calculate.

2. It needs the discount factors for calculation of present values.

3. It is not suitable for the projects having different effective lives.

Accept/Reject criteria

If the present value of cash inflows is more than the present value of cash outflows, it would be accepted. If not, it would be rejected.

2. PROFITABILITY INDEX METHOD

The *profitability index* (PI) is the ratio of the present value of change in operating cash inflows to the present value of investment cash outflows:

4. .

$$PI = \frac{\text{Present value of the change in operating cash inflows}}{\text{Present value of the investment cash outflows}}$$

Instead of the *difference* between the two present values, as in equation PI is the *ratio* of the two present values. Hence, PI is a variation of NPV. By construction, if the NPV is zero, PI is one.

3. INTERNAL RATE OF RETURN METHOD

This method is popularly known as time adjusted rate of return method/discounted rateof return method also. The internal rate of return is defined as the interest rate that equates the present value of expected future receipts to the cost of the investment outlay.This internal rate of return is found by trial and error. First we compute the present valueof the cash-flows from an investment, using an arbitrarily elected interest rate. Then we compare the present value so obtained with the investment cost. If the present value is higher than the cost figure, we try a higher rate of interest and go through the procedure again. Conversely, if the present value is lower than the cost, lower the interest rate and repeat the process. The interest rate that brings about this equality is defined as the internal rate of return. This rate of return is compared to the cost of capital and the project having higher difference, if they are mutually exclusive, is adopted and other one is rejected. As the determination of internal rate of return involves a number of attempts to make the present value of earnings equal to the investment, this approach is alsocalled the Trial and Error Method. Internal rate of return is time adjusted technique and covers the disadvantages of the Traditional techniques. In other words it is a rate atwhich discount cash flows to zero. It is expected by the following ratio

$$\frac{\text{Cash inflow}}{\text{Investment initial}}$$

Steps to be followed:

Step1. Find out factor Factor is calculated as follows:

$$F = \frac{\text{Cash outlay (or) initial investment}}{\text{Cash inflow}}$$

Step 2. Find out positive net present value **Step 3.**

Formula

$$IRR = \text{Base factor} + \frac{\text{Positive net present value}}{\text{Difference in positive and Negative net present value}} \times DP$$

Find out negative net present value **Step 4.** Find out formula net present value

Base factor = Positive discount rateDP = Difference in percentage **Merits**

1. It considers the time value of money.

2. It takes into account the total cash inflow and outflow.

3. It does not use the concept of the required rate of return.

4. It gives the approximate/nearest rate of return.

Demerits

1. It involves complicated computational method.

2. It produces multiple rates which may be confusing for taking decisions.

3. It is assume that all intermediate cash flows are reinvested at the

internal rate ofreturn.

Accept/Reject criteria

If the present value of the sum total of the compounded reinvested cash flows is greater than the present value of the outflows, the proposed project is accepted. If not it would be rejected.

Key differences between the most popular methods, the NPV (Net Present Value)Method and IRR (Internal Rate of Return) Method, include:

• **NPV** is calculated in terms of currency while **IRR** is expressed in terms of thepercentage return a firm expects the capital project to return;

• Academic evidence suggests that the **NPV Method is preferred** over other methodssince it calculates additional wealth and the IRR Method does not;

• The IRR Method cannot be used to evaluate projects where there are **changing cash flows** (e.g., an initial outflow followed by in-flows and a later out-flow, such as may berequired in the case of land reclamation by a mining firm);

• However, the **IRR Method does have one significant advantage** -- managers tend to better understand the concept of returns stated in percentages and find it easy to compareto the required cost of capital; and, finally,

• While both the NPV Method and the IRR Method are both DCF models and can even reach similar conclusions about a single project, the use of the IRR Method can lead to the belief that a smaller project with a shorter life and earlier cash inflows, is preferableto a larger project that will generate more cash.

• Applying NPV using **different discount rates** will result in different recommendations. The IRR method always gives the same recommendation.

Recent variations of these methods include:

• The Adjusted Present Value (APV) Method is a flexible DCF method that takes intoaccount interest related tax shields; it is designed for firms with active debt and a consistent market value leverage ratio;

• The Profitability Index (PI) Method, which is modeled after the NPV Method, is measured as the total present value of future net cash inflows divided by the initial investment; this method tends to favor smaller projects and is best used by firms withlimited resources and high costs of capital;

• The Bailout Payback Method, which is a variation of the Payback Method, includes thesalvage value of any equipment purchased in its calculations;

The Real Options Approach allows for flexibility, encourages constant reassessment based on the riskiness of the project's cash flows and is based on the concept of creating a list of value-maximizing options to choose projects from; management can, and is encouraged, to react to changes that might affect the assumptions that were made abouteach project being considered prior to its commencement, including postponing the project if necessary; it is noteworthy that there is not a lot of support for this method.

• among financial managers at this time.

PAYBACK PERIOD

Advantages

1. Simple to compute.
2. Provides some information on he risk of the investment.
3. Provides a crude measure of liquidity.

Disadvantages

1. No concrete decision criteria to tell us whether an investment increases the firm's value.
2. Ignores cash flows beyond the payback period.
3. Ignores the time value of money.
4. Ignores the riskiness of future cash flows.

DISCOUNTED PAYBACK PERIOD

Advantages

1. Considers the time value of money.
2. Considers the riskiness of the cash flows involved in the payback.

Disadvantages

1. No concrete decision criteria that tells us whether the investment increases the firm's value.
2. Calls for a cost of capital.
3. Ignores cash flows beyond the payback period.

NET PRESENT VALUE

Advantages

1. Decision criteria that tells us whether the investment will increase the firm's value.
2. Considers all cash flows.
3. Considers the time value of money.
4. Considers the riskiness of future cash flows.

Disadvantages

1. Requires a cost of capital for calculation.
2. Expressed in terms of dollars, not as a percentage.

PROFITABILITY INDEX

Advantages

1. Decision criteria that tells us whether an investment increases the firm's value.
2. Considers all cash flows.
3. Considers the time value of money.
4. Considers the riskiness of future cash flows.
5. Useful in ranking and selecting projects when capital is rationed.

Disadvantages

1. Requires a cost of capital for calculation.
2. May not give correct decision when comparing mutually exclusive projects.

INTERNAL RATE OF RETURN

Advantages

1. Decision criteria that tells us whether an investment increases the firm's value.
2. Considers the time value of money.
3. Considers all cash flows.
4. Considers riskiness of future cash flows.

Disadvantages

1. Requires a cost of capital for decision.
2. May not give value maximizing decision when comparing mutually exclusive projects.
3. May not give value maximizing decision when choosing projects with capital rationing.

FINANCE

DECISION

INTRODUCTION

Finance is the lifeblood of business concern, because it is interlinked with all activities performed by the business concern. In a human body, if blood circulation isnot proper, body function will stop. Similarly, if the finance not being properly arranged,the business system will stop. Arrangement of the required finance to each departmentof business concern is highly a complex one and it needs careful decision. Financial requirement of the business differs from firm to firm and the nature of the requirements on the basis of terms or period of financial requirement; it may be long term and short- term financial requirements Long-term Financial Requirements or Fixed Capital Requirement Short-term Financial Requirements or Working Capital Requirement

LONG-TERM FINANCIAL REQUIREMENTS OR FIXED CAPITALREQUIREMENT

Long-term financial requirement means the finance needed to acquire land and building for business concern, purchase of plant and machinery and other fixed expenditure. Long term financial requirement is also called as fixed capital requirements. Fixed capital is the capital, which is used to purchase the fixed assets of the firms such as land and building, furniture and fittings, plant and machinery, etc. Hence, it is also called a capital expenditure.

SHORT-TERM FINANCIAL REQUIREMENTS OR WORKING CAPITAL REQUIREMENT

Apart from the capital expenditure of the firms, the firms should need certain expenditure like procurement of raw materials, payment of wages, day-to-dayexpenditures, etc. This kind of expenditure is to meet with the help of short-termfinancial requirements which will meet the operational expenditure of the firms. Short- term financial requirements are popularly known as working capital.

SOURCES OF FINANCE

Sources of finance mean the ways for mobilizing various terms of finance to the industrial concern. Sources of finance state that, how the companies are mobilizing finance for their requirements. The companies belong to the existing or the new which need sum amount of finance to meet the long-term and short-term requirements such as purchasing of

fixed assets, construction of office building, purchase of raw materials and day-to-day expenses. Sources of finance may be classified under various categories according to the following important heads:

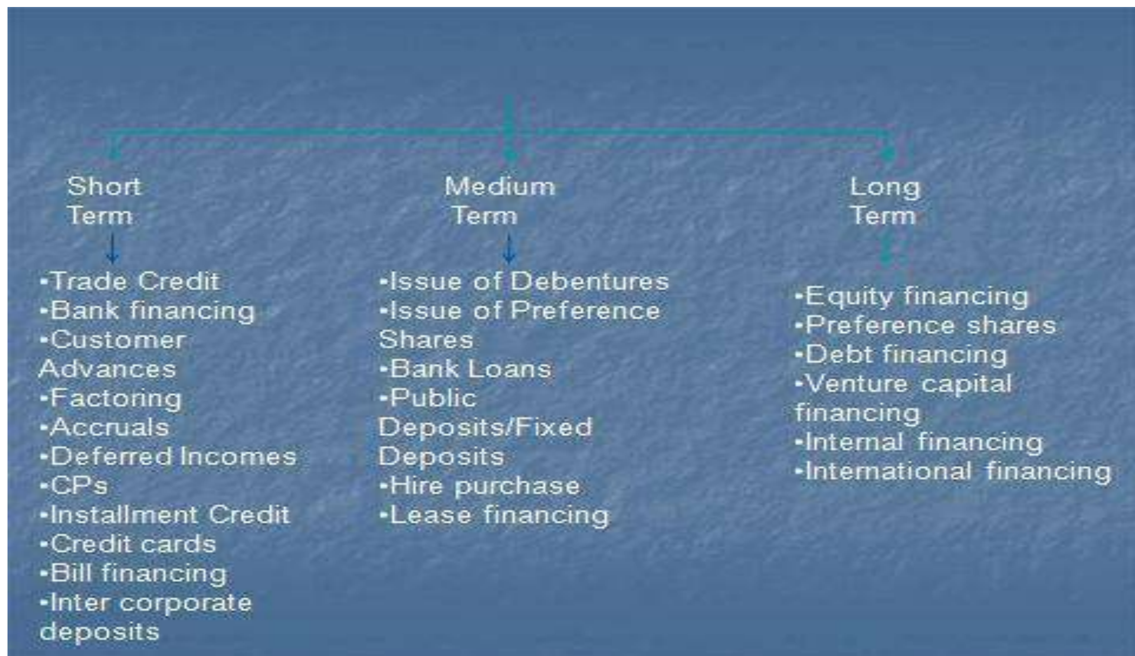
According to Ownership

Owned Capital- Share Capital, Retained Earnings, Profit Surplus etc
Borrowed Capital-Debentures, Bonds, Public Deposit, loans

According to source of Finance

External- Shares, Debentures, Public Deposit, loans etc. Internal- Retained Earnings,Profit Surplus ploughing back of profits, depreciation fund etc

ACCORDING TO PERIOD



I. LONG TERM SECURITY FINANCE

If the finance is mobilized through issue of securities such as shares and debenture, it is called as security finance. It is also called as corporate securities. This type of finance plays a major role in the field of deciding the capital structure of the company.

Characters of Security Finance Security finance consists of the following importantcharacters:

1. Long-term sources of finance.
2. It is also called as corporate securities.
3. Security finance includes both shares and debentures.
4. It plays a major role in deciding the capital structure of the company.

5. Repayment of finance is very limited.
6. It is a major part of the company's total capitalization.

Types of Security Finance Security finance may be divided into two major types:

1. Ownership securities or capital stock.

2. Creditor ship securities or debt capital.

OWNERSHIP SECURITIES The ownership securities also called as capital stock is commonly called as shares. Shares are the most Universal method of raising finance for the business concern. Ownership capital consists of the following types of securities.

- Equity Shares
- Preference Shares
- No par stock
- Deferred Shares

EQUITY SHARES

Equity Shares also known as ordinary shares, which means, other than preference shares. Equity shareholders are the real owners of the company. They have a control over the management of the company. Equity shareholders are eligible to get dividend if the company earns profit. Equity share capital cannot be redeemed during thelifetime of the company. The liability of the equity shareholders is the value of unpaid value of shares.

FEATURES OF EQUITY SHARES Equity shares consist of the following important features:

1. **Maturity of the shares:** Equity shares have permanent nature of capital, which has no maturity period. It cannot be redeemed during the lifetime of the company.

2. **Residual claim on income:** Equity shareholders have the right to get income left afterpaying fixed rate of dividend to preference shareholder. The earnings or the income available to the shareholders is equal to the profit after tax minus preference dividend.

3. **Residual claims on assets:** If the company wound up, the ordinary or equity shareholders have the right to get the claims on assets. These rights are only available to the equity shareholders.

4. **Right to control:** Equity shareholders are the real owners of the company. Hence, they have power to control the management of the company and they have power to takeany decision regarding the business operation.

