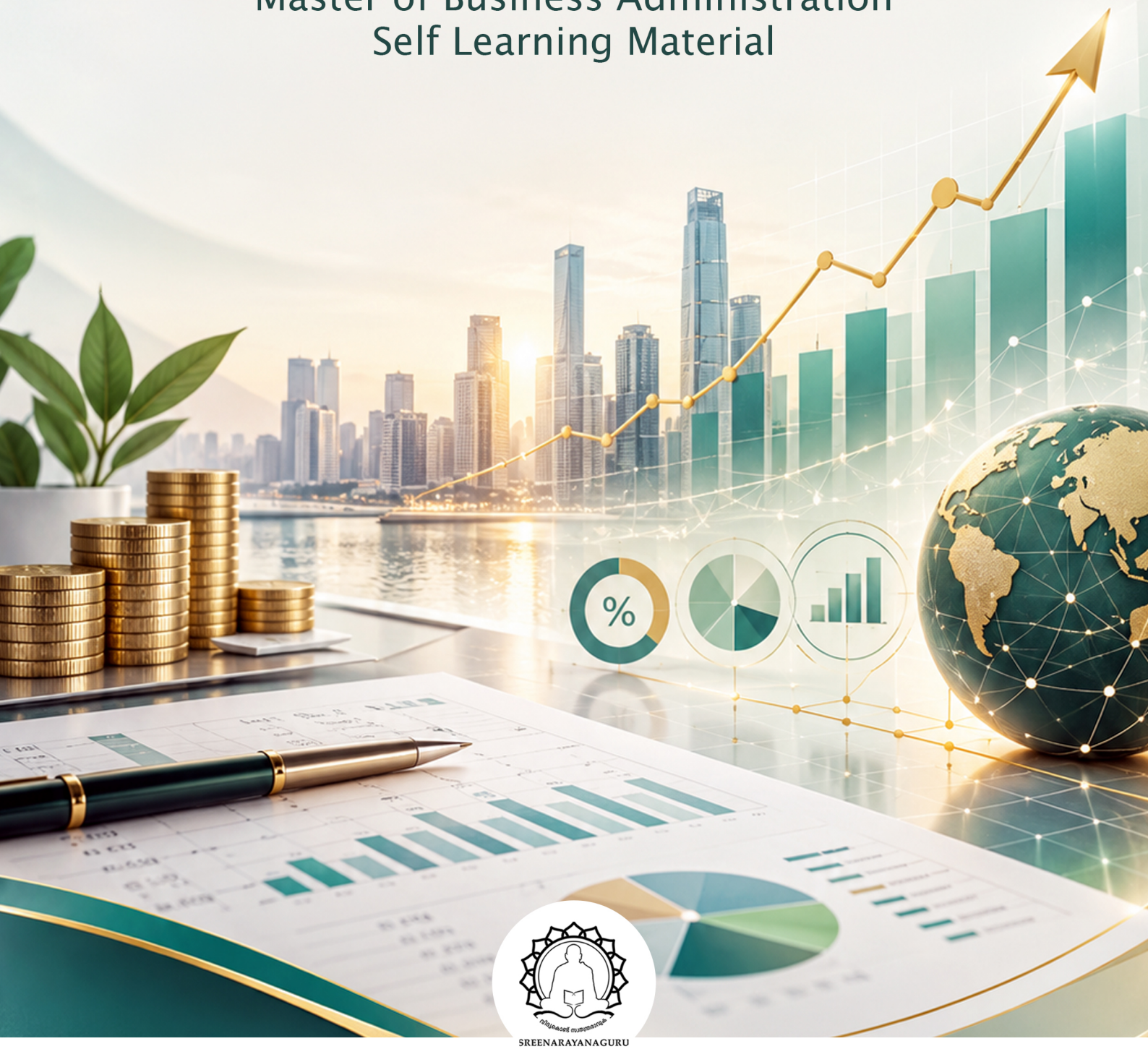
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FINANCIAL MANAGEMENT

COURSE CODE: M25BS05DC
Discipline Core Course
Master of Business Administration
Self Learning Material



SREENARAYANAGURU OPEN UNIVERSITY

SREENARAYANAGURU OPEN UNIVERSITY

The State University for Education, Training and Research in Blended Format, Kerala

SREENARAYANAGURU OPEN UNIVERSITY

Vision

To increase access of potential learners of all categories to higher education, research and training, and ensure equity through delivery of high quality processes and outcomes fostering inclusive educational empowerment for social advancement.

Mission

To be benchmarked as a model for conservation and dissemination of knowledge and skill on blended and virtual mode in education, training and research for normal, continuing, and adult learners.

Pathway

Access and Quality define Equity.

Financial Management

Course Code: M25BS05DC

Semester - II

Discipline Core Course
Master of Business Administration
2025-26 Admission
Self Learning Material

(With Model Question Paper Sets)

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OPEN UNIVERSITY

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SREENARAYANAGURU
OPEN UNIVERSITY

FINANCIAL MANAGEMENT

Course Code: M25BS05DC
Semester- II
Discipline Core Course
Master of Business Administration

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MESSAGE FROM VICE CHANCELLOR

Dear Learner,

It gives me immense pride and heartfelt satisfaction to welcome you to Sreenarayanaguru Open University—a transformative space where aspirations are nurtured, potential is unlocked, and futures are shaped with purpose.

Established in September 2020 as a pioneering state initiative, the University stands as a symbol of inclusive, accessible, and high-quality higher education. Anchored in our guiding philosophy—"access and quality define equity"—we are committed not merely to expanding educational opportunities, but to ensuring that every learner receives an education that is meaningful, relevant, and transformative.

Our journey is deeply inspired by the timeless vision of Sreenarayana Guru, whose ideals of knowledge, equality, and social empowerment continue to illuminate our path. His philosophy reminds us that education is not just a means to an end, but a powerful instrument for personal growth, societal progress, and human dignity.

In a rapidly evolving and digitally driven world, we recognize that learning must be flexible, dynamic, and future-ready. Our thoughtfully designed blended learning ecosystem—integrating Self-Learning Materials, Classroom Counselling, and Virtual Learning Platforms—ensures that you experience the best of both independence and guided academic engagement. This model empowers you to learn at your own pace while staying meaningfully connected to academic support systems.

The MBA programme at Sreenarayanaguru Open University is not just a degree—it is a gateway to leadership, innovation, and professional excellence. The curriculum is meticulously curated to reflect the realities of the contemporary global business landscape, seamlessly blending foundational management principles with cutting-edge developments in business and technology.
You will explore and engage with:

- Strategic management and entrepreneurial thinking
- Digital transformation, FinTech, and emerging technologies
- Logistics, supply chain, and global business ecosystems
- Consumer behaviour and evolving market intelligence
- Human resource management in the age of Artificial Intelligence
- Ethical leadership and sustainable decision-making

Designed with a multidisciplinary and future-oriented perspective, the programme offers diverse specializations, skill enhancement pathways, and exposure to innovative domains that align with industry expectations. It is structured to strengthen your employability, entrepreneurial mindset, and leadership capabilities—equipping you to excel in competitive and complex professional environments.

Our Self-Learning Materials are crafted with exceptional care, combining conceptual clarity with real-world relevance through case studies, contemporary examples, and practical insights. They are designed not only to inform but to inspire critical thinking, problem-solving, and adaptability—skills that are essential in today's disruptive and ever-changing business world.

At the heart of our mission lies an unwavering commitment to learner success. Our comprehensive learner support system is always within your reach, ensuring that your academic journey remains smooth, enriching, and fulfilling. We encourage you to actively engage, explore, question, and grow—because your success is the true measure of our purpose.

As you begin this important journey, I invite you to dream boldly, learn continuously, and lead responsibly. Let this programme be a stepping stone towards achieving your ambitions and making a meaningful impact in the world.

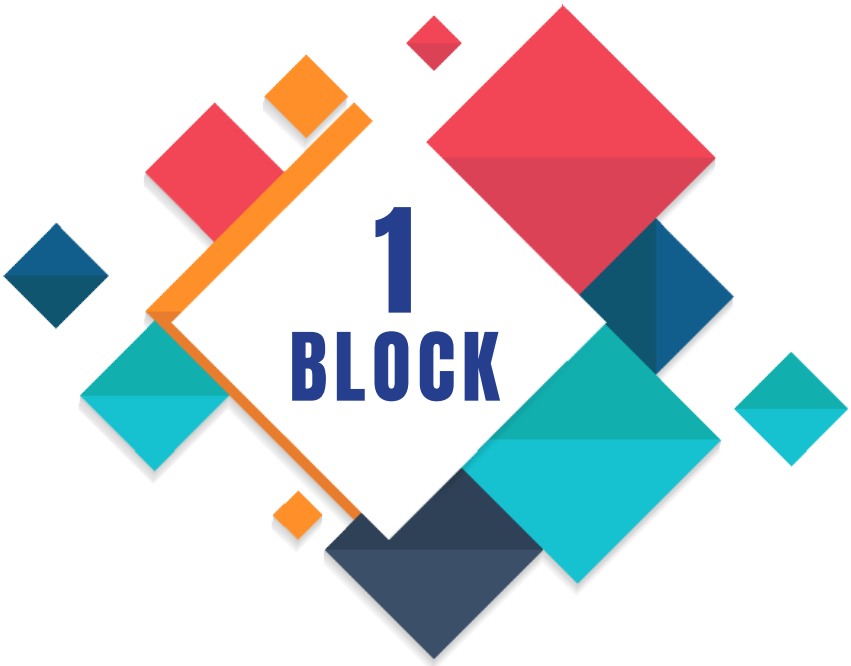
May your journey here be one of discovery, empowerment, and excellence.
With my best wishes for your success and lifelong learning,



Prof. (Dr.) Jagathy Raj V. P.
Vice Chancellor

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Introduction to Financial Management

Unit 1

Basics of Financial Management

Learning Outcomes

After completing this unit, learners will be able to:

- ◊ explain the nature and scope of financial management
- ◊ discuss the goals of financial management -profit maximisation and wealth maximisation
- ◊ describe the concept of financial forecasting
- ◊ illustrate the organisation and structure of the finance function in a business enterprise

Background

Every business, whether it is a small start-up or a multinational corporation, requires finance to carry out its activities and achieve its objectives. However, the way businesses understand and manage finance has changed considerably over time.

Initially, the scope of Financial Management was largely limited to raising funds for various business purposes. Over time, its focus gradually expanded to:

- ◊ How can we ensure the optimum utilisation of available funds?
- ◊ Where should we invest our money?
- ◊ What combination of risk and return is appropriate while raising and investing money?
- ◊ How can financial decisions increase the value of the firm?

◊ How can we manage financial risks in a globalised business environment?

Thus, Financial Management has evolved from a narrow function of raising funds into a strategic function concerned with the efficient utilisation of financial resources, investment and financing decisions, risk management, and value creation.



Keywords

Financial Goals, Profit Maximisation, Wealth Maximisation, Financing Decision, Financial Forecasting, Finance Function



Discussion

Imagine that you have a brilliant business idea, an ideal location, and even potential customers. But you do not have the money required to start the business. Can you actually turn your idea into a business?

Now suppose you have successfully started the business. You are making good sales, but many customers purchase on credit, and you will receive the money only after 60 days. However, can you wait 60 days to pay your employees, suppliers, electricity bills and rent? You need funds to meet these day-to-day obligations.

Consider another situation. The demand for your product has increased significantly, and you see an opportunity to expand into new markets. To meet the additional demand, you need to increase your production capacity by purchasing new machinery or expanding the plant. Where will the required funds come from?

These examples show that finance is involved at every stage of a business—from starting the business and meeting day-to-day expenses to expanding operations and taking advantage of new business opportunities.

Just as blood carries oxygen and nutrients to different parts of the human body and keeps the body functioning, finance provides the resources required for various business activities and keeps the business operating smoothly.

Therefore, finance is rightly described as the “lifeblood of business.”

It is very common to consider finance as the life blood of organisations. The importance for the field of finance comes from this notion. The ultimate success of a company lies in how well it is able to procure and manage financial resources effectively. Before

discussing the idea of optimizing finance for the success of the company, it is necessary to look into the term finance first.

Is finance simply the money available with an individual or a business, or does finance have a much broader meaning?

Usually, people associate the word finance with money and monetary resources. But in fact, it is not synonymous. Money simply is any country's currency, which is in the hands of a person or organisation. As long as the money is kept intact it stays as 'money' itself. When that money is used to buy something or invest in some avenues to generate return, it becomes 'finance'. Finance may be defined as the art and science of managing money. Finance also is referred as the provision of money at the time when it is needed.

Business finance specifically refers to the money required for carrying out business operations or activities of a business concern. It includes money required to establish a business, run its routine activities and to expand or make it grow over the course of its lifetime. Hence acquiring financial resources to be employed any kind of business activity, and optimizing its usage to generate maximum return in order to grow, expand and to sustain its existence can be called as business or corporate finance or financial management.

1.1.1 Meaning of Financial Management

When we hear the term **"**Financial Management**,"** what is the first thing that comes to our mind?

Is financial management simply about arranging or raising money for a business?

Or does it address decisions related to:

Investment of raised funds, management of risk associated with investments and decisions related to retaining / distribution of profit among owners?

These questions help us understand that financial management can be viewed in two ways: the narrow concept and the broader concept.

Narrow Concept of Financial Management

The narrow concept of financial management focuses mainly on procurement or raising of funds. It is concerned with identifying the financial requirements of a business and arranging the necessary funds from suitable sources, such as shares, debentures, loans and other sources of finance.

Under this concept, the primary responsibility of a finance manager is to ensure that sufficient funds are available to meet the financial needs of the business.

Broader Concept of Financial Management

The broader concept of financial management goes beyond merely raising funds. It includes procurement, allocation and effective utilisation of funds to achieve the

financial objectives of the business.

It covers major financial decisions, such as:

- ◊ Investment decisions: Deciding where and how funds should be invested.
- ◊ Financing decisions: Deciding the appropriate sources and mix of funds.
- ◊ Dividend decisions: Deciding how much profit should be distributed to shareholders and how much should be retained in the business.
- ◊ Working capital management: Managing short-term assets and liabilities to ensure smooth day-to-day operations.

In simple terms: The narrow concept of financial management is concerned with how to raise funds, whereas the broader concept is concerned with how to raise, allocate, manage and utilise funds effectively to maximise the value of the business.

Thus, financial management in the broader sense is a comprehensive process that involves planning, procuring, controlling and utilising financial resources to achieve the overall objectives of an organisation.

According to some experts, financial management is all about providing a company with the funds it requires on the best conditions while keeping its objectives in mind. Therefore, the primary goal of this strategy is to raise funds, which may need the employment of organisations, tools, and procedures. It also oversees the founder's financial and legal responsibilities to the business. Finance, according to another group of experts, is all about money. Since money is involved in every business transaction, whether directly or indirectly, finance encompasses all company activities. Raising funds and making sure they are used to their fullest potential constitute the third and more thorough approach to financial management. To sum up, financial management simply refers to acquisition of fund at optimum cost and its utilization with minimum financial risk. It is concerned with management of fund and also the application of management concepts for the financial activities of a business. It refers to those management activities or efforts to the proper management of finance and includes financial planning, financial administration, financial control.

1.1.2 Scope of Financial Management

As it deals with the planning, raising, and efficient use of financial resources, financial management is a crucial function of any company organisation. It is important to recognise that financial management encompasses much more than just money management. Important decisions about investments, financing, working capital, dividend distribution, financial planning, and risk management are all included. Making sure that the available funds are spent effectively while preserving a balance between profitability, liquidity, and risk is the primary goal. As a result, financial management is essential to an organisation's long-term performance, expansion, and financial stability. Generally, the scope of financial management is understood in the following three specific areas;

- ◊ Financing Decisions
- ◊ Investment Decisions and
- ◊ Dividend Decisions

1.1.2.1 Financing Decision

A finance decision refers to deciding how much money a business needs and how and from where to raise the funds required for investment and day-to-day operations. Every business needs funds to purchase machinery, buy raw materials, pay salaries, expand its activities and meet other expenses. These funds can be raised from various sources, such as equity shares, retained earnings, debentures, bank loans, financial institutions, public deposits and trade credit. The finance manager must select the most suitable sources of finance based on the cost, availability, repayment terms and financial needs of the business.

Finance decisions are important because they ensure the availability of adequate funds, reduce the cost of financing, maintain a proper balance between owned and borrowed funds and minimise financial risks. A good finance decision also helps a business use its funds effectively, maintain financial stability, expand its operations and improve profitability. Ultimately, the main objective of a finance decision is to ensure the best possible use of financial resources and maximise shareholders' wealth.

The most crucial decision that businesspeople must make is one related to finances. These are intelligent choices that require careful consideration and study. They choose the best time, location, and method for the company to obtain the funds. An increase in a company's share price is not only an indication of growth for the business, but it also increases the wealth of investors. They also make choices on the purchase of short-term resources (known as working capital) and long-term resources (known as capital structure) as part of their duties as managers.

1.1.2.2 Investment Decision

Investment decision answers the question, "Where should the business invest its funds?" Since the funds available to a business are limited, it must carefully decide where to invest them to earn better returns and achieve business objectives. Investment decisions are broadly classified into long-term and short-term investment decisions. Long-term investment decisions involve investing funds in assets or projects that provide benefits for more than one year. These are also called capital budgeting decisions. For example, purchasing machinery, constructing a factory or expanding the business are long-term investment decisions.

Short-term investment decisions involve investing funds in current assets required for the day-to-day operations of the business. These are also known as working capital decisions. They include decisions regarding cash, inventory, raw materials and credit given to customers. For example, purchasing raw materials worth ₹2 lakh to maintain sufficient stock for production is a short-term investment decision. Thus, investment

decisions help a business decide where and how its funds should be invested for efficient operations, profitability and future growth.

Investment decisions made by a company involve capital expenditures. As a result, they are called capital budgeting decisions. Allocating capital or committing funds to long-term assets that will provide benefits (cash flows) in the future is a capital budgeting decision. The assessment of the potential profitability of new investments and the determination of a cut-off rate that may be used to compare the potential return of new investments are two crucial components of investment decisions.

Investment returns in the future are unpredictable and hard to quantify. Investment risk arises from the uncertainity and variability of returns from an investment. Therefore, it is important to consider both risk and potential return when evaluating investment proposals. In addition to the decision to commit funds in fresh investment proposals, capital budgeting includes replacement decisions or the choice to recommit funds when an asset becomes less productive or unprofitable.

1.1.2.3 Dividend Decision

The third significant financial decision is a dividend decision. The decision whether the company should distribute all profits, keep them, or distribute a portion and keep the remainder rests with the financial manager. The dividend-payout ratio is the percentage of profits that are paid out as dividends, and the retention ratio is the percentage of profits that are kept. The dividend policy should be decided based on how it will affect the value of the shareholders, just like the debt policy. A dividend policy that maximises the market value of the company's shares is the best one. The finance management must therefore ascertain the ideal dividend-payout ratio if shareholders are not apathetic toward the company's dividend policy.

Solve it

1. A company has earned a net profit of ₹10 crore. The shareholders demand that the entire amount be distributed as dividend, while the CEO proposes retaining the entire ₹10 crore to finance the company's expansion. As the Finance Manager, what position would you take? What factors would you consider before recommending the appropriate dividend payout?

2. Dividend, Investment and Financing Decisions are closely interrelated. How is the dividend policy of a company connected with its investment decisions and financing decisions?

Nature of Financial Management

The management of finance is an organic function of every business. It concerns with getting hold of tangible resources, running production, compensating suppliers, etc.

The nature of Financial Management is described below:

◊ **Estimates Capital Requirements**

Financial management aids in anticipating need for fund by calculating the working capital and fixed capital requirements for conducting business activities. To understand fixed capital and working capital, let us take a simple example. Suppose you want to start a small tea shop. What would you need? You would need a shop, tables, chairs, stove, refrigerator and utensils. These are assets that are used for a long period and are not meant for regular sale or consumption. The money invested in such long-term assets is called Fixed Capital.

At the same time, you would need tea powder, sugar, milk, biscuits and other materials for daily operations. You would also need some cash to pay daily expenses such as electricity, wages and other small expenses. The money required for these day-to-day operating needs is called Working Capital. Thus, fixed capital is required for acquiring long-term assets, whereas working capital is required for the smooth day-to-day functioning of the business.

◊ **Decides Capital Structure**

From where can a business raise funds? Can it use only the owners' money, or can it also borrow from banks and other sources? If different sources are used, how much should be raised from each source? A business may raise funds through equity shares, retained earnings, debentures and bank loans.

The proper combination or ratio of different sources of long-term finance is called capital structure. For example, if a company raises 60% of its funds through equity and 40% through debt, this combination represents its capital structure. Thus, capital structure shows how a business finances its long-term needs.

Financial management helps in building Capital structure for the business. To minimise the cost of capital, a proper balance between debt fund and equity fund are needed which is possible through a well-designed capital structure with appropriate proportion of securities.

◊ **Select Source of Fund**

Source from which fund is to be collected is one crucial decision in every organisation. Every organisation should properly analyse various source of funds such as shares, bonds, debentures etc., and must select appropriate funds which involves minimal risk and maximum return.

◊ **Select Investment Pattern**

Financial Management aids to decide the appropriate investment pattern by analysing and evaluating the investment proposal based on its risk and return.

◊ **Raises shareholders value**

It aims to increase the amount of return to its shareholders by decreasing its cost of operations and increase in profits.

Finance manager should focus on raising the funds from different sources and invest them in profitable avenues.

◊ **Management of cash**

Finance manager observes all cash movements (inflow and outflow) and ensures they should face any deficiency or surplus of cash.

◊ **Apply financial controls**

Implying financial controls helps in keeping the company actual cost of operation within limits and earning the expected profits.

Box Information: Emerging Functions of Financial Management

In the context of globalisation, digitalisation and Artificial Intelligence (AI), the traditional functions of financial management have expanded. Today, financial management goes beyond raising and using funds and includes several emerging functions such as Global Financial Management, which deals with managing finances across countries; Foreign Exchange and Currency Risk Management, which manages risks arising from changes in currency values; and FinTech and Digital Finance Management, which uses digital technologies for financial services and transactions.

Modern financial management also includes:

◊ **AI-Based Financial Decision-Making:** Using AI to support financial decisions.

◊ **Predictive Financial Management:** Using data to predict future financial trends.

◊ **Real-Time Financial Monitoring:** Tracking financial activities instantly.

◊ **AI-Driven Risk Management:** Using AI to identify and manage financial risks.

◊ **Automated Financial Operations:** Automating routine financial tasks and processes.