5. **Voting rights:** Equity shareholders have voting rights in the meeting of the company with the help of voting right power; they can change or remove any decision of the business concern. Equity shareholders only have voting rights in the company meeting and also they can nominate proxy to participate and vote in the meeting instead of the shareholder.

6. **Pre-emptive right:** Equity shareholder pre-emptive rights. The pre-emptive right is the legal right of the existing shareholders. It is attested by the company in the first opportunity to purchase additional equity shares in proportion to their current holding capacity.

7. **Limited liability:** Equity shareholders are having only limited liability to the value ofshares they have purchased. If the shareholders are having fully paid up shares, theyhave no liability.
For example: If the shareholder purchased 100 shares with the face value of Rs. 10 each.He paid only Rs. 900. His liability is only Rs. 100. Total number of shares 100 Face value of shares Rs. 10 Total value of shares 100 × 10 = 1,000 Paid up value of shares900 Unpaid value/liability 100 Liability of the shareholders is only unpaid value of the share (that is Rs. 100).

PREFERENCE SHARES

The parts of corporate securities are called as preference shares. It is the shares, which have preferential right to get dividend and get back the initial investment at the time of winding up of the company. Preference shareholders are eligible to get fixed rateof dividend and they do not have voting rights. It means a preference shareholder enjoys two rights over equity shareholders :(a) right to receive fixed rate of dividend and (b) right to return of capital. After settling the claims of outsiders, preference shareholders are the first to get their dividend and then the balance will go to the equity shareholders. However, the preference shareholders do not have any voting rights in the annual general body meetings of the company. Preference shares may be classified into the following major types:

1. **Cumulative preference shares**: Cumulative preference shares have right to claim dividends for those years which have no profits. If the company is unable to earn profitin any one or more years, C.P. Shares are unable to get any dividend but they have right to get the comparative dividend for the previous years if the company earned profit

2. **Non-cumulative preference shares:** Non-cumulative preference shares have noright to enjoy the above benefits. They are eligible to get only dividend if the company earns profit during the years. Otherwise, they cannot claim any dividend.

3. **Redeemable preference shares:** When, the preference shares have a fixed maturity period it becomes redeemable preference shares. It can be redeemable during the lifetime of the company. The Company Act has provided certain restrictions on the return of the redeemable preference shares.

4. **Irredeemable Preference Shares:** Irredeemable preference shares can be redeemed only when the company goes for liquidator. There is no fixed maturity period for such kind of preference shares.

5. **Participating Preference Shares** Participating preference shareholders have right to participate extra profits after distributing the equity shareholders.

6. **Non-Participating Preference Shares** Non-participating preference shareholders are not having any right to participate extra profits after distributing to the equity shareholders. Fixed rate of dividend is payable to the type of shareholders.

7. **Convertible Preference Shares** Convertible preference shareholders have right to convert their holding into equity shares after a specific period. The articles of associationmust authorize the right of conversion.

8. **Non-convertible Preference Shares** There shares, cannot be converted into equity shares from preference shares.

FEATURES OF PREFERENCE SHARES

1. **Maturity period:** Normally preference shares have no fixed maturity period except inthe case of redeemable preference shares. Preference shares can be redeemable only at the time of the company liquidation.

2. **Residual claims on income:** Preferential shareholders have a residual claim on income. Fixed rate of dividend is payable to the preference shareholders.

3. **Residual claims on assets:** The first preference is given to the preference shareholders at the time of liquidation. If any extra Assets are available that should be distributed to equity shareholder.

4. **Control of Management:** Preference shareholder does not have any voting rights. Hence, they cannot have control over the management of the company.

DEFERRED SHARES

Deferred shares also called as founder shares because these shares were normallyissued to founders. The shareholders have a preferential right to get dividend before the preference shares and equity shares. According to Companies Act 1956 no public limited company or which is a subsidiary of a public company can issue deferred shares.These shares

were issued to the founder at small denomination to control over the management by the virtue of their voting rights.

NO PAR SHARES

When the shares are having no face value, it is said to be no par shares. The company issues this kind of shares which is divided into a number of specific shares without any specific denomination. The value of shares can be measured by dividing the real net worth of the company with the total number of shares. Value of no. per share
=the realnetworth/Total no. Of shares

CREDITORSHIP SECURITIES Creditor ship Securities also known as debt finance which means the finance is mobilized from the creditors. Debenture and Bonds are the two major parts of the Creditors hip Securities.

DEBENTURES

Debenture is a document issued by the company. It is a certificate issued by the company under its seal acknowledging a debt. Debentures are the loans taken by the company. It is a certificate or letter issued by the company under its common seal acknowledging the receipt of loan. A debenture holder is the creditor of the company. A

debenture holder is entitled to a fixed rate of interest on the debenture amount. Payment of interest on debenture is the first charge against profits. Apart from the loans from financial institutions, a company may raise loans through debentures. This is an additional source of long-term finance. The payment of interest and principal amounts on these debentures is subject to the terms and conditions of issue of debentures.

According to the Companies Act 1956, "debenture includes debenture stock, bonds and any other securities of a company whether constituting a charge of the assets of the company or not."

Types of Debentures it may be divided into the following major types:

1. Unsecured debentures: Unsecured debentures are not given any security on assets of the company. It is also called simple or naked debentures. This type ofdebentures is traded as unsecured creditors at the time of winding up of the company.

2. Secured debentures: Secured debentures are given security on assets of the company. It is also called as mortgaged debentures because these debentures are given against any mortgage of the assets of the company.

3. Redeemable debentures: These debentures are to be redeemed on the expiry of a certain period. The interest is paid periodically and the

initial investment is returned after the fixed maturity period.

4. Irredeemable debentures: These kinds of debentures cannot be redeemable during the life time of the business concern.

5. Convertible debentures: Convertible debentures are the debentures whose holders have the option to get them converted wholly or partly into shares. These debentures are usually converted into equity shares. Conversion of the debentures may be:

Non-convertible

debentures Fully

convertible

debentures

Partly

convertible

debentures

FEATURES OF DEBENTURES

1. Maturity period: Debentures consist of long-term fixed maturity period. Normally, debentures consist of 10–20 years maturity period and are repayable with the principle investment at the end of the maturity period.

2. Residual claims in income: Debenture holders are eligible to get fixed rate of interest at every end of the accounting period. Debenture holders have priority of claim in income of the company over equity and preference shareholders.

3. Residual claims on asset: Debenture holders have priority of claims on Assets of the company over equity and preference shareholders. The Debenture holders may have

either specific change on the Assets or floating change of the assets of the company. Specific change of Debenture holders are treated as secured creditors and floating change of Debenture holders are treated as unsecured creditors.

4. No voting rights: Debenture holders are considered as creditors of the company. Hence they have no voting rights. Debenture holders cannot have the control over the performance of the business concern.

5. Fixed rate of interest: Debentures yield fixed rate of interest till the maturity period. Hence the business will not affect the yield of the debenture.

RETAINED EARNINGS

Retained earnings are another method of internal sources of finance. Actually is not a method of raising finance, but it is called as accumulation of profits by a company for its expansion and diversification activities. Retained earnings are called under different names such as; self finance, inter finance, and plugging back of profits. According to the Companies Act 1956 certain percentage, as prescribed by the central government (not exceeding 10%) of the net profits after tax of a financial year have tobe compulsorily transferred to reserve by a company before declaring dividends for the year. Under the retained earnings sources of finance, a part of the total profits istransferred to various reserves such as general reserve, replacement fund, reserve for repairs and renewals, reserve funds and secrete reserves, etc.

II. MEDIUM-TERM FINANCE Medium-term finance refers to such sources of finance where the repayment is normally over one year and less than three years. This is normally utilized to buy or lease motor vehicles, computer equipment, or machinery whose life is less than three years. The sources of medium term finance are as given below:

Bank Loans: -

Bank loans are extended at a fixed rate of interest. Repayment of the loan and interest are scheduled at the beginning and are usually directly debited to the current account of the borrower. These are secured loans.

Hire-Purchase: -

It is a facility to buy a fixed asset while paying the price over a long period of time. In other words, the possession of the asset can be taken by making a downpayment of a part of the price and the balance will be repaid with a fixed rate of interest in agreed number of installments. The buyer becomes the owner of the asset only on payment of the last installment. The seller is the owner of the asset till the last installment is paid. In case there is any default in payment, the seller can reserve the right of collecting back the asset. Today, most of the consumer durables such as cars, refrigerators, TVs and so on, are sold on hire-purchase basis. It provides an opportunity to keep using the asset much before the full price is paid.

Leasing or Renting: -

Where there is a need for fixed assets, the asset need not be purchases. It can be taken on lease or rent for specified number of years. The company who owns the asset iscalled lesser and the company which takes the asset on leas is called lessee. Theagreement between the lesser and lessee is called a lease agreement. On the expiry of thelease agreement, the owner takes the asset back into his custody. Under lease agreement, ownership to the asset never passes. Only possession of the asset passes

from lesser to the lessee. Lease is not a loan. But when the business wants a certain asset for a short/medium period, lease can significantly reduce the financial requirements of the business to buy the asset.

Venture Capital: -

This form of finance is available only for limited companies. Venture capital is normally provided in such projects where there is relatively a higher degree of risk. For such projects, finance through the conventional sources may not be available. Many banks offer such finance through their merchant banking divisions, or specialist banks which offer advice and financial assistance. The financial assistance may take the formof loans and venture capital. In the case of viable or feasible projects, the merchant banks may participate in the equity also. In return, they expect one or two (depending upon the volume of funs pumped in) director positions on the board to exercise the control on the company matters. The funds, so provided by the venture capital, can be used for acquiring another company or launching a new product or financing expansion and growth.

III. SHORT-TERM FINANCE

Commercial Paper (CP):

It is a new money market instrument introduced in India in recent times. CPs areissued usually in large denominations by the leading, nationally reputed, highly ratedand credit worthy, large manufacturing and finance companies in the public and private sector. The proceeds of the issue of commercial paper are used to finance currenttransactions and seasonal and interim needs for funds. Reliance Industries is one of the early companies which are issued Commercial Paper.

Bank Overdraft:

This is a special arrangement with the banker where the customer can draw more than what he has in this savings/current account subject to a maximum limit. Interest is charged on a day-to-day basis on the actual amount overdrawn. This source is utilized to meet the temporary shortage of funds.

Trade Credit: -

This is a short-term credit facility extended by the creditors to the debtors. Normally, it is common for the traders to buy the material and other supplies from the suppliers on credit basis. After selling the stocks, the traders pay the cash and buy fresh

stocks again on credit. Sometimes, the suppliers may insist on the buyer to sign a bill (bill of exchange). This bill is called bills payable.

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Debt Factoring or Credit Factoring

Debt Factoring is the arrangement with factor where the trader agrees to sell its accounts receivable or debtors at discount to the specialized dealers called factors. In thecase of Credit Factoring, the trader agrees to sell his accounts payables (at premium).

Advance from Customers:

- It is customary to collect full or part of the order amount from the customer in advance. Such advances are useful to meet the working capital needs. Short-term deposited from the customers, sister companies and outsiders

It is normal to find the supermarkets and trading organizations inviting deposits of six months to one year duration. As an incentive, such deposit holders may be given 5-10 precept discounts on the purchases. Internal funds:- Internal funds are generated by the firm itself by way of secret reserve, depreciation provisions, taxation provision, and retained profits and so on and these can be utilized to meet the urgencies.

A BRIEF SURVEY OF FINANCIAL INSTRUMENTS

Financial Instrument is a lawful agreement which involves some monetary value. Financial instruments have unique characteristics and structure. Financial instruments are in the form of cash instruments and derivative instruments. Financial instruments can be categorized into two types. They are:

PRIMARY SECURITIES:

Primary securities are those securities which are sold for the first time in financial markets. They are also termed as direct securities as they are issued directly to the savers by the ultimate investors of funds. Shares and debentures are good examples for primary securities as they are issued directly to the public. Shares: Share is a small part of capital of a company which is widely spread to raise long-term funds from the market. Usually, shares of a company are of two types. They are, equity shares and performance shares:

---- Equity Shares: Equity shares represent the ownership position in the company.

----Preference Shares: Preference shares are those share which enjoy some extra benefits when compare to other types of shares.

-----Debentures: A company can obtain capital for long-term through issue of debentures. Debentures are similar to term loans in which borrower assure to pay interest and principle amount at specified time period, usually, debentures are more adaptable than term loans as it involves many exceptional characteristics.

SECONDARY SECURITIES:

Secondary securities are termed as „indirect securities‟ as they are sold byintermediaries to the final savers. These financial intermediaries issue securities to the people and the money gathered is invested in companies. Unit Trust of India and mutual funds are the example of financial intermediaries. Commercial Papers: Commercial papers are issued by reputed and praise worthy companies, for short period of time.They are issued in the form of unsecured promissory notes to raise funds for a period of3 months to 1 year.

Certificates of Deposits: It is a letter of acknowledgement issued by bank to the person or company in return of fixed deposits made for specified period. Certificate of deposits are in the form of negotiable instruments which can be bought and sold in financial market.

Secured Premium Notes: Secured premium notes are form of long term debentures which are redeemable at a price higher than the face value, known aspremium.