◊ **Fraud Detection & Financial Security:** Identifying suspicious transactions and preventing fraud.

◊ **Data Analytics for Financial Decisions:** Using financial data to make better decisions.

◊ **Cybersecurity & Digital Financial Risk:** Protecting financial information from cyber threats.

◊ **Sustainable Finance & ESG Management:** Considering environmental, social and governance factors in financial decisions.

1.1.3 Financial Goals: Profit maximisation Vs Wealth Maximisation

Investment and financing decisions made by the company are inevitable and ongoing. The company needs a goal in order to make them logically. Theoretically, it is widely accepted that the firm's financial objective should be Shareholder Wealth Maximisation (SWM), as shown by the market value of the company's shares. In this section, we demonstrate that the normative goal of maximising shareholder wealth is both operationally viable and theoretically sound for directing financial decision-making. Even then, avoiding the goal of creating promising profits for a firm is never a good thing. This can be explored further below.

1.1.3.1 Profit Maximisation

Businesses that provide products and services can operate in a market economy or one that is governed by the government. Prices for products and services are set in competitive markets within a market economy. In a market economy, businesses are required to create the goods and services that society wants as effectively as feasible.

The most crucial component of a market economy that determines what products and services the public want is the price system. High demand for goods and services results in higher prices. As a result, businesses make more money and generate more of these products and services. Increased profit margins entice additional businesses to manufacture these products and services. As competition increases, an equilibrium price is eventually attained where supply and demand are equal. Prices and earnings decline for products and services that society does not need.

These products and services are abandoned by producers in favour of more lucrative ventures. The price system focuses administrative attention on more lucrative products or services. Prices govern how resources are allocated for different productive activities and are influenced by supply and demand as well as competitive pressures.

Economic theory analyses a firm's behaviour in terms of maximising profits. Profit maximisation suggests that a business either utilizes the least amount of input to create a given output or produces the maximum output for a given amount of input. Efficiency is the fundamental principle of profit maximisation.

Profit is thought to be the best indicator of a company's performance, and it is argued that profit maximisation results in the effective distribution of resources in a competitive market.

Benefits of Profit Maximisation

As understood by scholars and thinkers of this field, no firm can avoid concentrating on creating profits to stabilise the actual business first. Rest of the goals follows this. Let us look into some of the advantages of focusing on profits here.

◊ **Increased revenue:**

As businesses concentrate on maximising their revenue streams through a variety of techniques, such as pricing optimisation and product diversity, profit maximisation tactics can increase sales and revenue. This profit can also be used to grow the business and reinvest in it.

◊ **Better value to share owners:**

Companies can boost dividends to shareholders by optimising profitability, which will eventually lead to greater stock prices and bigger dividends for shareholders.

◊ **Increase efficiency**

Profit-driven businesses encourage efficient use of resources and steer clear of wasteful spending. Improved operational efficiency follows from this.

◊ **Better financial standing:**

Profit-maximising companies are more likely to outperform their rivals and establish a solid financial base.

◊ **Chance of expansion and growth**

The business has the chance to develop and flourish as a result of increased profitability. So, they can launch goods, investigate new markets, take advantage of growth opportunities, etc.

Besides all these, there are people who still believe in the shortcoming of having profit maximisation as the ultimate goal for a firm and its financial management team for several reasons. These reasons are explained below.

Objections to Profit Maximisation

Is operational viability a requirement for profit maximisation? Apart from the aforementioned points of contention, profit maximisation is ineffective as a practical standard for maximising the economic welfare of the owner. It fails to offer a practical metric for evaluating the economic effectiveness of competing courses of action. The following drawbacks are present:

◊ **It is vague**

The profit maximisation objective's exact meaning is not apparent. The term 'profit' has a vague definition. Does it imply immediate or long-term gain? Does this mean revenue either before or after taxes? Total earnings or earnings per share? Does this refer to the sum of operating profits or to shareholder profits?

◊ **It ignores the timing of returns**

There is no stated differentiation between returns earned across different time periods in the profit maximisation aim. The time value of money is not taken into account, and advantages acquired throughout a range of time are valued equally.

◊ **It ignores risk**

Different levels of certainty may be present in the benefit streams. Even though the overall predicted earnings of two firms may be the same, it will be riskier if one of the firms' results varies significantly from the other. Owners of the company may prefer lesser but more guaranteed profits to a stream of advantages that could be larger but less certain.

1.1.3.2 Wealth Maximisation

Optimising the economic well-being of shareholders is the same as optimising the long-term utility of their consumption. Shareholders can optimise their consumption by adjusting their cash flows once their wealth has been maximised. From the perspective of the shareholders, the market value of the company's shares represents the wealth generated by its operations. Consequently, the wealth maximisation concept suggests that a company's primary goal is to increase the market value of its stock. The market price of the company's shares, which in turn reflects shareholders' opinions about the caliber of the company's financial choices, represents the value of those shares. The firm's performance indicator is the market price.

Compared to profit maximisation, wealth maximisation adopts a more comprehensive viewpoint. It focuses on raising the company's entire worth in addition to making profits. Wealth maximisation takes into account a number of factors, such as customer satisfaction, sales, goodwill, and the quality of goods and services.

Drawbacks of Wealth Maximisation

There are certain viewpoints put forth by people who believe having wealth maximisation as financial objective does not work out. It can be discussed in the following manner.

◊ **Unrealistic assumption of market:**

The fundamental premise is that the market price of the share is accurately reflected in an efficient capital market. In actual life, this assumption is rarely true. Numerous political and economic factors that are hard to predict and assess affect the market price.

◊ **Short term sacrifices:**

Businesses may have to make difficult short-term sacrifices in order to achieve long-term riches, such as lower immediate profits or higher expenses.

◊ **Conflicting interests:**

It is challenging to reconcile the differing opinions of the several parties with a stake in the company due to their conflicting interests. Owners (shareholders) and firm managers (agents) frequently diverge, with managers pursuing short-term compensation or personal power rather than genuine long-term value.

◊ **Ethical dilemmas:**

Putting shareholder wealth first could result in moral conundrums like cost-cutting strategies that hurt workers or environmental issues. Wealth maximisation may result in choices that put shareholder interests ahead of those of other stakeholders, raising ethical questions.

Benefits of Wealth Maximisation

Keeping the shareholders wealth maximisation as a motto of organisations arguably comes with a lot of benefits.

◊ **Long term focus:**

Wealth maximisation places more emphasis on creating long-term value for the business than it does on generating rapid profits. To put it simply, this component is predicated on precise and certain financial flows.

◊ **Time value consideration:**

Money's value fluctuates over time, as demonstrated by the fact that ₹100 now will not be worth the same amount a year later. Future cash flows are discounted at a suitable rate to demonstrate their current value in wealth maximisation.

◊ **Increased trust and morale:**

The interests of all stakeholders, including clients, staff, and investors, are given first priority by businesses that use the wealth maximisation strategy. This fosters loyalty and trust, both of which are extremely significant.

◊ **Capital allocation efficiency:**

Effective capital allocation is guided by wealth maximisation, which guaranties that funds are allocated to ventures and investments with the best chance of yielding profits.

◊ **Considers uncertainty:**

It produces much more accurate findings by taking risk and uncertainty factors into account when calculating the discounting rate.

◊ **Performance measurement:**

It gives stakeholders a foundation for assessing the financial performance of a business or investment portfolio, allowing them to determine success in an impartial manner.

◊ **Sustainable:**

Maximising wealth builds a strong basis for the company's future and promotes steady long-term growth. Because of its stability, the business is able to overcome obstacles and maintain its competitiveness.

While both wealth maximisation and profit maximisation seek to improve a com-

pany's financial performance, they differ in the duration, the risks they are prepared to accept, their consideration of interests and the impact on decision-making. Businesses must consider their individual circumstances, the nature of their industry, and their long-term goals when determining whether to concentrate on increasing profits or creating wealth.

There is no, one-size-fits-all solution to the conflict between wealth maximising and profit maximisation. Each strategy has a role in corporate management. It is important to keep in mind, though, that none of the tactics are guaranteed.

Box Information: Profit Maximisation vs Wealth Maximisation

At first, profit maximisation and wealth maximisation may appear contradictory because a decision that increases current profit may not always increase the long-term value of the business. For example, a company may increase its current profit by cutting R&D expenditure, reducing employee training or postponing maintenance. On the other hand, investing heavily in R&D may reduce current profit but can lead to innovative products, higher future cash flows and greater shareholder wealth. Thus, the two objectives may conflict in the short term, but wealth maximisation provides a broader and long-term framework for financial decision-making.

Profit maximisation and wealth maximisation are not contradictory but complementary. Higher profits provide the resources and financial strength needed for growth, while wealth maximisation focuses on converting these profits into sustainable long-term value for shareholders. Therefore, a business should not focus only on immediate profits; it should make decisions that balance current profitability with future growth and value creation.

Financial Forecasting

Financial forecasting is the process of examining past and present events and using that data to predict future events. Financial forecasting helps businesses anticipate risks, opportunities, and obstacles more accurately, which helps them plan and adjust to unpredictability.

For instance, suppose a business has the sales and expense data for the last two years. Based on this past financial data, management can forecast future sales. For example, if sales increased from ₹10 lakh in the first year to ₹12 lakh in the second year, the business may prepare a pessimistic forecast of ₹13 lakh and an optimistic forecast of ₹15 lakh for the next year. Similarly, future expenses can be estimated under these different situations.

Based on the estimated sales and expenses, the business can forecast its profit and cash-flow requirements. If the forecast indicates a shortage of cash, management can

decide whether additional funds are required and choose an appropriate source of finance. Thus, financial forecasting follows the process:

Past Financial Data → Sales Forecast → Expense Forecast → Profit Forecast → Cash-Flow Forecast → Financing Requirement → Management Decision.

In this way, financial forecasting helps management anticipate future needs, reduce uncertainty and make better financial decisions.

Businesses can create financial plans that project their anticipated income, expenses, and other organisation-specific macroeconomic elements influencing financial forecasting by following a detailed process. Both short-term and long-term outlooks on contingencies for expenses that are now deemed unnecessary as well as other circumstances that can potentially impact revenues are included in a solid prediction. Detailed models, knowledgeable professionals, solid corporate alliances and connections, and information-gathering methods like financial forecasting software are all necessary for accurate financial forecasts.

Financial forecasting is more accurate in the near term than in the long run since it varies with business trends and other factors.

What should be included in a financial forecast?

- ◊ Weighing past findings against present circumstances while closely evaluating the historical reliability of data sources and other presumptions
- ◊ A timeline that faces forward, either rolling or fixed
- ◊ Complete evaluation of all macroeconomic risks, including significant, unexpected worldwide occurrences like pandemics, wars, or natural disasters
- ◊ Revenue scenarios, both best and worst, and important business presumptions
- ◊ Best-case and worst-case projected costs
- ◊ Worst-case unforeseen expenses, like those resulting from cyberattacks, data loss, or disasters
- ◊ Internal risk evaluation for dangers like insider attacks
- ◊ Linking the company to "why" this projection is important and pertinent

Forecasting is not about predicting the future with certainty; rather, it is a systematic process of reducing uncertainty and preparing the organisation for different possible financial outcomes. Effective financial forecasting enables managers to anticipate opportunities and risks, allocate resources efficiently and make better investment, financing and operating decisions.

Traditional financial forecasting mainly depends on past financial data, historical trends and management experience. It generally assumes that past patterns will continue in the future. For example, a business may examine sales and expenses for the last few years and estimate next year's sales by applying an expected growth rate. It is

simple and useful when business conditions are relatively stable, but it may not respond quickly to sudden changes in markets or customer behaviour.

Modern financial forecasting uses real-time data, data analytics, AI and predictive tools to make more dynamic and accurate forecasts. It can consider factors such as market trends, customer behaviour, economic conditions and changing costs. For example, AI can analyse large amounts of sales data and provide different sales forecasts under optimistic, normal and pessimistic situations. Thus, while traditional forecasting looks mainly at what happened in the past, modern forecasting combines past data with current information and technology to anticipate what may happen in the future.

Box Information: Techniques of Financial Forecasting

Traditional Techniques

- ◊ **Trend Analysis:** Studies past trends in sales, expenses or profits to estimate future performance.
- ◊ **Ratio Analysis:** Uses financial ratios from past data to forecast future financial requirements and performance.
- ◊ **Time-Series Analysis:** Examines financial data over different time periods to identify patterns and trends.
- ◊ **Moving Average Method:** Uses the average of recent periods to smooth fluctuations and forecast future values.
- ◊ **Exponential Smoothing:** Gives greater importance to recent data while forecasting future values.
- ◊ **Regression Analysis:** Examines the relationship between variables to predict future financial outcomes.
- ◊ **Cash Budgeting:** Estimates future cash inflows and outflows to identify cash surpluses or shortages.
- ◊ **Expert Opinion / Management Judgment:** Uses the knowledge and experience of managers or experts to make financial forecasts.

Modern Techniques of Financial Forecasting

- ◊ **Scenario Analysis:** Prepares forecasts under different situations, such as optimistic, normal and pessimistic scenarios.
- ◊ **Sensitivity Analysis:** Examines how changes in one factor affect the financial forecast.
- ◊ **Econometric Forecasting:** Uses economic and statistical relationships to predict future financial conditions.

- ◊ **Monte Carlo Simulation:** Uses repeated simulations to estimate possible financial outcomes under uncertainty.
- ◊ **Predictive Analytics:** Uses data and statistical techniques to identify patterns and predict future results.
- ◊ **Artificial Intelligence and Machine Learning:** Uses AI and ML to analyse large datasets and generate dynamic financial forecasts.
- ◊ **Big Data Analytics:** Analyses large and varied datasets to identify trends, patterns and factors that influence future financial performance.

1.1.4 Finance Functions

Finance as any other functionalities of management has several important decisions to be planned in a systematic manner. The scope of finance function is already been discussed in the earlier sections. It covers acquisition of funds, allocation of these funds to meaningful and profitable avenues, managing the return from those investments and many more crucial decisions of optimising the finance inside the firm.

Finance functions refer to the specific financial decisions and activities performed by the finance manager for the effective management of funds. It is important to distinguish the three concepts: Nature explains the basic characteristics of financial management, Scope explains the broad areas covered, while Functions explain what financial management actually does in practice.

The major finance functions are:

1. Investment Decision: Deciding where the available funds should be invested. It includes long-term investments in fixed assets and short-term investments in current assets.
2. Financing Decision: Deciding how and from where funds should be raised. It involves selecting suitable sources such as equity, retained earnings, debentures and loans and determining the appropriate capital structure.
3. Dividend Decision: Deciding how much profit should be distributed to shareholders and how much should be retained for future business needs.
4. Working Capital Management: Managing funds required for day-to-day operations, such as purchasing raw materials, maintaining inventory and meeting regular expenses.
5. Financial Planning and Forecasting: Estimating future financial requirements, sales, expenses, profits and cash flows to support better financial decisions.
6. Financial Control and Risk Management: Monitoring financial performance, controlling costs and managing financial risks to ensure efficient use of funds.

In short, finance functions explain the practical activities through which financial management is carried out investing funds, raising funds, distributing profits and managing financial resources efficiently.

Establishing a solid and effective organisation is essential because the finance function is crucial to all kinds of organisations. Although there isn't a single system that works for all businesses, we can build the fundamental elements of a corporate organisation as follows:

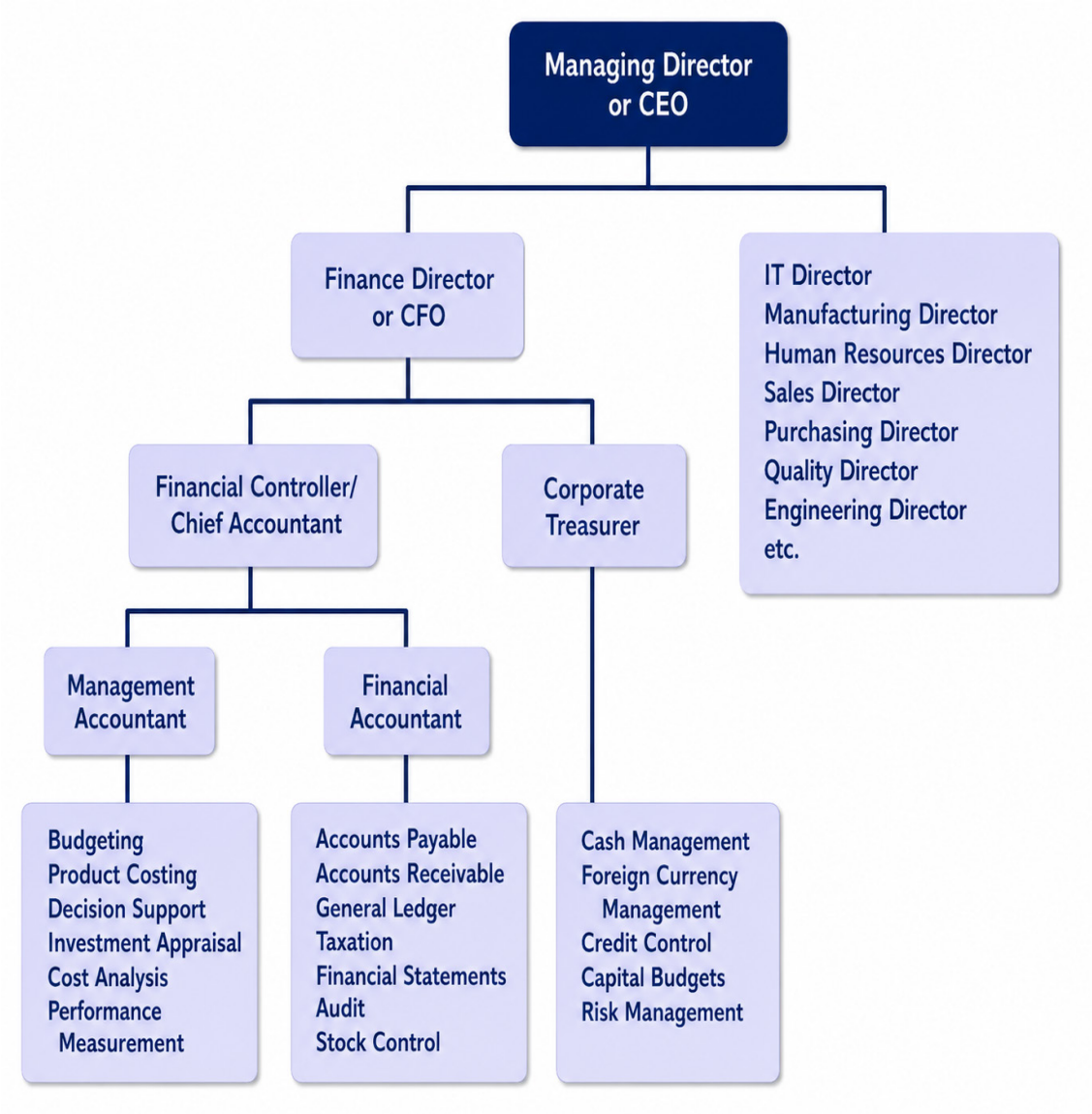


Fig 1.1.1 Organisation of finance function

The finance director (sometimes known as the chief financial officer, or CFO) is responsible for both accounting and finance in the typical structure of the finance department in a medium-sized to large-sized corporation (see Figure). A corporate treasurer, also known as a financial manager, may oversee cash and corporate finance, while the financial controller, sometimes known as the chief accountant, is in charge of

accounting. They both answer to the finance director. In most businesses, the finance director has historically been in charge of the IT function (information technology or data processing). This is due to the fact that the accounting department was the first to use computers extensively for payroll, followed by accounting ledgers, financial reporting, budgeting, financial data, etc.

The board of directors chooses and appoints top officials, approves financial strategy, announces dividends, and translates shareholder aspirations into precise goals and objectives. Planning, accounting, and control tasks are the Controller's main concerns. The Treasurer's primary responsibilities include investment activities, cash and receivables administration, and financing.

Each organisation's needs determine how the finance function is organised. Every company has different budgetary requirements. Certain firms may demand more working capital than others, such as manufacturing companies as opposed to service companies. Some organisations may need a longer gestation period before they begin to make money and turn a profit.



Summarised Overview

This section gives an overview of the fundamentals of financial management, including its definition, nature, importance, and scope within an organisation. It stresses the significance of generating long-term value for shareholders and outlines the main financial objectives of a company, particularly profit and wealth maximisation. Financial forecasting, which aids organisations in projecting future financial needs and efficiently allocating their resources, is also introduced in this subject. Lastly, it discusses the finance function, emphasizing crucial choices pertaining to financing, dividend distribution, and investment. All things considered, the unit aids students in comprehending how financial management supports the effective use of resources, financial stability, expansion, and accomplishment of organisational goals.



Self-Assessment Question

1. What is meant by financial Management?
2. State the nature of financial management.
3. What is the scope of financial management?
4. What are the main objectives of financial management?

5. What is meant by Profit Maximisation?
6. What is meant by Wealth Maximisation?
7. Distinguish between Profit Maximisation and Wealth Maximisation.
8. What is Financial Forecasting?
9. What is meant by the Finance Function?
10. State the main functions of financial management.



Assignments

1. The criterion of maximising profits is not practically achievable. Do you think so? Explain your points of view.
2. How is the goal of maximising wealth better than that of maximising profits? Describe.
3. Reviewing and controlling decisions to commit or recommit funds to new or existing uses is the role of financial management. Therefore, if choices are made about the acquisition or destruction of assets, financial management is directly involved with production, marketing, and other tasks inside a company in addition to raising cash. Explain.
4. What should be the structure of an organisation's financial department? What tasks are carried out by the financial officer?
5. 'The basic rationale for the objective of Shareholder Wealth Maximisation is that it reflects the most efficient use of society's economic resources and thus leads to a maximisation of society's economic wealth' (Ezra Solomon). Comment critically.



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1. Pandey, I.M (2015). Financial Management (11th Edition): Theory and Practices, Vikas Publishing House, New Delhi.
2. Maheshwari, S. N., & Maheshwari, S. K. (2018). A text book of financial management. Sultan Chand & Sons.

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Unit 2

Financial Planning

Learning Outcomes

After completing this unit, learners will be able to:

- ◊ explain the meaning and concept of financial planning
- ◊ describe the major components of a financial plan
- ◊ compare financial forecasting and financial planning
- ◊ explain the role of financial markets and financial institutions in India

Background

Effective and efficient management is essential for a company. This suggests that the company should be able to accomplish its goals with using the fewest resources possible. Therefore, management includes coordinating and controlling the company's activities to accomplish its goals. When management plans its future course of action ahead of time, makes professional decisions, and uses both individual and collective efforts in a coordinated and logical way, it facilitates the management process. Budgeting and financial planning are two methodical ways to achieve good management performance.