Non-convertible Debentures: Non-convertible debentures are those debentures which cannot be converted into equity shares. Investor gets the interest regularly and principle amount is paid only on maturity.

Zero Coupon Bonds: Zero coupon bonds have become famous in India a few years ago. These bonds do not yield any interest but they are sold to investor on heavy discount rate. Investor gets the profit from the difference of its purchase price and maturity value.

Zero Interest Fully Convertible Debentures Bonds: Zero interest bonds do not provide any interest but they are convertible into equity shares on specified period. Theyare introduced in India a few years ago.

Deep Discount Bonds: Deep discount bonds are those bonds which are sold by Issuer Company on heavy discount from its maturity value. But zero discount bonds do not yield any interest. IDBI was the first bank to introduce these bonds in India.

CAPITAL STRUCTURE

Capital structure refers to the kinds of securities and the proportionate amounts that make up capitalization. It is the mix of different sources of long-term sources suchas equity shares, preference shares, debentures, long-term loans and retained earnings. The term capital structure refers to the relationship between the various long-termsources financing such as equity capital, preference share capital and debt capital. Deciding the suitable capital structure is the important decision of the financial management because it is closely related to the value of the firm.

Capital structure is the permanent financing of the company represented primarily by long-term debt and equity.

DEFINITION OF CAPITAL STRUCTURE

According to the definition of Gerestenbeg, "Capital Structure of a company refers to the composition or make up of its capitalization and it includes all long-term capital resources".

According to the definition of James C. Van Horne, "The mix of a firm'spermanent long-term financing represented by debt, preferred stock, and common stock equity".

According to the definition of Persona Chandra, "The composition of a firm's financing consists of equity, preference, and debt".

FINANCIAL STRUCTURE

The term financial structure is different from the capital structure. Financial structure shows the pattern total financing. It measures the extent to which total fundsare available to finance the total assets of the business. Financial Structure = Total liabilities

OPTIMUM CAPITAL STRUCTURE

Optimum capital structure is the capital structure at which the weighted average cost of capital is minimum and thereby the value of the firm is maximum. Optimum capital structure may be defined as the capital structure or combination of debt and equity that leads to the maximum value of the firm.

Objectives of Capital Structure Decision of capital structure aims at the following twoimportant objectives:

1. Maximize the value of the firm.

2. Minimize the overall cost of capital.

Forms of Capital Structure Capital structure pattern varies from company to companyand the availability of finance.

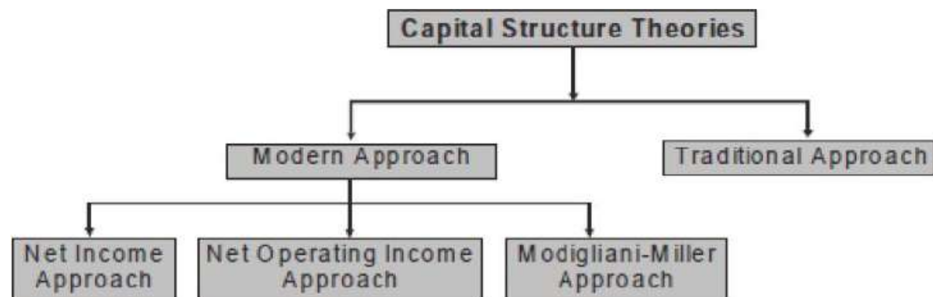
- Equity shares only.
- Equity and preference shares only.
- Equity and Debentures only.
- Equity shares, preference shares and debentures.

CAPITAL STRUCTURE THEORIES

Capital structure is the major part of the firm's financial decision

which affects the value of the firm and it leads to change EBIT and market value of the shares. Thereis a relationship among the capital structure, cost of capital and value of the firm. The aim of effective capital structure is to maximize the value of the firm and to reduce the

cost of capital. There are two major theories explaining the relationship between capitalstructure, cost of capital and value of the firm.



1. NET INCOME (NI) APPROACH

Net income approach suggested by the Durand. According to this approach, the capital structure decision is relevant to the valuation of the firm. In other words, a change in the capital structure leads to a corresponding change in the overall cost of capital as well as the total value of the firm. According to this approach, use more debt finance to reduce the overall cost of capital and increase the value of firm.

Net income approach is based on the following three important assumptions:

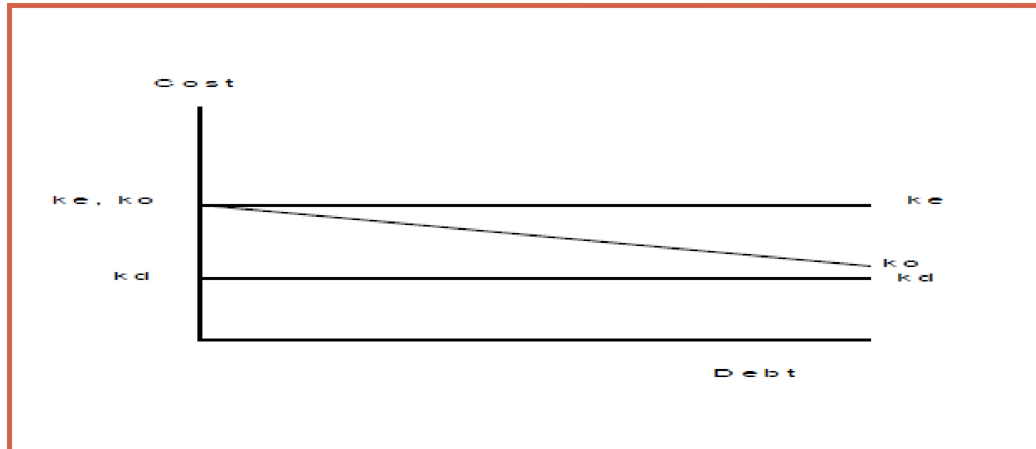
1. There are no corporate taxes.
2. The cost debt is less than the cost of equity.
3. The use of debt does not change the risk perception

of the investor. Where **V = S+B**

V = Value of firm S = Market value of equity B = Market value of debt Market value ofthe equity can be ascertained by the following formula:

$$S = NI/K_e$$

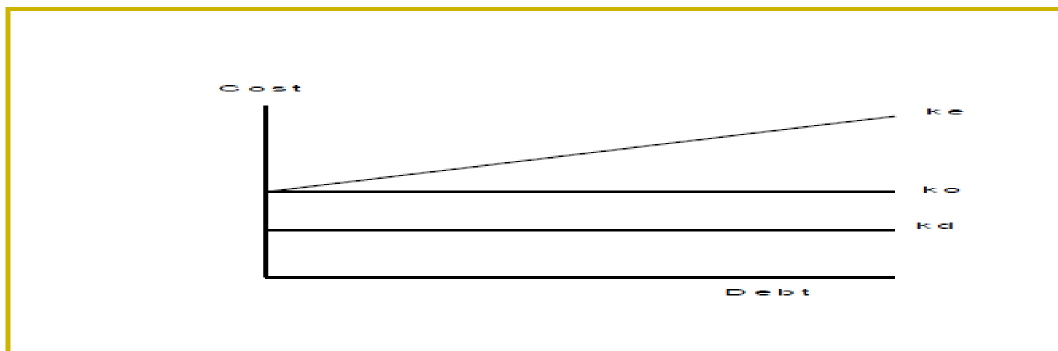
NI = Earnings available to equity shareholder Ke = Cost of equity/equitycapitalization rate



2. NET OPERATING INCOME (NOI) APPROACH

Another modern theory of capital structure, suggested by Durand. This is just theopposite of the Net Income approach. According to this approach, Capital Structure decision is irrelevant to the valuation of the firm. The market value of the firm is not at all affected by the capital structure changes. According to this approach, the change in capital structure will not lead to any change in the total value of the firm and market price of shares as well as the overall cost of capital. NI approach is based on the following important assumptions; The overall cost of capital remains constant; There areno corporate taxes; The market capitalizes the value of the firm as a whole; Value of the firm (V) can be calculated with the help of the following formula

V = EBIT/Ko Where, V = Value of the firm EBIT = Earnings before interestand tax Ko = Overall cost of capital



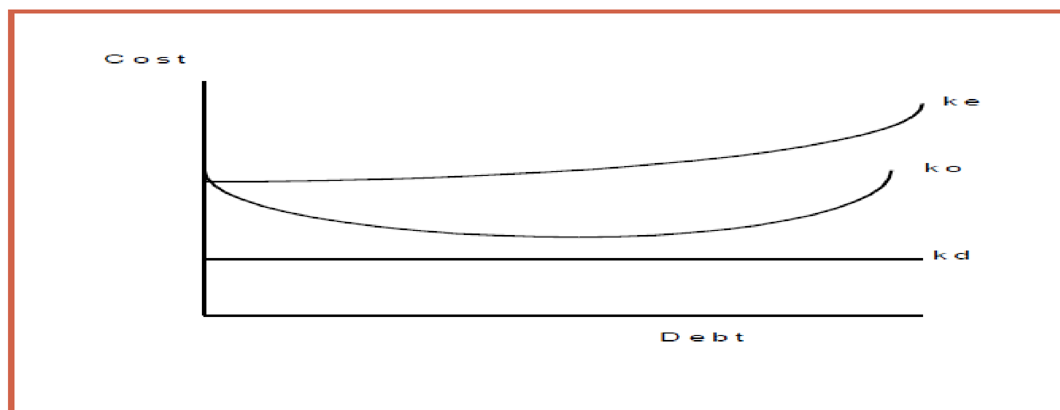
3. TRADITIONAL APPROACH

It is the mix of Net Income approach and Net Operating Income

approach. Hence, it is also called as intermediate approach. According to the traditional approach, mix of debt and equity capital can increase the value of the firm by reducing overall costof capital up to certain level of debt. Traditional approach states that the Ko decreases only within the responsible limit of financial leverage and when reaching the minimum

level, it starts increasing with financial leverage. Assumptions Capital structure theoriesare based on certain assumption to analysis in a single and convenient manner:

- There are only two sources of funds used by a firm; debt and shares.
- The firm pays 100% of its earning as dividend.
- The total assets are given and do not change.
- The total finance remains constant.
- The operating profits (EBIT) are not expected to grow.
- The business risk remains constant.
- The firm has a perpetual life.
- The investors behave rationally.



4. MODIGLIANI AND MILLER APPROACH

Modigliani and Miller approach states that the financing decision of a firm does not affect the market value of a firm in a perfect capital market. In other words MM approach maintains that the average cost of capital does not change with change in the debt weighted equity mix or capital structures of the firm.

Modigliani and Miller approach is based on the following important assumptions:

- There is a perfect capital market.

- There are no retained earnings.
- There are no corporate taxes.
- The investors act rationally.
- The dividend payout ratio is 100%.
- Value of the firm can be calculated with the help of the following formula:
- *V=EBIT/ K (l-t)*

- **COST OF CAPITAL**
- The cost of capital of a firm is the minimum rate of return expected by its investors. It is the weighted average cost of various sources of finance used by a firm. The capital used by a firm may be in the form of debt, preference capital, retained earnings and equity shares. The concept of cost of capital is very important in the financial management. A decision to invest in a particular project depends upon the cost of capital of the firm or the cut off rate which is the minimum rate of return expected by the investors.

- *DEFINITIONS*
- James C.Van Horne defines cost of capital as,"a cut-off rate for the allocation of capital to investments of projects. It is the rate of return on a project that will leave unchanged the market price of the stock.
- According to Solomon Ezra, "Cost of capital is the minimum required rate of earning or the cut-off rate of capital expenditures".
- *COMPUTATION OF WEIGHTED AVERAGE COST OF CAPITAL*
- Weighted average cost of capital is the average cost of the costs of various sources of Financing. Weighted average cost of capital is also known as composite cost of capital, overall cost of capital or average cost of capital. Once the specific cost of individual sources of finance is determined, we can compute the weighted average cost of capital by putting weights to the specific costs of capital in proportion of the various sources of funds to the total. The weights may be given either by using the book value ofthe

source or market value of the source. The market value weights suffer from the following limitations: It is very difficult to determine the market values because of frequent fluctuations. With the use of market value weights, equity capital gets greater importance. For the above limitations, it is better to use book value which is readily available. Weighted average cost of capital can be computed as follows:

- $Kw = \Sigma XW / \Sigma W$
- $Were, Kw = Weigted\ average\ cost\ of\ capital$
- X = Cost of specific source of finance
- W = Weight, proportion of specific source of finance

MARGINAL COST OF CAPITAL

Sometimes, we may be required to calculate the cost of additional funds to be raised, called the marginal cost of capital. The marginal cost of capital is the weighted average cost of new capital calculated by using the marginal weights. The marginal weights represent the proportion of various sources of funds to be employed in raising additional funds. In case, a firm employs the existing proportion of capital structure and the component costs remain the same the marginal cost of capital shall be equal to the weighted average cost of capital.

MEASUREMENT OF COST OF CAPITAL

The term cost of capital is an overall cost. This is the combination cost of the specific cost associated with specific source of financing. The computation of cost capital therefore, involves two steps: The computation of the different elements of the cost in term of the cost of the different source of finance.

The calculation of the overall cost by combining the specific cost into a composite cost. From the view point of capital budgeting decisions the long-term sources of fund are relevant as the constitute the major source of financing of fixed cost. In calculating the cost of capital, therefore, the focus is to be on the long-term funds.