Financial decisions are crucial to an organisation's long-term success and effective operation in the business world. Companies work in a dynamic environment where resources are few, risks exist, and choices taken now might have an impact on performance in the future. Therefore, managers and decision-makers must have a thorough awareness of the financial aspects of business operations. The main concepts that serve as a basis for comprehending financial decision-making are introduced in this course.

Keywords

Financial Planning, Financial Forecasting, Decision Making, Financial Markets, Financial Institutions

Discussion

An automobile company plans to expand its EV production over the next three years. Such a strategic decision cannot be implemented merely by setting a production target. The finance team must prepare a financial plan covering the investment required for new EV models, battery technology, manufacturing capacity, charging-related initiatives, working capital, technology development and marketing.

If the management estimates that an expansion programme will require ₹1000 crore over a specified period, the finance team would develop a financial plan around questions such as:

Financial Planning Question	Decision Required
How much investment is required?	Estimate capital expenditure for plants, equipment and technology
How much working capital is required?	Estimate inventory, receivables and operating cash requirements
How much can be generated internally?	Assess retained earnings and operating cash flows
How much external finance is required?	Determine debt/equity requirements
What will be the future cash flows?	Prepare cash-flow forecasts
Can the company service additional debt?	Analyse interest and repayment capacity
What if sales are lower than expected?	Conduct sensitivity and scenario analysis

It is important to note that financial planning integrates the three major financial management decisions: the investment decision, financing decision and working capital decision.

Thus, financial planning serves as a financial roadmap for the organisation, translating its strategic objectives and growth plans into a realistic framework for investment, financing and effective cash management.

1.2.1. Financial Planning - Meaning

The process of converting a business strategy into a clear and practical course of action is known as financial planning. It makes it possible for an organisation to comprehend its present financial situation, decide where it wants to go, and figure out how to finance and accomplish its objectives. Fundamentally, financial planning facilitates more precise and well-coordinated decision-making by linking an organisation's personnel, information, and resources with its business aims. An organisation can estimate income, expenses, and cash flows, assess risks and opportunities, and react swiftly to changes in the business environment with the support of an efficient financial plan.

Financial planning shows a company's expansion, performance, investments, and funding needs over a specific time frame, typically three to five years. It entails creating a balance sheet, funds flow statement, and projected or pro forma profit and loss account. The financial manager of a company can control the flow of finances, which is his main concern, with the aid of financial planning and profit planning.

Financial planning is often mistaken for budgeting. Budgets are a part of financial planning, but the phrases are not synonymous. Budgets are only one component of a financial business plan, which should also contain other crucial details that help paint a full picture of a company's financial health, such as forecasts of income, cash flow, and revenue as well as thorough, itemized breakdowns of the company's assets and typical expenses. Financial plans for businesses typically also highlight long-term goals and particular growth targets, as well as any potential roadblocks to reaching those goals.

By precisely projecting future financial outcomes, the comprehensive financial planning process in business is intended to ascertain the most efficient use of the company's financial resources to support the organisation's goals, both short and long-term. Financial planning procedures balance the use of measurements and data to forecast the future with institutional knowledge in teams and departments. They are both analytical and enlightening.

1.2.1.1 Steps in Financial Planning

Planning refers to what a business wants to happen in the future and contains the essential action plans to carry out the established intentions. Essentially financial planning has the following major steps to be carried out.

◊ **Review past performance**

Analysis of the company's historical performance to determine the connections between financial factors and the company's financial advantages and disadvantages.

◊ **Deciding operating elements**

To determine its growth aim, the company's operating characteristics product,

market, competition, production and marketing policies, control systems, operating risk, etc. are analysed.

◊ **Determining needs and strategy**

Next step is estimating the investment needs and strategic choices considering the intended growth for the organisation ahead.

◊ **Forecasting the revenue and expenses**

Estimating the company's income, costs, and funding requirements depending on its dividend and investment strategies.

◊ **Alternative financing choices**

Determining the best way to raise money and evaluating financial options within its financial policies.

◊ **Reviewing the outcomes**

Evaluating how its financial strategies may affect the company's long-term viability. Constant check on the working of the plans is essential.

◊ **Consistency**

Assessing how well financial policies align with the firm plan and with one another. The review of plans needs to be done on a continuous basis to ensure consistency with the other firm level plans.

1.2.1.2 Relevance of Financial Planning

There are two primary goals of a financial business plan. A company needs a financial plan that demonstrates its ability to expand, scale, and provide long-term value for shareholders. For all parties involved in the company, maintaining growth, scale, and steady shareholder value is essential. In a similar vein, the financial strategy demonstrates to banks and lenders that the company can pay back any loans.

◊ **Credibility:**

A well-prepared financial plan demonstrates that the organisation has a clear understanding of its financial position and future requirements. This can strengthen confidence among investors, lenders, suppliers, and other stakeholders.

◊ **Balancing the Balance Sheet:**

It helps maintain an appropriate relationship between the organisation's assets, liabilities, and equity. This supports financial stability and reduces the possibility of excessive dependence on external borrowing.

◊ **Long-term Financial Planning Visibility:**

It provides management with a clearer view of future financial requirements, expected cash flows, investment needs, and funding sources. This enables the organisation to

prepare for future growth and changing financial conditions.

◊ **Strategic Marketing:**

Financial estimates help management determine the resources available for marketing activities and assess whether proposed marketing initiatives are financially viable. This allows marketing decisions to be aligned with broader organisational objectives.

◊ **Monitoring Assets and Liabilities (In's and Out's):**

It facilitates the systematic monitoring of funds flowing into and out of the organisation. By tracking assets, liabilities, income, and expenditure, management can identify financial gaps and take corrective measures when necessary.

◊ **Measuring Profit and Loss:**

It provides a basis for comparing expected and actual revenues and expenses. This helps management assess profitability, identify areas of financial weakness, and take appropriate measures to improve overall performance.

1.2.2 Financial Plan

An organisation's financial goals, anticipated needs, funding sources, and intended use of financial resources over a given time period are all outlined in a financial plan. By projecting future revenues, expenses, cash flows, investments, and financing requirements, it converts the organisation's business goals into financial terms. It assists management in figuring out how much money is needed, when it will be needed, where it will come from, and how it will be used. Additionally, a financial plan serves as a foundation for managing risks, reviewing financial performance, assessing the financial viability of activities, and coordinating financial decisions.

1.2.2.1 Estimating Financial Requirements

Determining how much money an organisation will need to support its current and future business operations is known as estimating financial requirements. It is a crucial stage in the financial decision-making process since too much money could go unused and raise the cost of capital, while too little money could cause operations to be disrupted. The estimate often takes into account the organisation's anticipated revenues, operational costs, working capital requirements, capital expenditures, expansion plans, debt commitments, and other financial commitments. The timing of these needs and the accessibility of various funding sources are also taken into account by management. An accurate estimate helps the organisation to plan ahead, retain sufficient liquidity, steer clear of financial problems, and support both its immediate operations and long-term expansion goals. The accurate estimate or plan of any business organisation could possibly have several smaller elements or components.

Elements of Financial Plan

i. Sales and Revenue Projection

The starting point of a financial plan is an estimate of the organisation's future sales and revenues. It considers factors such as market demand, pricing, competition, economic conditions, past sales trends, and expected changes in business activities. Revenue forecasts provide a basis for estimating future cash inflows and profitability.

ii. Expense and Cost Estimation

The organisation must project the costs that are anticipated to occur during the planning phase. Production costs, personnel costs, marketing costs, administrative costs, interest charges, and other operating costs are a few examples of these. Precise cost estimating aids management in determining the amount of money needed to conduct commercial operations and limiting wasteful spending.

iii. Cashflow Projection

The anticipated cash inflows and expenditures over a specific time period are estimated in a cash flow projection. It assists management in determining if there will be enough cash on hand to cover operating costs, debt payments, investment requirements, and other payments. In order to take the necessary precautions, it also aids in identifying times when there is a financial surplus or shortfall.

iv. Projected Financial Statements

The organisation's anticipated financial performance and position are shown in projected financial statements. These typically consist of a forecast cash flow statement, projected balance sheet, and projected income statement. They make it possible for management to evaluate predicted profitability, assets, liabilities, and general financial well-being.

v. Capital Expenditure Plan

The money needed for long-term expenditures in assets including land, buildings, machinery, equipment, technology, and other infrastructure is determined by a capital expenditure plan. It assists the organisation in assessing significant investment plans and figuring out whether there will be enough money to support growth and modernization.

vi. Financing Plan

The financing strategy identifies appropriate funding sources and establishes how much money the organisation needs. These could include bonds, bank loans, retained earnings, equity capital, and other types of borrowing. In order to enable the organisation to satisfy its financial needs without incurring undue financial risk, the plan also takes into account the proper ratio of debt to equity.

vii. Working Capital Plan

The organisation's daily activities depend on working capital. The working capital plan takes into account current liabilities like trade payables and short-term obligations in addition to estimating the money required for inventories, trade receivables, cash, and other current assets. Maintaining liquidity and ensuring the seamless continuation of corporate operations are two benefits of effective working capital planning.

viii. Profitability Plan

The amount of profit the organisation anticipates making throughout the planning period is estimated by profitability predictions. They are created by contrasting projected income with projected spending and costs. These forecasts assist management in determining the likelihood that investment choices and business strategies will yield profitable returns.

ix. Risk and Contingency Plan

Uncertainties in business operations include shifts in demand, prices, interest rates, the state of the economy, and unforeseen expenses. As a result, a financial strategy must take possible risks into account and include backup plans. The organisation can handle unforeseen events by keeping suitable cash reserves and other funding arrangements.

x. Financial Monitoring and Control Plan

A financial plan should provide a basis for comparing actual results with planned results. Management can monitor variations in sales, expenses, cash flows, investments, and profits and identify areas where corrective action may be necessary. Continuous monitoring ensures that financial activities remain consistent with organisational objectives.

1.2.3 Difference between Financial Planning and Financial Forecasting

Despite their close relationship, financial forecasting and financial planning have distinct functions. Financial planning focuses on determining what the organisation wants to accomplish and how its financial resources will be used to accomplish those goals, whereas financial forecasting is primarily concerned with estimating what is likely to happen in the future based on past and current financial information.

The differences between these terms can be understood from the below table.

Table 1.2.1 Financial Planning Vs Financial Forecasting

Financial Planning	Financial Forecasting
It involves setting financial objectives and determining the actions and resources required to achieve them.	It involves estimating the organisation's future financial performance and position based on available information.
To establish a financial direction and guide future financial decisions.	To predict likely future financial outcomes.
Focuses on what the organisation wants to achieve and how it will achieve it.	Focuses on what is likely to happen in the future.

More action-oriented and involves setting targets and making decisions.	More prediction-oriented and involves estimating future results.
Generally considers both short-term and long-term objectives.	May cover short-term, medium-term, or long-term periods depending on the requirement.
Based on organisational objectives, strategies, policies, and available resources.	Based mainly on historical data, current trends, assumptions, and market conditions.
Provides a framework for allocating resources and may be revised as objectives or conditions change.	Updated when assumptions, trends, or business conditions change.
Produces financial targets, budgets, funding requirements, investment decisions, and resource - allocation plans.	Produces estimates of sales, revenue, expenses, cash flows, profits, and financial position.
Helps management decide what actions should be taken.	Helps management understand what outcomes may occur if current trends and assumptions continue.

1.2.4 Role of Financial Markets and Financial Institutions in India

The Indian financial system is a network of institutions, markets, financial instruments and services that facilitates the flow of funds from savers to individuals, businesses and governments that require finance. It plays a vital role in mobilising savings, promoting investment, supporting business activities and contributing to economic development. Its major components are financial markets, financial institutions, financial instruments and financial infrastructure, supported by regulatory authorities such as the Reserve Bank of India (RBI) and the Securities and Exchange Board of India (SEBI).

Financial markets are arrangements through which financial assets are issued and traded. Their major components include the money market, capital market, foreign exchange market and derivatives market. Financial institutions are organisations that facilitate the flow of funds by accepting deposits, providing loans, offering investment services and managing financial risks. Their major elements include banks, non-banking financial companies (NBFCs), insurance companies, mutual funds and development financial institutions. The major components of financial markets and financial institutions are presented below in a chart to provide a clear overview of their structure and interrelationship.

The operation and growth of the Indian economy depend heavily on financial markets and financial institutions. By bringing together people who have extra money and those

who need it, they make it easier to mobilize, distribute, and employ financial resources effectively. While financial institutions offer a range of financial services and credit facilities to people, companies, and the government, financial markets offer a venue for the trading of financial instruments including shares, bonds, and other securities.

1.2.4.1 Financial Markets' Interventions

a. Channeling surplus funds from individuals and institutions to profitable purposes is one of the focuses of organised or unorganised financial markets. Funds are procured from where it is in excess and provided to where it is scarce and needy is one of the roles played by financial markets.

b. Allocation of capital to different businesses is possible because of the existence of financial markets. Finding capital to be employed into productive business ideas is done from primary and secondary capital markets.

c. By providing space and possibilities for trading of financial assets, financial markets ensure liquidity to the investors.

d. With the interaction of demand and supply conditions in the market, fair pricing of financial assets becomes possible.

e. Organised financial markets helps investors in managing the risk associated with pumping higher volumes of their hard-earned money.

f. By facilitating the flow of funds to productive sectors, financial markets contribute to capital formation, business expansion, employment, and overall economic development.

1.2.4.2 Role of Financial Institutions

Financial institutions play an important role in the Indian financial system by connecting people and organisations with surplus funds to those who need finance. This process is known as financial intermediation, through which savings are channelled into lending and investment. Financial institutions perform several important functions that support individuals, businesses and the economic development of the country.

1. Provision of Funds to the Needy

Financial institutions provide funds to individuals, businesses and government through loans, credit facilities and other financial arrangements. These funds help individuals meet personal needs and enable businesses to start operations, purchase assets, expand production and meet working-capital requirements.

Example: A bank may provide a business loan to an entrepreneur to purchase machinery and establish a manufacturing unit.

2. Mobilisation of Savings

Mobilisation of savings refers to collecting small and scattered savings from the public and making them available for productive use. Banks accept deposits, while

mutual funds and other institutions offer investment opportunities that channel savings into financial assets and economic activities.

Example: Savings deposited by individuals in banks may be used to provide loans to businesses for expansion.

3. Development of Industries

Financial institutions promote industrial development by providing financial assistance to new and existing businesses. They help industries obtain funds for purchasing machinery, adopting new technology, expanding production capacity and developing infrastructure. Specialised institutions also support micro, small and medium enterprises (MSMEs), which contribute to employment generation and economic growth.

Box Information: Major Institutions Supporting Industrial Development in India

- ◊ **Small Industries Development Bank of India (SIDBI):** Provides financial and developmental support to micro, small and medium enterprises (MSMEs).
- ◊ **Industrial Finance Corporation of India (IFCI):** Provides financial assistance and related services to eligible industrial and infrastructure projects.
- ◊ **Export-Import Bank of India (EXIM Bank):** Provides financial assistance and support for export and import activities, helping Indian businesses participate in international trade.
- ◊ **National Bank for Agriculture and Rural Development (NABARD):** Supports agriculture, rural development and eligible rural enterprises through finance and developmental initiatives.
- ◊ **State Financial Corporations (SFCs):** Provide financial assistance to eligible small and medium industrial enterprises within their respective states.
- ◊ **State Industrial Development Corporations (SIDCs):** Support industrial development through activities such as industrial infrastructure development, project assistance and investment facilitation.

4. Provision of Financial Services

Financial services are services that help individuals and organisations manage money, make payments, obtain finance, invest savings and protect themselves against financial risks. Financial institutions offer services such as payment facilities, leasing, insurance, investment management, money transfers and advisory services.

Example: An insurance company provides protection against specified risks, while a mutual fund enables investors to invest in a diversified portfolio of securities.

5. Promotion of Financial Inclusion

Financial inclusion means ensuring that individuals and businesses, particularly those in underserved communities, have access to affordable and appropriate financial services. Banks and other financial institutions promote inclusion through basic bank accounts, digital payments, small loans, insurance and other accessible financial products.

Example: Basic savings bank accounts and banking services through business correspondents help people in rural areas access formal financial services.

6. Maintaining Financial Stability

Financial stability refers to the ability of the financial system to function effectively and withstand financial shocks without serious disruption. Financial institutions contribute to stability by assessing borrowers' creditworthiness, managing lending risks, maintaining adequate liquidity and following applicable regulations. Regulatory authorities such as the Reserve Bank of India (RBI) and the Securities and Exchange Board of India (SEBI) oversee different segments of the financial system.

Example: Banks assess a borrower's repayment capacity before granting a loan to reduce the risk of loan defaults.

Conclusion

Financial institutions act as intermediaries by mobilising savings and directing funds towards productive activities. Through lending, industrial financing, financial services, financial inclusion and risk management, they support capital formation, business development and economic growth. While financial institutions facilitate the mobilisation and allocation of funds, financial markets provide the arrangements through which financial assets are issued and traded. Together, they contribute to the efficient functioning and development of the Indian financial system.

Summarised Overview

Financial planning is a crucial component of corporate financial management because it offers a methodical framework for evaluating a company's financial requirements and advancing its goals. The unit starts by defining financial planning and emphasizing how it connects organisational goals to financial choices and resource distribution. Estimating financial requirements, which calls for the company to evaluate its working capital needs, capital expenditures, operating expenses, investment plans, and current financial obligations, is one of the process's multiple crucial elements. Precise estimation aids the company in choosing suitable funding sources and determining the quantity and timing of funds needed.

The unit also takes into account the function of financial markets and financial institutions in India, which enable the mobilisation of savings, capital allocation, loan provision, liquidity, investment, and risk management. Financial markets offer ways to raise and transfer money, while financial institutions help businesses by offering financing and financial services. Overall, the unit demonstrates that maintaining financial stability, assisting with investment decisions, and accomplishing a company's long-term goals depend on efficient access to financial markets and institutions, accurate financial requirement estimation, and effective financial planning.

Self-Assessment Question

1. What is meant by Financial Planning?
2. What are the steps involved in financial planning?
3. What is meant by estimating financial requirements?
4. What factors should be considered while estimating financial requirements?
5. What is a Financial Market?
6. State any two functions of the financial market.
7. What is meant by Financial Institutions?
8. Explain the role of financial markets in India.
9. Explain the role of financial institutions in India.
10. Distinguish between Financial Markets and Financial Institutions.

Assignments

1. What is the relevance of financial planning in achieving the common goals of businesses? How does it impact the effectiveness of decision making in your opinion?
2. Review the key components of financial planning. How does each stage support a company's expansion and financial stability?
3. Examine the elements that need to be taken into account when calculating a company's financial needs. What might happen if these needs are overestimated or underestimated?
4. "Efficient use of funds requires accurate estimation of financial requirements." Examine this claim with appropriate examples.
5. Analyse the relationship between financial planning, financial requirements, financial markets, and financial institutions. How do these elements collectively support the financial management of a firm?
6. Examine how India's financial markets mobilise savings and make it easier for money to move to the country's productive sectors.
7. Analyse how Indian financial institutions help firms with their financing needs. In what ways do they support business expansion and economic advancement?

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1. Pandey, I.M (2015). Financial Management (11th Edition): Theory and Practices, Vikas Publishing House, New Delhi.
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2
BLOCK

Sources of Fund

Unit 1

Equity, Debt, and Internal Sources of Finance

Learning Outcomes

After completing this unit, learners will be able to:

- ◊ identify different sources of finance available to a firm
- ◊ explain the basic features of various sources of finance
- ◊ differentiate between different financing options
- ◊ understand the suitability of different sources for business needs

Background

Every business organisation requires adequate financial resources to establish its operations, sustain day-to-day activities, and pursue growth and expansion. The availability, cost, and effective utilisation of these resources have a significant influence on the financial stability and overall performance of a firm. As business requirements vary according to the nature, scale, and stage of operations, organisations need to make informed decisions about the resources available to them. A clear understanding of the financial environment and the factors influencing such decisions provides an essential foundation for effective corporate financial management.

Keywords

Equity Shares, Preference Shares, Debentures, Bonds, Retained Earnings, Public Deposits, Internal Financing, External Financing

Discussion

When starting a new business or expanding an existing one, the fundamental question is not only "How much finance is required?" but also "From where should the finance be raised?" A company can broadly choose among three major sources of finance - debt, equity and internal finance - each having different implications for cost, risk, ownership and control.

Debt finance involves borrowing funds that must generally be repaid with interest. It creates a fixed financial obligation but normally does not dilute the ownership or voting control of existing shareholders. Equity finance involves raising funds from investors in return for an ownership interest and a claim on the company's future profits. Unlike debt, equity does not involve a fixed repayment obligation, but it may result in dilution of the ownership and control of existing shareholders. Internal finance (generated within the business), does not create additional debt or dilute ownership. However, retaining earnings has an opportunity cost, as shareholders forgo the opportunity to receive those profits as immediate dividends.

Therefore, the choice among debt, equity and internal sources of finance is an important financing decision. A finance manager should not consider merely "Which source is the cheapest?" but should ask: "Which source, or combination of sources, can provide the required funds at an acceptable cost and level of risk while maintaining financial flexibility and an appropriate ownership and control structure?"

In this module, you will learn about the different sources of finance, their features, advantages and limitations, and the factors that influence the choice of an appropriate source or combination of sources of finance.

2.1.1 Sources of Finance

Sources of financing refer to the methods used to mobilize different forms of funding for industrial concerns. Financial sources reveal how businesses are raising money to meet their needs. The businesses, whether new or established, require a certain amount of funding to cover both short-term and long-term needs, such as buying fixed assets, creating an office, buying raw materials, and covering daily expenses. Sources of Finance may be classified under various categories based on the period to which the fund is expected to utilise. The classification can be understood from the following;

2.1.1.1 Short-Term Finance

Short-term finance refers to funds required for a period of up to one year. It is mainly used to meet the working capital and day-to-day operating requirements of a firm, such as purchasing raw materials, paying wages and salaries, meeting utility expenses, and maintaining inventory. Common sources include trade credit, bank overdrafts, cash credit, short-term bank loans, and commercial paper.

2.1.1.2 Medium-Term Finance

Medium-term finance refers to funds required generally for a period of more than one year and up to five years. It is used for purposes such as purchasing equipment, replacing machinery, undertaking moderate expansion, and financing improvements in business operations. Common sources include medium-term bank loans, lease finance, hire purchase, and other institutional finance.