In other words the specific cost has to be calculated for: 1) Long term debt 2) Preference Shares 3) Equity Shares 4) Retained earnings

COST OF DEBT

The cost of debt is the rate of interest payable on debt. For example, a company issues Rs.1, 00,000 10%debentures at par; the before-tax cost of this debt issue will also be 10%. By way of a formula, before tax cost of debt may be calculated as:

$$Kdb = Kdb = I/P$$

$where,\ Kdb = before\ tax\ cost\ of\ debt$ I=Interest P=Principal

In case the debt is raised at premium or discount, we should consider P as the amount of net proceeds received from the issue and not the face value of securities. The formula may be changed to

$$Kdb = I/NP\ (where, NP = Net\ Proceeds)$$

Further, when debt is used as a source of finance, the firm saves a considerable amount in payment of tax as interest is allowed as a deductible expense in computation of tax. Hence, the effective cost of debt is reduced. The After-tax cost of debt may be calculated with the help of following formula:

$$Kda = I/NP(1-t)$$

$where,\ Kda = After\ tax\ cost\ of\ debt$ t= Rate of Tax

COST OF PREFERENCE CAPITAL

A fixed rate of dividend is payable on preference shares. Though dividend is payable at the discretion of the Board of directors and there is no legal binding to pay dividend, yet it does not mean that preference capital is cost free. The cost of preference capital is a function of dividend expected by its investors, i.e., its stated dividend. In casedividend share not paid to preference shareholders, it will affect the fund raising capacity of the firm. Hence, dividends are usually paid regularly of preference shares expect when there are no profits to pay dividends. The cost of preference capital whichis perpetual can be calculated as:

$$Kp = D/P$$

Where, Kp = Cost of preference Capital D = Annual Preference Dividend P = Preference Share Capital (Proceeds.) Further, if preference shares are issued at Premium or Discount or when costs of floatation are incurred to issue preference shares, the nominal or par value or preference share capital has to be adjusted to find out the net proceeds from the issue of preference shares. In such a case, the cost of preference capital can be computed with the following formula:

$$Kp = D/NP$$

COST OF EQUITY SHARE CAPITAL

The cost of equity is the „maximum rate of return that the company must earn of equity financed portion of its investments in order to leave unchanged the market price of its stock‟. The cost of equity capital is a function of the expected return by its investors. The cost of equity is not

the out-of-pocket cost of using equity capital as the equity shareholders are not paid dividend at a fixed rate every year. Moreover, payment of dividend is not a legal binding. It may or may not be paid. But is does not mean that equity share capital is a cost free capital. Share holders invest money in equity shares on the expectation of getting dividend and the company must earn this minimum rate sothat the market price of the shares remains unchanged. Whenever a company wants to raise additional funds by the issue of new equity shares, the expectations of the shareholders have to evaluate. The cost of equity share capital can be computed in the following ways:

Dividend Yield Method or Dividend/Price Ratio method:

According to this method, the cost of equity capital is the „discount rate that equates thepresent value of expected future dividends per share with the new proceeds (or current market price) of a share‟. Symbolically.

$$Ke = D/NP \text{ or } D/MP$$

$Where,\ Ke = Cost\ of\ Equity\ Capital\ D = Expected\ dividend\ per\ Share$
$NP = Net\ proceeds\ per\ Share\ MP = Market\ Price\ per\ Share$

(b) **Dividend Yield plus Growth in Dividend Method:** When the dividends of the firm are expected to grow at a constant rate and the dividend-pay-out ratio is constant this method may be used to compute the cost of equity capital. According to this method the cost of equity capital is based on the dividends and the growth rate.

$$Ke = DI/NP + G$$

Further, in case cost of existing equity share capital is to be calculated, the NP should be changed with MP (market price per share) in the above equation.

$$Ke = DI/MP + G$$

MEANING OF DIVIDEND

Dividend refers to the business concerns net profits distributed among the shareholders. It may also be termed as the part of the profit of a business concern, which is distributed among its shareholders. According to the **Institute of Chartered Accountant of India**, dividend is defined as “a distribution to shareholders out of profits or reserves available for this purpose”.

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TYPES OF DIVIDEND/FORM OF DIVIDEND

(A) Cash dividend: A cash dividend is a usual method of paying dividends. Payment of dividend is cash results in the reduction out flow of funds and reduces the net worth of the company. The share holders get an opportunity to invest the cash in any manner,they desire. Hence, the ordinary share holders prefer to receive dividends in cash. In case of companies having cash dividends, the firm must have adequate liquid resources, so that its liquidity position is not adversely affected on account of cash dividend.

(B) Scrip (or) Bond dividend: A scrip dividend promises to pay the share holders at a future specific date. In case a company does not have sufficient funds to pay dividendsin cash, it may issue notes or bonds for amounts due to the share holders. The objective of scrip dividends is to postpone the immediate payment of cash. A scrip dividend bears interest and is accepted as collateral security.

(c) Property Dividend: Property dividends are paid in the form of some assets other than cash. They are distributed under exceptional circumstances and are not popular in India.

(d) Stock Dividend: Stocks dividend means the issue and the bonus shares to the existing share holders. If a company does not have liquid resources, it is better to declarestock dividends. Stock dividend amounts to capitalization of earnings and distribution ofprofits among the existing share holders without affecting the cash position of the firm.

BONUS SHARE: A company can pay bonus to its share holders either in cash or in the form of shares. Many a times a company need not in a position to pay bonus in cash, in spite of sufficient profits, because of unsatisfactory cash position or because of its adverse effects on the working capital of the company. In such cases, if the Articles of

Association provide any conditions, then it can pay bonus to its share holders in the formof cash. The dictionary meaning of bonus shares is a premium or gift, usually a stock, bya corporation to share holders. A Bonus share is neither dividend nor a Gift

FACTORS DETERMINING DIVIDEND POLICY

1. Profitable Position of the Firm

Dividend decision depends on the profitable position of the business concern. Whenthe firm earns more profit, they can distribute more dividends to the shareholders.

2. Uncertainty of Future Income

Future income is a very important factor, which affects the

dividend policy. When the shareholder needs regular income, the firm should maintain regular dividend policy.

3. Contractual constraints

Often, the firm's ability to pay cash dividends is constrained by restrictive provisions in a loan agreement. Generally, these constraints prohibit the payment of cashdividends until a certain level of earnings have been achieved, or they may limit dividends to a certain amount or a percentage of earnings. Constraints on dividends help to protect creditors from losses due to the firm's insolvency. The violation of a contractual constraint is generally grounds for a demand of immediate payment by the funds supplier.

4. Internal constraints

The firm's ability to pay cash dividends is generally constrained by the amountof excess cash available rather than the level of retained earnings against which to charge them. Although it is possible for a firm to borrow funds to pay dividends, lendersare generally reluctant to make such loans because they produce no tangible or operatingbenefits that will help the firm repay the loan. Although the firm may have highearnings, its ability to pay dividends may be constrained by a low level of liquid assets. (Cash and marketable securities) We will take the previous example to explain thispoint. In our example, the firm can pay Rs.1, 40,000 in dividends. Suppose that the firm has total liquid assets of Rs.50, 000 (Rs.20, 000 cash +marketable securities worthRs.30, 000) and Rs.35, 000 of this is needed for operations, the maximum cash dividend the firm can pay is 15,000 (Rs.50, 000 – Rs.35, 000)

5. Growth prospects

The firm's financial requirements are directly related to the anticipated degree of asset expansion. If the firm is in a growth stage, it may need all its funds to finance capital expenditures. Firms exhibiting little or no growth may never need replace or renew assets. A growth firm is likely to have to depend heavily on internal financing through retained earnings instead of distributing current income as dividends

6. Owner considerations

In establishing a dividend policy, the firm's primary concern normally would be to maximize shareholder's wealth. One such consideration is then tax status of a firm's owners. Suppose that if a firm has a large percentage of wealthy shareholders who are in a high tax bracket, it may decide to pay out a lower percentage of its earnings to allow the owners to delay the payments of taxes until they sell the stock. Of

course, when the equity share is sold, the proceeds are in excess of the original purchase price, the capital gain will be taxed, possible at a more favorable rate than the one applied to ordinary income. Lower-income shareholders, however who need dividend income will prefer a higher payout of earnings. As of now, the dividend income is not taxed in the hands of the share holders in India. Instead, for paying out such dividends to its share holders, the company bears the dividend distribution tax.

7. Market Considerations

The risk-return concept also applies to the firm's dividend policy. A firm where the dividends fluctuate from period to period will be viewed as risky, and investors will require a high rate of return, which will increase the firm's cost of capital. So, the firm'sdividend policy also depends on the market's probable response to certain types of policies. Shareholders are believed to value a fixed or increasing level of dividends as opposed to a fluctuating pattern of dividends.

8. Legal Constrains

9. The Companies Act 1956 has put several restrictions Capital Market Conditions

Due to the capital market conditions, dividend policy may be affected. If thecapital market is prefect, it leads to improve the higher dividend.

TYPES OF DIVIDEND POLICY

Dividend policy depends upon the nature of the firm, type of shareholder and profitable position. On the basis of the dividend declaration by the firm, the dividend policy maybe classified under the following types:

• Regular dividend policy

• Stable dividend policy

• Irregular dividend policy

• No dividend policy.

Regular Dividend Policy Dividend payable at the usual rate is called as regular dividend policy. This type of policy is suitable to the small investors, retired persons andothers. Stable Dividend Policy

Stable dividend policy means payment of certain minimum amount of dividend regularly. This dividend policy consists of the following three important forms: Constantdividend per share Constant payout ratio Stable rupee dividend plus extra dividend.

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Irregular Dividend Policy When the companies are facing constraints of earnings and unsuccessful business operation, they may follow irregular dividend policy. It is one of the temporary arrangements to meet the financial problems. These types are having adequate profit. For others no dividend is distributed.

No Dividend Policy Sometimes the company may follow no dividend policy becauseof its unfavorable working capital position of the amount required for future growth of the concerns

regarding payments anddeclaration of dividends. Similarly, Income Tax Act, 1961 also lays down certain restrictions on payment of dividends.

10. Liquidity Position

Liquidity position of the firms leads to easy payments of dividend. If the firmshave high liquidity, the firms can provide cash dividend otherwise, they have to pay stock dividend.

11.Sources of Finance

If the firm has finance sources, it will be easy to mobilize large finance. The firmshall not go for retained earnings.

12.Growth Rate of the Firm

High growth rate implies that the firm can distribute more dividends to itsshareholders.

13.Tax Policy

Tax policy of the government also affects the dividend policy of the firm. Whenthe government gives tax incentives, the company pays more dividends.

CURRENT ASSTES

MANAGEMENT CONCEPTS AND CHARACTERISTICS OF WORKING CAPITALMEANING OF WORKING CAPITAL

Capital required for a business can be classified under two main categories

(1) Fixed Capital
(2) Working Capital

Every business needs funds for two purposes for its establishment and to carry out its day-to-day operations. Long-term funds are required to create production faculties through purchase of fixed assets such as plant and machinery, land, building, furniture etc. Investments in these assets represent that part of firm's capital which is blocked on a permanent or fixed basis and is called fixed capital. Funds are also needed for short-term purposes for the purchase of raw materials, payment of wages and other day-to-day expenses, etc. These funds are known as working capital.

Definition

In the words of ***Shubin****, "*Working capital is the amount of funds necessary to cover thecost of operating the enterprise".

According to ***Genestenberg****, "*Circulating capital means current assets of a company thatare changed in the ordinary course of business from one form to another, as for example,from cash to inventories, inventories to receivables, receivables into cash".

CONCEPTS OF WORKING CAPITAL

There are two concepts of working capital:

(A) Balance Sheet Concept
(B) Operating Cycle or Circular Flow Concept

(A) Balance Sheet Concept: There are two interpretations of working capital under the balance sheet concept:

(i) Gross Working Capital

(ii) Net Working capital

In the broad sense, the term working capital refers to the gross working capitaland represents the amount of funds invested in current assets. Thus, the gross working capital is the capital invested in total current assets of the enterprise; current assets are those assets which in the ordinary course of business can be converted into cash within ashort period of normally one accounting year.

Examples of Current Assets are:

CONSTITUENTS OF CURRENT ASSETS	
1.	Cash in hand and bank balances.
2.	Bills Receivables.
3.	Sundry Debtors (less provision for bad debts.)
4.	Short-term loans and advances.
5.	Inventories of stocks, as:
	(a) Raw Materials,
	(b) Work-in-Process,
	(c) Stores and spares,
	(d) Finished Goods.
6.	Temporary Investments of surplus funds.
7.	Prepaid Expenses.
8.	Accrued Incomes.

In a narrow sense, the term working capital refers to the new working capital.

Net working capital is the excess of current assets over current liabilities or say:

Net Working Capital = Current Assets – Current Liabilities.

Net Working Capital may be positive or negative. When the current assets exceed the current liabilities the working capital is positive and the negative working capital results when the current liabilities are more than the current assets. Current liabilities are those liabilities which are intended to be paid in the ordinary course of business within a short period of

normally one accounting year out of the current assets or the income of the business.