2.1.1.3 Long-Term Finance

Long-term finance refers to funds required for a period of more than five years. It is generally used to finance major investments such as acquisition of land and buildings, purchase of large-scale machinery, business expansion, diversification, and other long-term projects. Major sources include equity shares, preference shares, retained earnings, debentures, bonds, and long-term loans.

2.1.2 Types of Long-Term Sources

Long-term sources of funding are those that are deployed in big amounts and have repayment terms longer than five years. Following are some of the commonly used long term financing sources for corporations.

2.1.2.1 Equity Shares

Equity Shares also known as ordinary shares, which means, other than preference shares. The company's true owners are its equity stockholders. They are in charge of the company's management. If the company makes sufficient profit, equity shareholders can get dividends. Throughout the company's existence, equity share capital cannot be redeemed.

The unpaid share value is the equity stockholders' liability. The face value of a share is the original value assigned to it by the company at the time of issue. The paid-up value is the portion of the face value that the shareholder has actually paid, while the unpaid value is the remaining amount yet to be paid. For example, if a share has a face value of ₹10 and the shareholder has paid ₹7, the paid-up value is ₹7 and the unpaid value is ₹3.

Characteristics of Equity Shares

- ◊ Perpetual: The capital of equity shares is everlasting and has no maturity date. Throughout the company's existence, it cannot be repaid.
- ◊ Claim on residual income: After preference shareholders get a fixed dividend rate, equity stockholders are entitled to any remaining income. The profit after taxes less the preference dividend equals the earnings or income accessible to the shareholders.
- ◊ Last claim on asset: Ordinary or equity shareholders are entitled to claims on assets in the event that the business closes. Only equity stockholders have access to these rights.

- ◊ Control rights: The company's true owners are its equity stockholders. As a result, they have the authority to oversee the company's management and make any decisions pertaining to its operations.
- ◊ Voting rights: With the use of their voting rights, equity shareholders can alter or revoke any decision made by the corporation. Only in company meetings do equity shareholders have the ability to vote, and they may designate a proxy to attend and cast a vote in place of the shareholder.
- ◊ Pre-emptive rights: Pre-emptive rights to equity shareholders. The legal right of current shareholders is known as the pre-emptive right. The corporation certifies that it has the first chance to buy more equity shares in proportion to its existing holding capacity.
- ◊ Limited Liability: The liability of equity shareholders can alter is restricted to the purchase price of their shares. The stockholders are not liable if their shares are completely paid up.

Advantages of Equity Shares

Equity shares are the most common and universally used shares to mobilize finance for the company. It consists of the following advantages.

i. Permanent sources of finance: Equity share capital is belonging to long-term permanent nature of sources of finance, hence, it can be used for long-term or fixed capital requirement of the business concern.

ii. Voting rights: Equity shareholders are the real owners of the company who have voting rights. This type of advantage is available only to the equity shareholders.

iii. No fixed dividend: Equity shares do not create any obligation to pay a fixed rate of dividend. If the company earns profit, equity shareholders are eligible for profit, they are eligible to get dividend otherwise, and they cannot claim any dividend from the company.

iv. Less cost of capital: Cost of capital is the major factor, which affects the value of the company. If the company wants to increase the value of the company, they have to use more share capital because, it consists of less cost of capital (Ke) while compared to other sources of finance.

v. Retained earnings: When the company have more share capital, it will be suitable for retained earnings which is the less cost sources of finance while compared to other sources of finance.

Disadvantages of Equity Shares

i. Irredeemable: Equity shares cannot be redeemed during the lifetime of the business concern. It is the most dangerous thing of over capitalization.

ii. Obstacles in management: Equity shareholder can put obstacles in management by manipulation and organizing themselves. Because, they have power to contrast any decision which are against the wealth of the shareholders.

iii. Leads to speculation: Equity shares dealings in share market leads to speculation during prosperous periods.

iv. No fixed income to investor: The Investors who desire to invest in safe securities with a fixed income have no attraction for equity shares.

v. No trading on equity: When the company raises capital only with the help of equity, the company cannot take the advantage of trading on equity.

2.1.2.2 Preference Shares

Preference shareholders enjoy two main rights over equity shareholders: (1) Preference in dividend payment, as they are entitled to receive dividends before equity shareholders, and (2) Preference in repayment of capital, as they have the right to receive their capital before equity shareholders at the time of winding up of the company. Preference shares are the components can alter of corporate securities. At the moment of the company's winding up, the shareholders have a preferred right to receive their initial investment back. Preference shareholders can vote, but their voting rights are limited. Under the Companies Act, 2013 in India, preference shareholders generally have the right to vote only on resolutions that directly affect their rights and on resolutions relating to winding up or repayment or reduction of share capital. If dividends on their class of preference shares remain unpaid for two years or more, they can vote on all resolutions of the company. They are entitled to a predetermined dividend rate.

Preference shares can be of several types as below;

a. Cumulative Preference Shares: In years where there are no earnings, cumulative preference shares are entitled to dividend payments. C.P. Shares are not eligible for a dividend if the firm fails to turn a profit in one or more years, but they are entitled to receive the comparable dividend for the prior years if the business turned a profit.

b. Non-Cumulative Preference Shares: Preference shares that are not cumulative are not entitled to the aforementioned advantages. They can only receive dividends if the business makes money over the years. If not, they are not eligible to receive any dividends.

c. 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.

d. 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.

e. Participating Preference Shares: Participating preference sharesholders have right to participate extra profits after distributing the equity shareholders.

f. Non-Participating Preference Shares: Non-participating preference sharesholders 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.

g. Convertible Preference Shares: Convertible preference sharesholders have right to convert their holding into equity shares after a specific period. The articles of association must authorize the right of conversion.

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

Features of Preference Shares

The following are the important features of the preference shares:

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

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

◊ 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.

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

2.1.2.3 Debentures and Bonds

Both bonds and debentures are significant long-term debt financing tools that help businesses and other organisations raise capital from investors. The issuer typically agrees to pay interest at a predetermined rate and refund the original amount under predetermined circumstances in exchange for the cash supplied. Even though the terms are commonly used synonymously, depending on the nation and the particular issuance, they can differ in terms of security, issuer, maturity, and legal structure.

A debenture is a paper that the business issues. It is a document that acknowledges a debt and is issued by the business under its seal.

“Debenture includes debenture stock, bonds, and any other securities of a company whether constituting a charge of the assets of the company or not,” states the Companies Act of 1956.

A long-term promissory note used to raise money for loans is called a debenture. The company guaranties to make the required principle and interest payments. Debenture holders are the people who buy debentures. In India, bonds are an alternative to debentures. In India, bonds are mostly issued by public sector organisations. In the United States, unsecured bonds are commonly referred to as debentures.

A bond is a type of financial instrument used by businesses, governments, and other organisations to borrow money from investors for a predetermined amount of time. Typically, the issuer repays the principal amount upon maturity and makes recurring interest payments. In terms of interest rates, maturity, security, convertibility, and redemption, bonds may be issued with a variety of features. They are frequently employed to raise significant sums of long-term funding.

Types of Debentures

Debentures, due to many of its peculiar conditions can be of several categories as follows;

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

b. 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.

c. 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.

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

e. 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:

   i. Non-convertible debentures

   ii. Fully convertible debentures

   iii. Partly convertible debentures

f. Other types: Debentures can also be classified into the following types. Some of the common types of the debentures are as follows:

   iv. Collateral Debenture

   v. Guaranteed Debenture

   vi. First Debenture

Box Information: Coupon Rate and Legal Provisions Relating to Debentures

Coupon Rate

The coupon rate is the fixed annual rate of interest payable on the face value of a debenture or bond. It is usually expressed as a percentage and determines the interest payable to debenture holders.

Example: If a company issues a debenture with a face value of ₹1,000 and a coupon rate of 8%, the annual interest payable is ₹80 per debenture (₹1,000 × 8%). The interest is calculated on the face value, not necessarily on the market price of the debenture.

Section 71 of the Companies Act, 2013

Section 71 deals with the issue of debentures by companies. It provides that a company may issue debentures with an option to convert them into shares, either wholly or partly, at the time of redemption, subject to approval by a special resolution of shareholders. It also prohibits a company from issuing debentures carrying voting rights.

The section further provides for the appointment of debenture trustees where required, the protection of debenture holders' interests, and the repayment of debentures according to the terms of issue. If a company fails to redeem debentures or pay interest when due, the debenture holders or trustee may approach the National Company Law Tribunal (NCLT) for appropriate directions.

SEBI Regulations for Listed Non-Convertible Securities

For listed non-convertible securities, the applicable Securities and Exchange Board of India (SEBI) regulatory framework governs their issue and listing. The SEBI *Issue and Listing of Non-Convertible Securities Regulations, 2021* provide the relevant regulatory requirements for issuing and listing such securities. The regulations were last amended on **21 January 2026**.

Features of Debentures

◊ **Fixed Rate of Interest**

Debentures usually carry a fixed rate of interest, known as the coupon or contractual rate. The interest is paid periodically on the face value of the debenture, regardless of changes in its market price. For example, a ₹1,000 debenture carrying 10% interest will normally provide ₹100 as annual interest.

◊ **Fixed Maturity Period**

Debentures are issued for a specific period. The maturity period represents the time for which the company borrows the funds. On maturity, the company is required to

repay the principal amount to the debenture holders according to the terms of the issue.

◊ **Redemption**

Debentures are generally redeemable, meaning that the company has to repay the borrowed amount. Redemption may take place at maturity or, where permitted, before maturity through provisions such as a call or buy-back facility.

◊ **Sinking Fund**

A company may create a sinking fund by setting aside a certain amount of money periodically to meet the repayment of debentures. This reduces the burden of making a large repayment at the time of maturity and helps the company plan its debt repayment in advance.

◊ **Buy-back or Call Provision**

Some debentures contain a provision that allows the company to redeem them before the maturity date at a specified price. If the redemption price is higher than the face value, the additional amount is known as the call or buy-back premium.

◊ **Indenture or Debenture Trust Deed**

An indenture is a legal agreement between the issuing company and the debenture trustee, who represents the interests of debenture holders. It specifies the terms of the issue, rights of debenture holders, obligations of the company, and responsibilities of the trustee.

◊ **Security**

Debentures may be secured or unsecured. Secured debentures are backed by a charge on the company's assets, providing protection to investors in case of default. Unsecured debentures, also called naked debentures, are not backed by specific assets.

◊ **Yield**

The yield represents the return earned by a debenture holder based on the market price of the debenture. Since the market price may change, the yield may differ from the fixed coupon rate.

◊ **Priority of Claims on Income**

Debenture holders have a prior claim on the company's income compared with shareholders. Interest on debentures must generally be paid before dividends can be distributed to preference and equity shareholders.

◊ **Priority of Claims on Assets**

In the event of liquidation, debenture holders have a claim on the company's assets before shareholders. Among debenture holders, secured debenture holders generally have priority over unsecured debenture holders.

◊ **Tax Treatment**

Interest paid on debentures is generally treated as a business expense for the company while determining taxable income, subject to applicable tax laws. The interest received by debenture holders is generally taxable according to the applicable tax provisions.

◊ **No Ownership Rights**

Debenture holders are creditors of the company and not owners. They generally do not have voting rights or control over the management of the company merely because they hold debentures.