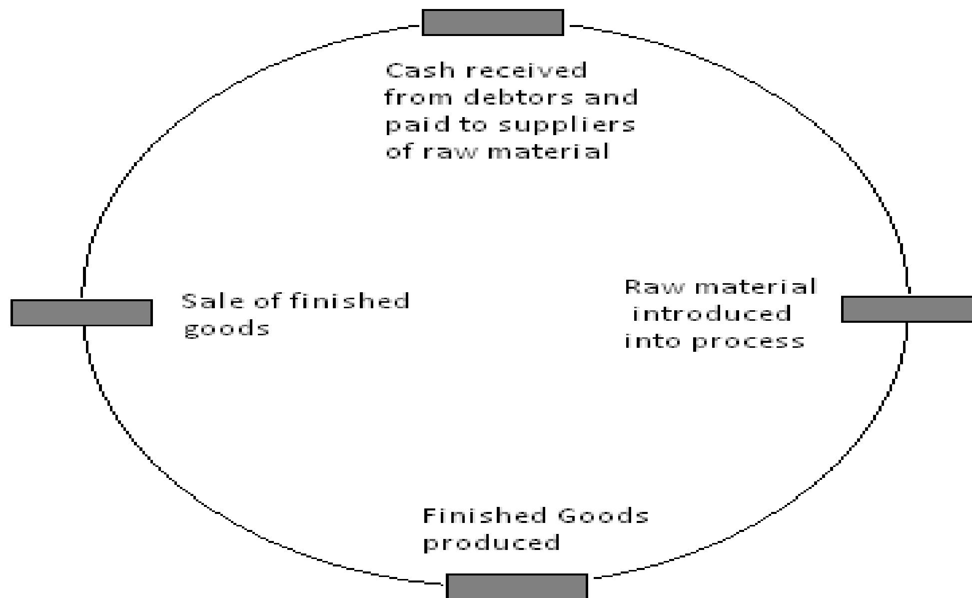
Examples of current liabilities are:

CONSTITUENTS OF CURRENT LIABILITIES	
1.	Bills Payable.
2.	Sundry creditors or accounts payable.
3.	Accrued or outstanding expenses.
4.	Short-term loans, advances and deposits.
5.	Dividends payable.
6.	Bank overdraft.
7.	Provision for taxation, if it does not amount to appropriation of profits.

The gross working capital concept is financial or going concern concept whereas net working capital is an accounting concept of working capital. These two concepts of working capital are not exclusive; rather both have their own merits.

(B) *Operating Cycle or Circular Flow Concept*

As discussed earlier, working capital refers to that part of firm's capital which is required for financing short-term or current assets such as cash, marketable securities, debtors and inventories. Funds, thus, invested in current assets such as cash, marketable securities, debtors and inventories. Funds, thus, invested again in exchange for other current assets.



The gross operating cycle of a firm is equal to the length of the inventories andreceivables conversion periods. Thus,

Gross Operating Cycle = RMCP + WIPCP + RCP

Where, RMCP = Raw Material

Conversion Period WIPCP =

Work-in-Process Conversion

PeriodFGCP = Finished

Goods Conversion Period RCP

= Receivables Conversion

Period

However, a firm may acquire some resources on credit and thus defer payments forcertain period. In that case, net operating cycle period can be calculated as below:

Net Operating Cycle Period = Gross Operating Cycle Period – Payable Deferral Period

Further, following formula can be used to determine the conversion periods.

1. Raw Material Conversion Period $= \frac{\textit{Average Stock of Raw Material}}{\textit{Raw Material Consumoption Per Day}}$

2. Work-in-Process Conversion Period $= \frac{Average\ Stock\ of\ Work-in-Progress}{Total\ Cost\ of\ Production\ Per\ Day}$

3. Finished Goods Conversion Period $= \frac{Average\ Stock\ of\ Finished\ Goods}{Total\ Cost\ of\ Goods\ Sold\ Per\ Day}$

4. Receivables Conversion Period $= \frac{Average\ Accounts\ Receivables}{Net\ Credit\ Sales\ Per\ Day}$

5. Payables Deferral Period $= \frac{Average\ Payables}{Net\ Credit\ Purchases\ Per\ Day}$

CHARACTERISTICS OF WORKING CAPITAL

1. **Short –term Requirements:** Working capital is utilized to purchase current assets which can be easily converted into cash in short period of time. The length of production process decides the duration of working capital; it is the time period between sale and cash receipts.

2. **Circular Movement:** Working capital is continuously transformed into cash but it again turns into working capital. This process is on continuous basis. When cash isutilized to purchase current assets and with the help of current assets goods are produced and sold then therefore working capital is also termed as circulating capital.
3. **Permanence:** Working capital is a short-term capital but in order to continue the production process it is always required by the firm. Hence working capital is also termed as permanence or regular working capital**.**

4. **Instability:** Though working capital is required permanently in a firm but the amount of working capital required frequently changes with the changes in production level, changes in purchase, sale policy, price level and demand level. The amount of working capital that changes due to changes in other factors is calledvariable working capital.

5. **Liquidity:** Working capital can be easily converted into cash, hence it is more liquid. Firms which maintain adequate amount or working capital finds easy to convert it into cash in time when cash is required.

6. **Less Risky:** Working capital is the investment in current assets which is for a shortperiod of time. Hence it involves less risk. Working capital does not involve any risk related to technological changes. It involves a very less amount of physical riskonly.

7. **Special Accounting System not Required:** As working capital is for short-term usually for one year. Hence, there is no need to adopt

special accounting system forit.

FACTORS DETERMINING THE WORKING CAPITAL REQUIREMENTS

The Working capital requirements of a concern depend upon a large number of factors such as nature and size of business, the character of their operations, the length of production cycles, the rate of stock turnover and the state of economic situation. It is not possible to rank them because all such factors are of different importance and the influence of individual factors changes for a firm over time. However the following are important factors generally influencing the working capital requirements.

1. **Nature or Character of Business**: The Working capital requirements of a firm basically depend upon the nature of its business. Public utility undertakings like Electricity. Water supply and Railways need very limited working capital because they offer cash sales only and supply services, not products, and as such no funds are tied up in inventories and receivables. On the other hand trading and financial firms require less investment in fixed assets but have to invest largeamount in current assets like inventories, receivables and cash; as such they needlarge amount of working capital. The manufacturing undertakings also require sizable working capital along with fixed investments. Generally speaking it may be said that public utility undertaking require small amount of working capital, trading and financial firms require relatively very large amount, whereas manufacturing undertakings require sizable working capital between these two extremes.
2. **Size Business/Scale of Operations:** The working capital requirements of a concern are directly influenced by the size of its business which may be measured in terms of scale of operations. Greater the size of business unit, generally larger will be the requirements of working capital. However, in some cases even a smaller concern may need more working capital due to high overhead charges, inefficient use of available resources and other economicdisadvantages of small size.

3. **Production Policy:** In certain industries the demand is subject to wide fluctuations due to seasonal variations. The requirements of working capital in such cases depend upon the production policy. The production could be kept either steady by accumulating inventories during slack periods with a view to meet high demand during the peak season or the production could be curtailed during the slack season and increased during the peak season. If the policy is to keep production steady by accumulating inventories it will require higher working capital.

4. **Manufacturing Process/Length of Production Cycle:** In

manufacturing business, the requirements of working capital increase in direct proportion to length of manufacturing process. Longer the process period of manufacture, larger is the amount of working capital required. The longer the manufacturing time, the raw material and other supplies have to be carried for a longer period in the process with progressive increment of labor and service costs before the finished product is finally obtained. Therefore, if there are alternative processes of production, the process with the shortest production period should be chosen.

5. **Seasonal Variations:** In certain industries raw material is not available throughout the year. They have to buy raw materials in bulk during the season toensure an uninterrupted flow and process them during which gives rise to more working capital requirements. Generally, during the busy season, a firm requires larger working capital than in the slack season.

6. **Working Capital Cycle:** In a manufacturing concern, the working capital cycle starts with the purchase of raw material and ends with the realization of cashfrom the sale of finished products. This cycle involves purchase of raw materialsand stores, its conversion into stocks of finished goods through work-in-progress with progressive increment of labor and service costs, conversion of finished stock into sales, debtors and receivables and ultimately realization of cash and this cycle continues again from cash to purchase of raw material and so on.

7. **Rate of Stock Turnover:** There is a high degree of inverse co-relationship between the quantum of working capital and the velocity or speed with which thesales are affected. A firm having a high rate of stock turnover will need lower amount of working capital as compared to a firm having a low rate of turnover. **Credit Policy:** The credit policy of a concern in its dealing with debtors and creditors influence considerably the requirements of working capital. A concern that purchases its requirements on credit and sells its products/services on cash requires lesser amount of working capital. On the other hand a concern buying its requirements for cash and allowing credit to its customers, shall need larger amount of working capital as very huge amount of funds are bound to be tied up in debtors or bills receivables.

8. **Business Cycles:** Business cycle refers to alternate expansion and contraction ingeneral business activity. In a period of boom i.e., when the business is prosperous, there is a need for larger amount of working capital due to increasein sales, rise in prices, optimistic

expansion of business, etc.

9. **Rate of Growth of Business:** The working capital requirements of a concern increase with the growth and expansion of its business activities. Although, it is difficult to determine the relationship between the growth in the volume ofbusiness and the growth in the working capital of a business, yet it may be concluded that for normal rate of expansion in the volume of business, we may have retained profits to provide for more working capital but in fast growing concerns, we shall require larger amount of working capital.

10. **Earning Capacity and Dividend Policy:** Some firms have more earning capacity than others due to quality of their products, monopoly conditions, etc. Such firms with high earning capacity may generate cash profits from operations and contribute to their working capital. The dividend policy of a concern also influences the requirements of its working capital. A firm that maintains a steady high rate of cash dividend irrespective of its generation of profits needs more working capital than the firm that retains larger part of its profits and does not pay so high rate of cash dividend.

11. **Price Level Changes:** Changes in the price level also affect the working capital requirements. Generally, the rising prices will require the firm to maintain largeramount of working capital as more funds will be required to maintain the same current assets. The affect of rising prices may be different for different firms. Some firms may be affected much while some others may not be affected at all by the rise in prices.

Other Factors: Certain other factors such as operating efficiency, management ability, irregularities of supply, import policy, asset structure, importance oflabor, banking facilities, etc., also influence the requirements of working capital *FORECAST/ESTIMATE OF WORKING CAPITAL REQUIREMENTS*

"Working capital is the life-blood and controlling nerve centre of a business". No business can be successfully run without an adequate amount of working capital. To avoid the shortage of working capital at once, an estimate of working capital requirements should be made in advance so that arrangements can be made to procure adequate working capital.

Methods of Estimating Working Capital Requirements

The following method are usually followed in forecasting working

capitalrequirements of a firm

1. Percentage of Sales Method
2. Regression Analysis Method
3. Cash Forecasting Method
4. Operating Cycle Method
5. Projected Balance Sheet Method

1.Percentage of Sales Method: This method of estimating working capital requirements is based in the assumption that the level of working capital for any firm is directly related to it sales value. If past experience indicates a stable relationshipbetween the amount of sales and working capital, then this basis may be used todetermine the requirements of working capital for future period. Thus, if sales for the year 2007 amounted to Rs.30,00,000 and working capital required was Rs.60,00,000;the requirement of working capital for the year 2008 on an estimated sales liabilities can also be estimated on the basis of the past experience as a percentage of sales. This method is simple to understand and easy to operate but it cannot be applied in all cases because the direct relationship between sales and working capital may not be established.

2. Regression Analysis Method (Average Relationship between Sales and Working Capital): This method of forecasting working capital requirements is based upon the statistical technique of estimating or predicting the unknown value of a dependentvariable from the known value of an independent variable. It is the measure of the average relationship between two or more variables, i.e., sales and working capital, in terms of the original units of the data.

The relationships between sales and working capital is represented by the equation:

$$Y = a + bx$$

Where, y = Working Capital (dependent variable)

a = Intercept of the least square b = Slope of the regression line x = Sales (independent variable)

The ratio helps to examine the following alternative working capital policies:

1. Conservative Policies: Assuming a constant level of fixed assets, a higher current assets to fixed assets ratio, refers to conservative policies. It indicates the firm's sound liquidity position and lower risk to meet its current obligations and investments. This policy is also termed as flexible policy. It also indicates that the current assets are efficiently utilized at every levels or output.

Conservative Policy Indicates

- (i) Sound liquidity
- (ii) Lower risk
- (iii) Current assets are efficiently utilized in production
- (iv) No bottlenecks in production, because of the mainetenance of huge stock
- (v) Prompt payment of accounts payable, because of huge liquid cash in hand

2. Moderate Policies: Moderate policy is otherwise termed as average current assets policy. This ratio occurs between higher and lower ratio of current assets to fixed assetsratio. In other words, the current assets policy of most firms may fall between the conservative policies and aggressive policies. This indicates moderate risk and average liquidity position of a firm.

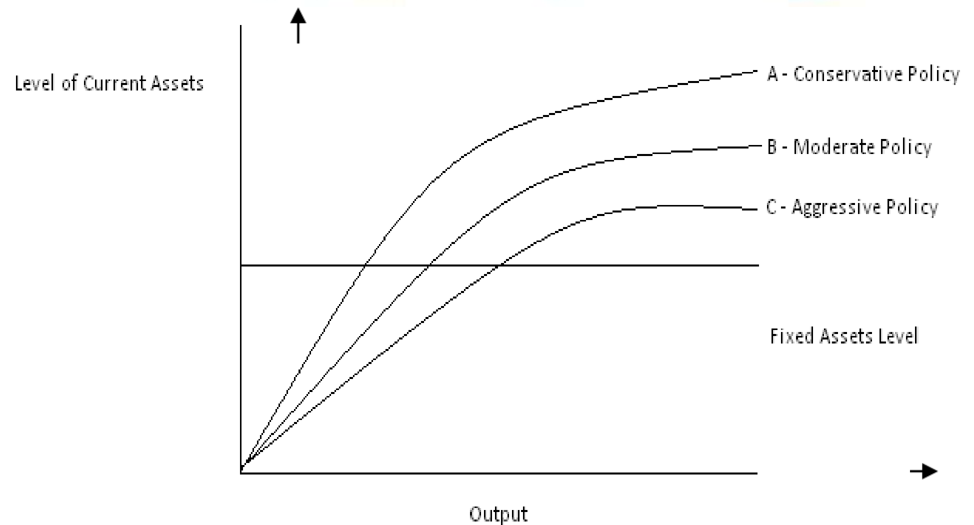
Moderate Policy Indicates:

- (i) Moderate risk
- (ii) Average liquidity position
- (iii) Current assets are used in production
- (iv) Maintenance of stock of raw materials, work-in-progress and finishedgoods are at an average level.

3. Agressive Policies: Lower level of current assets to fixed assets ratio represents aggressive policy. This aggressive policy indicates higher risk and poor liquidity position of a firm. It also indicates that the current assets are inefficiently utilized at all levels of output. This policy is also termed as restrictive policy.

Aggressive Policy Indicates

- (i) Poor liquidity position
- (ii) Higher risk
- (iii) Current assets are utilized at lowest in all levels of output
- (iv) Maintenance of small stock levels
- (v) Declining size of sales because of rare credit sales facilities
- (vi) Stoppage and bottlenecks in production, due to lack of stock
- (vii) Slower accounts payable payments, because of low cash balance in hand



CURRENT ASSETS

MANAGEMENTCASH

MANAGEMENT

Cash management has assumed importance because it is the most significant of all the current assets. It is required to meet business obligations and it is productive when not used.

Cash management deals with the following:

(i) Cash inflows and outflows
(ii) Cash balances held by the firm at a point of time
(iii) Cash balances held y the fire at a point of time

Cash management need strategies to deal with various facets of cash. Following are some of its facets:

(a) Cash Planning: Cash Planning is technique to plan and control the use of cash. A projected cash flow statement may be prepared, based on the present business operations and anticipated future activities. The cash inflows from various sources may be anticipated and cash outflows will determine the possible uses of cash;

(b) Cash Forecasts and Budgeting: A cash budget is the most important device for the control of receipts and payments of cash. A cash budget is an estimate of cash receipts and disbursements during a future period of time. It is an analysis of flow of cash in a business over a future, short or long period of time. It is a forecast of expected cash intake and outlay.

Both Short-term and long-term cash forecasts may be made with the help of following methods:

(i) Receipts and disbursements method
(ii) Adjusted net income method

(i) Receipts and Disbursements Method: In this method the receipts and payments of cash are estimated. The receipts and disbursements are to be equaled over a short as well as long periods. Any shortfall in receipts will have to be met from banks or other sources. Similarly, surplus cash may be invested in risk free marketable securities. It may be easy to make estimates for payments but cash receipts may not be accurately made. The payments are to be made by outsiders, so there may be some problem in finding out the exact receipts at a particular period. Because of uncertainty, the reliability of this method may be reduced.

(ii) Adjusted Net Income Method: This method may also be known as sources and uses approach. It generally has three sections: sources of cash, uses of cash and adjustedcash balance. The adjusted net income method helps in projecting the company's need for cash at some future date and to see whether the shares, etc. In preparing itsstatement the items like net income, depreciation, dividends, taxes, etc.

RECEIVABLE MANAGEMENT

The term receivable is defined as debt owed to the concern by customers arising from sale of goods or services in the ordinary course of business. Receivables are also one of the major parts of the current assets of the business concerns. It arises only due to credit sales to customers, hence, it is also known as Account Receivables or Bills Receivables. Management of account receivable is defined as the process of making decision resulting to the investment of funds in these assets which will result in maximizing the overall return on the investment of the firm.

The objective of receivable management is to promote sales and profit until that point is reached where the return on investment in further funding receivables is lessthan the cost of funds raised to finance that additional credit.The costs associated with the extension of credit and accounts receivables are identified as follows:

A. Collection Cost

B. Capital Cost

C. Administrative Cost

D. Default Cost.

Collection Cost

These costs incurred in collecting the receivables from the customers, to who credit sales have been made.

Capital Cost

This is the cost on the use of additional capital to support credit sales which alternatively could have been employed elsewhere.

Administrative Cost

This is an additional administrative cost for maintaining account receivable in the form of salaries to the staff kept for maintaining accounting records relating to customers, cost of investigation etc.

Default Cost

Default costs are the over dues that cannot be recovered. Business concern may not be able to recover the over dues because of the inability of the customers.

4.4.1FACTORS CONSIDERING THE RECEIVABLE SIZE

Receivables size of the business concern depends upon various factors. Some of the important

factors are as follows:

1. Sales Level

Sales level is one of the important factors which determines the size of receivable of the firm. If the firm wants to increase the sales level, they have to liberalisetheir credit policy and terms and conditions. When the firms maintain more sales, there will be a possibility of large size of receivable.

2. Credit Policy

Credit policy is the determination of credit standards and analysis. It may vary from firm to firm or even some times product to product in the same industry. Liberal credit policy leads to increase the sales volume and also increases the size of receivable. Stringent credit policy reduces the size of the receivable.

3. Credit Terms

Credit terms specify the repayment terms required of credit receivables, depend upon the credit terms, size of the receivables may increase or decrease. Hence, credit term is one of the factors which affects

the size of receivable.

4. Credit Period

It is the time for which trade credit is extended to customer in the case of credit sales. Normally it is expressed in terms of 'Net days'.

5. Cash Discount

Cash discount is the incentive to the customers to make early payment of the due date. A special discount will be provided to the customer for his payment before the due date.

6. Management of Receivable

It is also one of the factors which affects the size of receivable in the firm. When the management involves systematic approaches to the receivable, the firm can reduce the size of receivable.

INVENTORY MANAGEMENT

Inventories constitute the most significant part of current assets of the business concern. It is also essential for smooth running of the business activities. A proper planning of purchasing of raw material, handling, storing and recording is to be considered as a part of inventory management. Inventory management means, management of raw materials and related items. Inventory management considers what to purchase, how to purchase, how much to purchase, from where to purchase, where to store and When to use for production etc.

MEANING

The dictionary meaning of the inventory is stock of goods or a list of goods. In accounting language, inventory means stock of finished goods. In a manufacturing point of view, inventory includes, raw material, work in process, stores, etc.

KINDS OF INVENTORIES

Inventories can be classified into five major categories.

A. Raw Material: It is basic and important part of inventories. These are goods whichhave not yet been committed to production in a manufacturing business concern.

B. Work in Progress: These include those materials which have been committed toproduction process but have not yet been completed.

C. Consumables: These are the materials which are needed to smooth running of themanufacturing process.

D. Finished Goods: These are the final output of the production process of the businessconcern. It is ready for consumers.

E. Spares: It is also a part of inventories, which includes small spares and parts.

OBJECTIVES OF INVENTORY MANAGEMENT

Inventory occupies 30–80% of the total current assets of the business concern. It is also very essential part not only in the field of Financial Management but also it is closely associated with production management. Hence, in any working capital decision regarding the inventories, it will affect both financial and production function of the concern. Hence, efficient management of inventories is an essential part of any kind of manufacturing process concern. The major objectives of the inventory management are as follows:

- To efficient and smooth production process.
- To maintain optimum inventory to maximize the profitability.
- To meet the seasonal demand of the products..
- To ensure the level and site of inventories required.
- To plan when to purchase and where to purchase
- To avoid both over stock and under stock of inventory.
- To avoid price increase in future.

TECHNIQUES OF INVENTORY MANAGEMENT

Inventory management consists of effective control and administration of inventories. Inventory control refers to a system which ensures supply of requiredquantity and quality of inventories at the required time and at the same time prevents unnecessary investment in inventories. It needs the following important techniques

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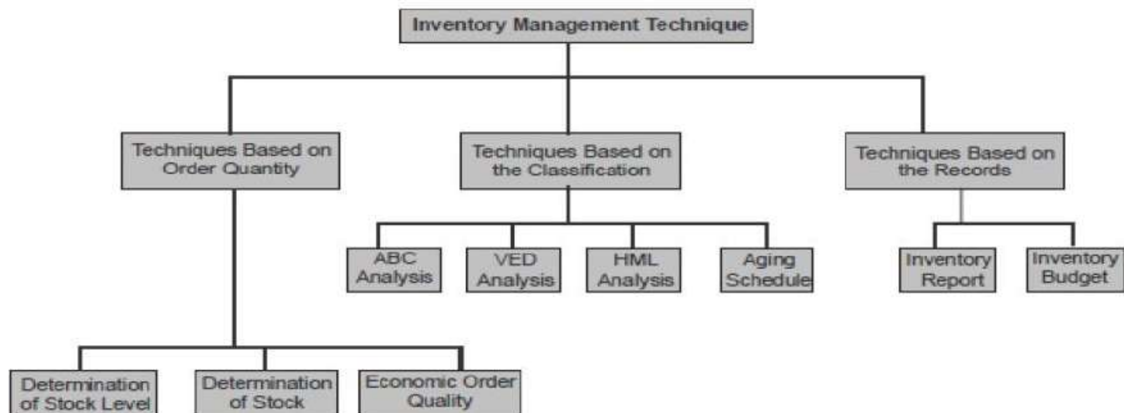


1. *Stock Level:*

Stock level is the level of stock which is maintained by the business concern at all times. Therefore, the business concern must maintain optimum level of stock to smooth running of the business process. Different level of stock can be determined based on the volume of the stock.

2. *Minimum Level:*

The business concern must maintain minimum level of stock at all times. If thestocks are less than the minimum level, then the work will stop due to shortage of material.

V = Vital item

of inventories #

E = Essential

item of

inventories

D = Desirable item of inventories

HML Analysis

Under this analysis, inventories are classified into three categories on the basis of the value of the inventories.

H = High value of inventories

M = Medium

value of

inventoriesL =

Low value of

inventories

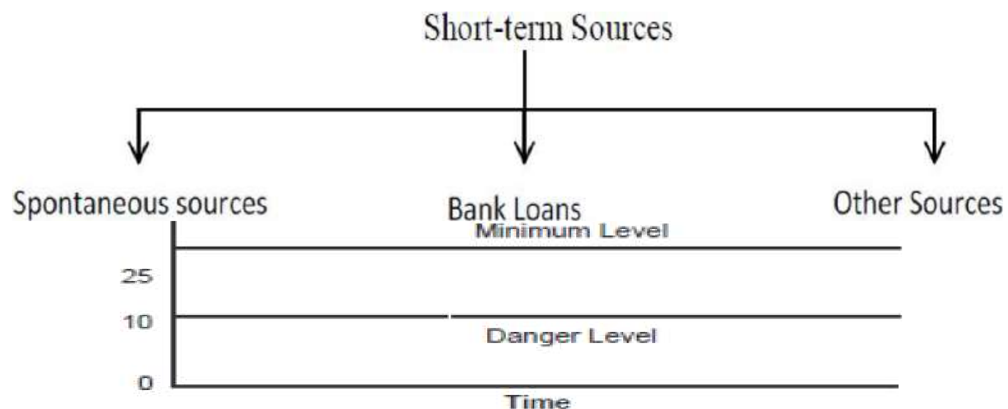
Valuation of Inventories

Inventories are valued at different methods depending upon the situation and nature of manufacturing process. Some of the major methods of inventory valuation are mentioned as follows:

1. First in First out Method (FIFO)
2. Last in First out Method (LIFO)
3. Highest in First out Method (HIFO)
4. Nearest in First out Method (NIFO)
5. Average Price Method

4.6 FINANCING WORKING CAPITAL THROUGH SHORT-TERM SOURCES

Funds available for a period of one year or less are called short-term sources of finance. They are raised from sources, which can provide funds only for short period quickly, and its cost is less than the funds raised from long-term sources. These fundsare usually met by taking short-term loans or getting the bills discounting from the commercial banks. Spontaneous sources and bank loans are important sources of short-term funds. They are explained in detail below.



1. Re-order Level

Re-ordering level is fixed between minimum level and maximum level. Re-order level is the level when the business concern makes fresh order at this level. Re-order level=maximum consumption × maximum Re-order period.

2. Maximum Level

It is the maximum limit of the quantity of inventories, the business concern must maintain. If the quantity exceeds maximum level limit then it will be overstocking. Maximum level = Re-order level + Re-order quantity – (Minimum consumption ×Minimum delivery period

3. Danger Level

It is the level below the minimum level. It leads to stoppage of the production process. Danger level=Average consumption × Maximum re-order period for emergencypurchase

4. Average Stock Level

It is calculated such as, Average stock level= Minimum stock level + ½ of re- order quantity

3. Lead Time

Lead time is the time normally taken in receiving delivery after placing order s with suppliers. The time taken in processing the order and then executing it is known as lead time.

4. Safety Stock

Safety stock implies extra inventories that can be drawn down when actual lead time and/ or usage rates are greater than expected. Safety stocks are determined by opportunity cost and carrying cost of inventories. If the business concerns maintain low level of safety stock, it will lead to larger opportunity cost and the larger quantity of safety stock involves higher carrying costs.

ECONOMIC ORDER QUANTITY (EOQ)

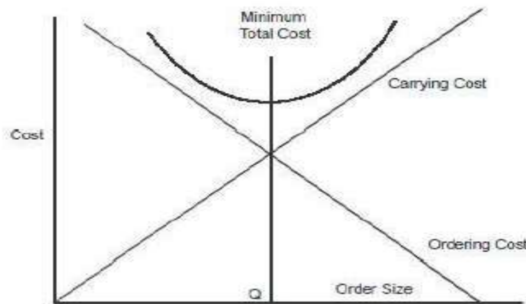
EOQ refers to the level of inventory at which the total cost of inventory comprising ordering cost and carrying cost. Determining an optimum level involves two types of cost such as ordering cost and carrying cost. The EOQ is that inventory level that minimizes the total of ordering of carrying cost. EOQ can be calculated with thehelp of the mathematical formula: **EOQ = 2ab/c**

Where,

a = Annual usage of inventories (units)

b = Buying cost per order

c = Carrying cost per unit



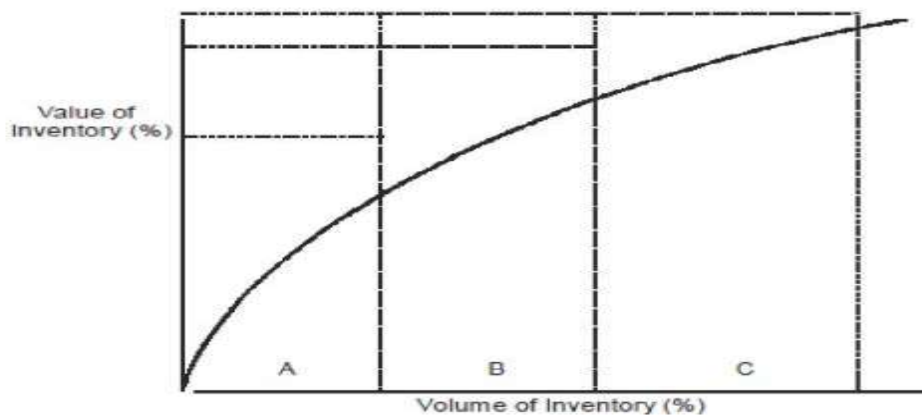
TECHNIQUES BASED ON THE CLASSIFICATION OF INVENTORIES

A-B-D analysis

It is the inventory management techniques that divide inventory into three categories based on the value and volume of the inventories; 10% of the inventory'sitem contributes to 70% of value of consumption and this category is known as a category. About 20% of the inventory item contributes about 20% of value of consumption and this category is called category B and 70% of inventory item contributes only 10% of value of consumption and this category is called C category.

Inventory Breakdown Between Value and Volume

Category	Volume (%)	Value (%)
A	10	70
B	20	20
C	70	10
Total	100	100



1. Spontaneous Sources Some sources of funds, which are created

during the course of normal business activity have zero cost and are termed as spontaneous sources. For example suppliers supply goods; employees provide services where the payment is madeat a later stage.

Trade Credit The credit extended in connection with the goods purchased for resale bya retailer or a wholesaler for materials used by manufacturers in producing its productsis called the trade credit. Trade credit is a form of short-term financing common isalmost all types of business firm. As a matter of fact, it is the largest source of short-term funds. The amount of such financing depends on the volume of purchase and the payment timings. Small and new firms are usually more dependent on the trade credit, asthey find it difficult to obtain funds from other sources.

(a) An opening account credit and (b) Acceptance credit management / bills payable.

2. Bank Loans

The bank loans, in general, are a short-term financing say for a year or so. This short-term financing to business firm is regarded as self-liquidating. It means, banks routinely provide finance to meet the seasonal demand e.g., to cover the seasonalincrease in inventories or receivables. Sometimes, the banks may approve separate limitsfor peak season and non-peak season. The main sources of short-term funds are cash credit, overdraft and bill discounting.

Types of Bank Loans In India banks provide financial assistance for working capital indifferent shapes and forms. The usual forms of bank loans are as follows:

In case of credit sales, it attracts more customers, resulting in increased sales and higher profit, but it has a cost also. This cost may be of two types, namely investment cost and administrative cost. Moreover, the sellers have to raise funds from various sources in order to finance the receivables. While maintaining receivables, a firm may have to face two types of problems. First, the problem of rising funds to finance the receivables, and second the problem relating to collection, delay and defaults of the receivables. If the firm concentrates on managing funds and receivables, it cannot concentrate on other functions like finance, production, marketing, personal etc. Under this situation a firm can avail the services of a specialist organization engaged in receivables management. These specialist firms are known as **factoring firms.**

Commercial Papers (CPs)

Commercial Papers are debt instruments issued by corporate for raising short- term resources from the money market. These are unsecured debts of corporate. Theyare issued in the form of promissory notes, redeemable at par to the holder at maturity. Only corporate who get an investment grade rating can issue CPs as per RBI rules. Though CPs are issued by corporate, they could be good investments if proper caution isexercised.

Inter Corporate Deposits (ICD)

Sometimes, the companies borrow funds for a short-term period; say up to six months, from other companies, which have surplus liquidity for the time being. The ICD are generally unsecured and are arranged by a financier. The ICD are very common and popular in practice, as these are not influenced by the legal hassles. The convenience isthe basic virtue of this method of financing. There is no regulation at present in India toregulate these ICD. Moreover, these are not covered by the section 58A of the companies Act, 1956, as the ICD are not for long term

What is 'Cash Budget'

Cash budget is an estimation of the cash inflows and outflows for a business or individual for a specific period of time. Cash budgets are often used to assess whether the entity has sufficient cash to fulfill regular operations and/or whether too much cash is being left in unproductive capacities.

For individuals, creating a cash budget is a good method for determining where their cash is regularly being spent. This awareness can be beneficial because knowing the value of certain expenditures can yield opportunities for additional savings by cutting unnecessary costs.

For example, without setting a cash budget, spending a dollar a day on a cup of coffee seems fairly unimpressive. However, upon setting a cash budget to account for regular annual cash expenditures, this seemingly small daily expenditure comes out to an annualtotal of $365, which may be better spent on other things. If you frequently visit specialtycoffee shops, your annual expenditure will be substantially more.

Credit terms or terms of credit is the agreement between a seller and buyer that lists the timing and amount of payments the buyer will make in the future. In other words, this is the contract that describes the specific details of the seller’s payment requirements that the buyer must meet into order to purchase goods on account.

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Most companies have credit policies set up with vendors or customers, so purchases can be made on account. These credit purchases help speed up commerce and increase sales because it allows customers to purchase items before they actually have the funds to buythem.

Before a credit sale can be made, credit terms must be established. Most terms are dictated by industry practices and the specific goods sold in those industries. A standard term rate that applies across most industries is 2/10 N/30—often called 2/10 net/30.

This is the standard way to write out and abbreviate term details. Here is a cypher to understand the code:

Percent discount if paid in cash / days to cash discount is available Net amount of payment due / number of total days in credit period
These terms mean that a customer can receive a 2 percent discount on his purchase if he pays the entire balance in cash within 10 days. This is often referred to as the cash discount period. If the discount isn't taken, the customer must pay the full invoice amount within 30 days of the purchase. This 30-day credit period is a sort of short-term financing for the customer. They can purchase goods without actually coming up with the cash immediately. They can then sell the goods to retail customers and pay for the goods within 30 days. This way the credit purchaser is never out of any cash.

UNIT V CORPORATE RESTRUCTURES

INTRODUCTION

Restructuring is widely used in both the developed and developing countries nowadays. Companies and economies are restructuring to achieve a higher level of performance or to survive when the given structure becomes functional. Restructuring takes place at different levels. At the level of the whole economy, it **is a long-term response to market trends, technological change, and macroeconomic policies**. At the sector level, restructuring causes change **in the production structure and new arrangements across enterprises**. At the enterprise level, firms restructure through new **business strategies and internal reorganization in order** to adapt to new market requirements.

An entrepreneur may grow its business either by internal expansion or by external expansion. In the case of internal expansion, **a firm grows gradually over time in the normal course of the business, through acquisition of new assets, replacement of the technologically** obsolete equipments and the establishment of new lines of products. But in external expansion, **a firm acquires a running business and grows overnight through corporate combinations. These combinations are in the form of mergers, acquisitions, amalgamations and takeovers** and

have now become important features of corporate restructuring.

Mergers and acquisitions (M & As) have been a very important marketentry strategy as well as expansion strategy. This present era is known as competition era. In this era companies, to avoid the competition, go for merger, and enjoy sometimesmonopoly. Consolidation through mergers and acquisitions (M & As) is considered one of the best ways of restructuring structure of corporate units.

CONCEPT AND DEFINITION

Merger is defined as **combination of two or more companies into a single company where one survives and the other lose their corporate existence.** The survivor acquires the assets as well as liabilities of the merged company or companies. **A merger is a combination of two companies where one corporation is completely absorbed by another corporation**. The less important company losses its identity and becomes part of the more important corporation, which retains its identity. A merger extinguishes the merged corporation and the surviving corporation assumes allthe right, privileges, and liabilities of the merged corporation. A merger is not the same as a consolidation in which two corporations lose their separate identities and unite to form a completely new corporation. A merger is a combination of two or more businesses into one business. Laws in India use the term 'amalgamation' for merger. The Income Tax Act, 1961 [Section 2(1A)] defines amalgamation as the merger of one or more companies with another or the merger of two or more companies to form a new company, in such a way that all assets and liabilities of the amalgamating companies become assets and liabilities of the amalgamated company and shareholders not less than nine-tenths in value of the shares in the amalgamating company or companies become shareholders of the amalgamated company.

ACCORDING TO THE OXFORD DICTIONARY

The expression merger or amalgamation means “Combining of two commercial companies into one” and “Merging of two or more business concerns into one” respectively. A merger is just one type of acquisition. One company can acquire another in several other ways including purchasing some or all of the company’s assets or buying up its outstanding share of stock.

ACQUISITION:-

Acquisition in general sense **is acquiring the ownership in the property**. Acquisition is the purchase by one company of controlling interest in the share capital ofanother existing company. This means that even after the takeover although there is change in the management of both the firms retain their separate legal identity. An essential feature of merger

through absorption as well as consolidation is the combination of the companies. The acquiring company takes over the ownership of one or more other companies and combines their operations. However, an acquisition does not involve combination of companies. It is simply an act of acquiring control over management of other companies. The control over management of another company canbe acquired through either an 'either take-over' or through 'forced' or 'unwilling acquisition'. When a company takes-over the control of another company through mutual agreement, it is called acquisition or friendly take-over is opposed by the 'target' company it is known as hostile take-over

CONSOLIDATION:-

Consolidation is known as the **fusion of two existing companies into a new entity in which both the existing companies extinguish**. Thus, consolidation is mixingup of the two companies to make them into a new one in which both the existing companies lose their identity and cease to exist. The mixes up assets of the two companies are known by a new name and the share holders of two companies become shareholders of the new company. . For example, merger of Hindustan Computers Ltd, Hindustan Instruments Ltd, Indian Software Company Ltd and Indian ReprographicsLtd into an entirely new company called HCL Ltd.

COMBINATION:-

Combination refers to mergers and consolidation as a common term used interchangeably but carrying legally distinct interpretation. All mergers, acquisitions andamalgamations are business combinations.

TAKEOVER

A takeover generally involves the acquisition of a certain block of equity capital of a company which enables the acquirer to exercise control over the affairs of the company. Normally merger, amalgamation, acquisition, takeover are used interchangeably.

TYPES OF MERGER

There are mainly four types of mergers based on the competitive relationshipsbetween the merging parties: 1) Horizontal Mergers

2) Vertical Mergers
3) Conglomerate Mergers

HORIZONTAL MERGERS:

Horizontal Mergers is a combination of two or more firms in the same area of business. Horizontal merger is a merger of two companies

which are essentially operating in the same business. The main purpose of this merger is to obtain economy ofscale in production by eliminating duplication of facilities, reducing of competition, reduction of cost, increase in share price and market segments.

For example, the merger of ICICI Bank and Bank of Madura is a horizontal merger. But the merger of ICICI bank and Mahindra Tractor it is not a horizontal merger. Horizontal mergers raise three basic competitive issues. The first is the elimination of competition between the merging firms, which, depending on their size, may be significant. The second is that the unification of the merging firm's operations may create substantial market power and could enable the merged entity to raise prices by reducing output unilaterally. The third problem is that by increasing concentration in the relevant market, the transaction may strengthen the ability of the markets remaining participants to co-ordinate their pricing and output decisions. The fear is not that the entities will engage in secret collaboration but that the reduction in the number of industry members will enhance co-ordination of behavior.

VERTICAL MERGERS

Vertical merger is a combination of two or more firms involved in different stages of production or distribution of the same product. It is a merger of one company with another having different stages of production / distribution process of the same product / service. In short the merging companies are engaged in different stages of production or distribution. The main objective is to increase profitability by the previousdistributors. For example, ICICI Ltd With ICICI Bank is an example of vertical merger with backward linkage as far as ICICI Bank is concerned.

Vertical merger may take the form of forward or backward merger. When a company combines with the supplier of material, it is called backward merger and when it combines with the customer, it is known as forward merger. And their two benefits: first, the vertical merger internalizes all transactions between manufacturer and its supplier or dealer thus converting a potentially adversarial relationship into something more like a partnership. Second, internalization can give the management more effective ways to monitor and improve performance. Vertical mergers may also be

anticompetitive because their entrenched market power may impede new business fromentering the market.

CONGLOMERATE MERGER

Conglomerate merger is an amalgamation of two companies engaged in different line of business, in other words, the merging companies are engaged in diverse business activities For example, ICICI Ltd merger with Mahindra tractor and Reliance Industries Ltd. merged

with Reliance Petroleum Ltd. Conglomerate transactions take many forms, ranging from short term joint ventures to complete mergers. Whether a conglomerate merger is pure, geographical or a product line extension it involves firms that operate in separate market. Conglomerate transactions ordinarily have no direct effect on competition.

Conglomerate merger can supply a market or demand for firms thus giving entrepreneurs liquidity at an open market price and with a key inducement to form new enterprises. Conglomerate merger also provide opportunity for firms to reduce capital cost and overhead and achieve other efficiencies. This type of merger may also reduce the number of smaller firms and increase the merged firm's political power, thereby impairing the social and political goal of retaining independent decision making centre guaranteeing small business opportunities and preserving democratic processes.

MOTIVES BEHIND MERGER AND ACQUISITION:

Accelerating a company's growth particularly when its internal growth is constrained due to paucity of resources, internal growth requires that a company should develop its operating facilities- manufacturing, research, marketing, etc. But, lack or inadequacy of resources and time needed for internal development may constrain a company's pace of growth.

(1) STRATEGIC BENEFIT:

Strategic benefit mainly aims at achieving long term plans and implementing them. When a firm desires to enter or expand in a particular industry, acquisitionprovides more advantages than internal expansion. Some of them are: acquisition provides more advantages than internal expansion. Some of them are acquisition provides more advantages than internal expansion. Some of them are: acquisition provides more advantages than internal expansion. Some of them are:

(i) If prevents competitors and avoids competition.

(ii) It can pass over several stages of expansion in a short span of time.

(iii) It ensure less risk and less cost

(iv)Merging in a saturated market helps in expansion and replacement which is moreadvantages than internal expansion.

(2) OPERATING ECONOMIES:-

Arise because, a combination of two or more firms may result in cost reduction due to operating economies. In other words, a combined firm may avoid or reduce over- lapping functions and consolidate its management functions such as manufacturing, marketing, R&D and thus reduce operating costs. For example, a combined firm may

eliminate duplicate channels of distribution, or crate a centralized training center, orintroduce an integrated planning and control system.

(1) SYNERGY:-

Implies a situation where the combined firm is more valuable than the sum of theindividual combining firms. It refers to benefits other than those related to economies of scale. Operating economies are one form of synergy benefits. But apart from operating economies, synergy may also arise from enhanced managerial capabilities, creativity, innovativeness, R&D and market coverage capacity due to the complementarily of resources and skills and a widened horizon of opportunities.

(2) CROSS SELLING: -

For example, a bank buying a stockbroker could than sell its banking products to the stock broker's customers, while the broker can sign up the bank's customers for broker's accounts.

(3) TAXES SAVINGS: -

A profitable company can buy a loss making unit to use the targets tax writeoffs. In the U.S. and many countries, rules are in place to limit the ability of profitable companies to shop for loss making companies limiting the tax motive of an acquiring company.

(4) GREATER VALUE GENERATION:-

Companies go for Mergers and Acquisition from the idea that, the joint company will be able to generate more value than the separate firms. When a company buys out another, it expects that the newly generated shareholder value will be higher than the value of the sum of the shares of the two separate companies.

(5) GAIN IN MARKET SHARE:-

Mergers and Acquisitions can prove to be really beneficial to the companies when they are weathering through the tough times. If the company which is suffering from various problems in the market and is not able to overcome the difficulties, it can go for an acquisition deal. If a company, which has a strong market presence, buys out the weak firm, then a more competitive and cost efficient company can be generated. Here, the target company benefits as it gets out of the difficult situation and after being acquired by the large firm, the joint company accumulates larger market share. This is because of these benefits that the small and less powerful firms agree to be acquired by the large firms.

(6) RESOURCE TRANSFER:-

Resource are unevenly distributed across firms and the interaction of target and acquiring firm resources can create value through either overcoming information or combining scarce resources.

(3) DIVERSIFICATION:

The main reason for merger is to reduce risk through diversification.Diversification implies dividing or spreading the business in different product lines. Reduction of risk in the merging concept depends on correlation between the earnings. Correlation explains how the two variables are related or dependent on each other. Whenthere is a negative correlation it implies low risk and positive correlation implies high risk

VALUATION OF FIRMS

The question of valuing the business to be acquired and consolidated poses a problem at the very outset. All parties try to convince about their viewpoints and want to tilt the values in their favor. The valuation issue should be settled impartially because it will affect the whole financial management after merger and consolidation. Some of the important methods for valuing property of companies are discussed as follows:

1. Capitalized Earning:

The capitalized earning method is based on the philosophy that the price which a buyer would like to pay for the property of a concern will depend upon the present and expected earning capacity of the business. (I) Estimate of earnings and (ii) Rate of capitalization. The estimation of earnings will involve the study of past earnings. The past earnings of one or two years may be influenced by abnormal causes such as price fluctuations, etc., so, a true and fair opinion will not be made available and nothing should be concealed. If the earnings are showing stability then the earnings will be easily calculated: if, o n the other hand, the earnings are showing a trend then some allowance should be made for the conditions prevailing at that time.

2. Assets Approach:

Assets approach is the commonly used method of valuation. The assets may be taken from a current balance sheet. The excess of assets over debts will determine the assets values, divided by the number of equity shares will give the value of one share. If preference stock is also outstanding then preference stock should be deducted before dividing the assets values by the number equity shares. This approach is also known as net worth value. Valuation related to mergers and acquisitions employ this method whenthe subject or the target company is a loss making company.

Under such circumstances, the assets of the loss making company are calculated. Along with this method, the market based method as well as the income based method may also be employed. Valuations obtained from this method may generate very less value. However, it is morelikely to generate the actual picture of the assets of the target company.

3. *Market Value Approach:*
4. *This approach is based on the actual price of securities settled between the buyer and the seller. The market value will be the realistic value because buyer will be ready topay in lieu of a purchase. Earnings per Share:*

Another method of determining the values of the firms under merger or consolidation is the earnings per share. According to this approach, the value of prospective merger or acquisition is a function of the impact of merger/acquisition onthe earnings per share. Such impact could either be positive resulting into the increasesin EPS or may be negative resulting into dilution of EPS. As the market price per shareis a function (product) of EPS and price-earnings ratio. The future EPS will have an impact on the market value of the firm

CORPORATE GOVERNANCE

Corporate governance is, "the framework of rules, relationships, systems and processes within and by which authority is exercised and controlled in corporations." It encompasses the mechanisms by which companies, and those in control, are held to account. Corporate governance influences how the objectives of the company are set andachieved, how risk is monitored and assessed, and how performance is optimized. Effective corporate governance structures encourage companies to create value, through entrepreneurialism, innovation, development and exploration, and provide accountabilityand control systems commensurate with the risks involved.

Corporate governance refers to the system by which corporations are directed and controlled. The governance structure specifies the distribution of rights and responsibilities among different participants in the corporation (such as the board of directors, managers, shareholders, creditors, auditors, regulators, and other stakeholders)and specifies the rules and procedures for making decisions in corporate affairs. Governance provides the structure through which corporations set and pursue theirobjectives, while reflecting the context of the social, regulatory and market environment.Governance is a mechanism for monitoring the actions, policies and decisions of corporations. Governance involves the alignment of interests among the stakeholder

DEFINITION

The following definitions will help us to understand the concept of corporate governance better:

The Cadbury Committee Report (1991) defines Corporate Governance as "a system by which corporate are directed and controlled".

According to Advisory Board of NACD (National Association of Corporate Directors) "Corporate Governance ensures that long term strategic objectives and plans are established and that proper management structure is in place to achieve those objectives, while at the same time making clear that the structure functions to maintain the corporation's integrity, reputation and responsibility to its various constituencies".

THE FUNDAMENTALS

Fundamental to any corporate governance structure is establishing the roles ofthe board and senior executives

Principle 1, with a balance of skills, experience and independence on the board appropriate to the nature and extent of company operations

Principle 2, there is a basic need for integrity among those who can influence a company's strategy and Financial performance, together with responsible and ethical decision-making which takes into account not only legal obligations but also the interests of stakeholders

Principle3, Meeting the information needs of a modern investment communityis also paramount in terms of accountability and attracting capital. Presenting a company's financial and nonfinancial position requires processes that safeguard, both internally and externally, the integrity of company reporting

Principle 4, and provide a timely and balanced picture of all material matters

Principle 5, the rights of company owners, that are shareholders, need to be clearly recognized and upheld

Principle 6, every business decision has an element of uncertainty and carries a risk that can be managed through effective oversight and internal control

Principle 7,Rewards are also needed to attract the skills required to achieve the performance expected by shareholders

PRINCIPLES OF GOOD CORPORATE GOVERNANCE

The principles of good corporate governance must have the qualities of truthfulness, responsibility, faith, work-oriented, openness, accountability, mutual understanding and dedication towards organization. In order to develop a model of governance, directors and management must support the values of corporate participantsand then regularly evaluate this model for its effectiveness. Some essential principles of corporate governance which are applicable to all organizations are:

1) *All Shareholders are Equal:*

In order to continue good corporate governance it is the responsibility of an organization to respect and protect the rights of the shareholders. The organization must communicate its information in an understandable manner to the shareholders so that they can exercise their voting rights by participating in the general meetings.

Organizations should respect the rights of shareholders and help shareholders to exercise those rights. They can help shareholders exercise their rights by openly and effectively communicating information and by encouraging shareholders to participatein general meetings.

2) *Claims of Other Stakeholders:*

Organization must identify that they have legal as well as other responsibilities towards lawful stakeholders. Organizations should recognize that they have legal, contractual, social, and market driven obligations to non-shareholder stakeholders, including employees, investors, creditors, suppliers, local communities, customers, and policy makers.

3) *Duties of the Board:*

Board members of every company must have knowledge and skills so that they can solve problems in different fields of business. Every board member must have the capacity to evaluate and stimulate the performance of management. The number of board of directors in a company must be adequate and must possess the feeling of

dedication towards their duties and responsibilities. Organizations should recognize that they have legal, contractual, social, and market driven obligations to non-shareholder stakeholders, including employees, investors, creditors, suppliers, local communities, customers, and policy makers.

4) *Rules and Regulations of Behaviour:*

Every organization must have rules regarding behavior of members of organization in a written format which is termed as a code of conduct. The code of conduct must involve all applicable laws which help in making ethical and responsible decisions. Many firms are developing compliance and ethics programs in order to avoid risk which is outside the boundaries of law and ethics. Integrity should be a fundamental requirement in choosing corporate officers and board members. Organizations should develop a code of conduct for their directors and executives that promotes ethical and responsible decision making.

5) *Disclosure:*

In order to attract investors and increase the value of shareholders, an organization must reveal true and fair accounting information, objective of the organization, etc., so that shareholders can feel satisfied. Disclosure of material facts must be done on time so that investors, auditors etc, can access to information andrealize the financial conditions of the organization. Organizations should clarify and make publicly known the roles and responsibilities of board and management to provide stakeholders with a level of accountability. They should also implement procedures to independently verify and safeguard the integrity of the company's financial reporting. Disclosure of material matters concerning the organization should be timely and balanced to ensure that all investors have access to clear, factual information.

Environmental and Social Responsibilities:

An inseparable relationship prevails among goals of corporate performance, social development and environmental protection. If an organization desires to persist in long run, it must identify these three concerns and manage them effectively as theyresult in conflicts.

6) **Audit Committee:** An effective audit committee must have the following characteristics:

(*i*) *It must comprise of only independent directors.*

(ii) Among the directors of audit committee at least two of them must have adequate knowledge of accounting, financial analysis and financial reporting and one director must have complete knowledge about the business of the organization.

(iii) Audit committee must recruit independent external auditors who must be accountable to the committee.

(iv) Audit committee requires an appropriate system for internal control and risk management to focus on underlying transactions.

7) Market price is affected by the factors like demand and supply and position of money market.