Difference between Debentures and Bonds

1. Issuer: Debentures are mainly associated with corporate companies, while bonds can be issued by companies, governments, municipalities, and financial institutions.
2. Security: Debentures may be secured or unsecured, depending on the terms of the issue. Bonds may also be secured or unsecured based on their structure and conditions.
3. Purpose: Debentures are generally issued to meet corporate financing and investment requirements. Bonds may be issued to finance large projects, government expenditure, infrastructure, business expansion, and other long-term requirements.
4. Interest: Debentures generally carry a specified rate of interest, while bonds may carry fixed or variable rates of interest, depending on their terms.
5. Maturity: Debentures are generally issued for medium- to long-term periods, whereas bonds can have short-, medium-, or long-term maturities.
6. Claim on Assets: Debenture holders have a claim on the company's assets according to the security attached to the debenture. Similarly, bondholders have a claim based on the terms and security of the bond.
7. Nature: Both are forms of borrowed capital and make the issuer liable to pay interest and repay the principal. However, the exact legal and financial features of each depend on the terms of the particular issue.

Retained Earnings

Retained earnings are an additional internal funding source. It is actually referred to as a company's accumulation of profits for its expansion and diversification operations rather than a means of acquiring capital. Retained earnings are referred to by several names, including ploughing back profits, internal finance, and self finance.

The Companies Act of 2013 places limitations on dividend distribution but gives businesses a great deal of latitude in holding onto profits and shifting them to reserves. This aids businesses in striking a balance between the need to hold onto money for future needs and the interests of shareholders.

Advantages of Retained Earnings

Retained earnings consist of the following important advantages:

- ◊ Useful for expansion and diversification: Retained earnings are most useful to expansion and diversification of the business activities.
- ◊ Economical sources of finance: Retained earnings are one of the least costly sources of finance since it does not involve any floatation cost as in the case of raising of funds by issuing different types of securities.
- ◊ No fixed obligation: If the companies use equity finance they have to pay dividend and if the companies use debt finance, they have to pay interest. But if the company uses retained earnings as sources of finance, they need not pay any fixed obligation regarding the payment of dividend or interest.
- ◊ Flexible sources: Retained earnings allow the financial structure to remain completely flexible. The company need not raise loans for further requirements, if it has retained earnings.
- ◊ Increase the share value: When the company uses the retained earnings as the sources of finance for their financial requirements, the cost of capital is very cheaper than the other sources of finance; Hence the value of the share will increase.
- ◊ Avoid excessive tax: Retained earnings provide opportunities for evasion of excessive tax in a company when it has small number of shareholders.
- ◊ Increase earning capacity: Retained earnings consist of least cost of capital and also it is most suitable to those companies which go for diversification and expansion.

Disadvantages of Retained Earnings

Retained earnings also have certain disadvantages:

- ◊ Misuses: The management by manipulating the value of the shares in the stock market can misuse the retained earnings.
- ◊ Leads to Monopolistic Attitude: Excessive use of retained earnings leads to monopolistic attitude of the company.
- ◊ Tax evasion: Retained earnings lead to tax evasion. Since, the company reduces tax burden through the retained earnings.
- ◊ Dissatisfaction: If the company uses retained earnings as sources of finance, the shareholder can't get more dividends. So, the shareholder does not like to use the retained earnings as source of finance in all situations.

Box Information: Are Retained Earnings Truly a Cost-Free Source of Finance, or Do They Also Involve an Implicit Cost?

Retained earnings are often considered a cost-free source of finance because the company does not have to pay interest or incur direct borrowing costs. However, they involve an implicit cost, as the profits retained in the business could otherwise be distributed to shareholders as dividends and invested elsewhere to earn returns. Therefore, shareholders expect the company to use retained earnings to generate returns at least comparable to what they could earn from alternative investments with similar risk. Thus, retained earnings are not entirely cost-free, even though they do not involve an explicit interest payment.

2.1.2.4 Public Deposits

Public deposits are funds accepted by a company from the public for a specified period, generally with an obligation to repay the amount along with interest according to the agreed terms. They provide companies with an alternative source of borrowed finance, while offering depositors an opportunity to earn interest on their savings.

Under the Companies Act, 2013, acceptance of deposits by companies is regulated mainly by Sections 73 to 76 and the Companies (Acceptance of Deposits) Rules, 2014. Banking companies and certain other regulated financial entities are subject to their respective regulatory frameworks.

Features of Public Deposits

1. Source of Finance – Public deposits provide companies with funds that can be used for working capital, expansion, investment, and other business requirements.
2. Fixed Period – Deposits are accepted for a specified period, after which the company is required to repay the principal amount according to the terms of the deposit.
3. Interest Payment – Depositors generally receive interest at an agreed rate. The rate and terms of payment are specified when the deposit is accepted.
4. No Ownership Rights – Depositors are creditors of the company and do not become owners of the company. They generally have no voting or management rights merely because they have placed deposits with the company.
5. Alternative to Bank Finance – Public deposits can provide an additional source of borrowed funds and may reduce a company's dependence on bank loans.
6. Regulated Source of Finance – Companies cannot freely accept public deposits. The Companies Act, 2013 and the relevant rules prescribe conditions designed to protect depositors.

Regulations Governing Public Deposits in India

1. Restriction on Acceptance – Section 73 generally prohibits companies from inviting, accepting, or renewing deposits from the public except in accordance with the prescribed legal framework.

2. Eligibility of Companies – Certain public companies meeting prescribed net-worth or turnover requirements may accept deposits from persons other than members, subject to the conditions under Section 76 and the applicable rules.

3. General Meeting Approval – Companies accepting deposits from members are required to comply with prescribed approval and disclosure requirements, including the passing of an appropriate resolution.

4. Credit Rating – Companies permitted to accept deposits from the public are required to obtain a credit rating from a recognised credit rating agency, subject to the applicable provisions. The rating provides information regarding the company's financial strength and ability to repay deposits.

5. Security for Deposits – Where deposits are secured, the company is required to create the prescribed charge on its assets in favour of deposit holders. Deposits that are unsecured or only partially secured must be appropriately identified as such.

6. Deposit Repayment Reserve – Companies accepting deposits are subject to requirements relating to maintaining a deposit repayment reserve, intended to provide funds for repayment of deposits becoming due.

7. Disclosure and Compliance – Companies are required to provide prescribed information to depositors and comply with reporting, documentation, and other statutory requirements.

Risks of Public Deposits

For the Company:

◊ The company has a fixed repayment obligation, irrespective of whether it earns sufficient profit.

◊ Failure to repay deposits or interest on time can create financial and legal difficulties.

◊ Excessive dependence on deposits can increase the company's financial risk and repayment burden.

◊ A decline in liquidity may make it difficult for the company to meet deposits when they mature.

For Depositors:

◊ The major risk is default by the company in repayment of principal or interest.

◊ Unsecured deposits do not have specific assets backing them, increasing the risk of loss if the company faces serious financial difficulties.

- ◊ The financial position and creditworthiness of the company may deteriorate during the deposit period.
- ◊ Depositors may also face liquidity risk, as the funds are generally committed for a specified period.

Public deposits can provide companies with a useful source of finance and can offer investors an interest-bearing investment opportunity. However, because they create repayment obligations for companies and expose depositors to credit risk, their acceptance and use are subject to regulatory safeguards under Indian company law.

2.1.3 Internal Financing

A business can raise money from both internal and external sources. An established business may raise money from both internal and external sources to meet its financial needs, but a new business is only permitted to raise money from external sources like shares, debentures, and loans. In contrast to other forms of funding, internal financing is another significant source of funding and includes the cost of capital.

Internal source of finance may be broadly classified into two categories:

a. Depreciation Funds

b. Retained earnings

2.1.4 External Financing

External financing refers to funds obtained from sources outside the business. It may include equity shares, preference shares, debentures, bonds, bank loans, public deposits, and other forms of borrowed finance. External financing enables a firm to raise substantial funds for expansion, acquisition of assets, working capital, and other major financial requirements. However, it may involve interest and repayment obligations in the case of debt or dilution of ownership and control in the case of new equity.

Differences Between Internal and External Financing

Both internal and external financing sources are not similar in nature. Following are the key differences between the internal and external sourcing of finance for a firm.

Table 1 Internal Financing Vs External Financing

Internal Financing	External Financing
Funds are generated from within the business.	Funds are obtained from outside the business.
Major sources include retained earnings, depreciation provisions, and sale of surplus assets.	Major sources include equity shares, preference shares, debentures, bonds, bank loans, and public deposits.

Generally does not create a fixed repayment obligation.	Debt financing generally creates interest and repayment obligations.
Does not normally result in dilution of ownership or control.	External equity financing may result in dilution of ownership and control.
Availability depends mainly on the profitability and internal resources of the firm.	Can provide access to larger amounts of capital from external investors and lenders.
Generally involves lower financial risk.	Debt-based external financing can involve higher financial risk due to fixed financial obligations.
Funds can generally be used with greater flexibility.	Use of funds may be subject to conditions imposed by lenders or investors.
It helps the firm maintain financial independence.	It can increase the firm's dependence on external investors or creditors.

Case Study -Choosing the Appropriate Source of Finance

Aroma Manufacturing Ltd**.** is planning to expand its production capacity by establishing a new manufacturing facility. The total cost of the proposed project is estimated at ₹100 crore.

The Finance Manager is considering three sources of finance - internal finance, debt and equity - and has gathered the following information:

- ◊ The company has ₹30 crore of retained earnings available for investment.
- ◊ A bank is willing to provide a term loan of up to ₹60 crore at an interest rate of 9% per annum.
- ◊ The company can raise the remaining funds through equity shares by issuing new shares to investors.
- ◊ The company currently has ₹40 crore of existing debt, and its annual cash flows are stable.
- ◊ Existing shareholders are concerned about the dilution of their ownership and voting control if new equity shares are issued.
- ◊ The Finance Manager wants to maintain adequate liquidity to meet the company's working-capital requirements.

Additional Information

- ◊ The company expects the new project to generate sufficient operating cash flows after commencement.
- ◊ Interest on debt is tax-deductible, subject to applicable tax provisions.
- ◊ The Finance Manager wants to avoid both excessive financial risk and unnecessary dilution of existing ownership and control.
- ◊ The company must retain an adequate cash reserve to meet its working-capital and other short-term financial requirements.

Question

As the Finance Manager of Aroma Manufacturing Ltd., decide the appropriate capital structure for financing the ₹100 crore project.

Determine the amount to be raised through:

1. Internal finance (retained earnings)
2. Debt finance
3. Equity finance

Justify your proposed financing mix by considering the following factors:

- ◊ Cost of finance
- ◊ Financial risk
- ◊ Existing level of debt
- ◊ Interest and repayment obligations
- ◊ Ownership and voting control
- ◊ Liquidity and cash-flow requirements
- ◊ Tax implications
- ◊ Financial flexibility

Explain why your proposed combination of internal finance, debt and equity is appropriate for Aroma Manufacturing Ltd.

Summarised Overview

This unit provides an overview of the major sources of finance available to a firm and examines their suitability for meeting different financial requirements. It begins with the classification of sources of finance into long-term, medium-term, and short-term finance based on the period for which funds are required and their intended use. The unit then examines equity shares, focusing on their key features, advantages, and limitations as a source of permanent capital. It also discusses preference shares, including their major types and distinctive features. The unit further covers debentures and bonds, explaining their types, important features, and the major differences between the two as instruments of borrowed capital. Retained earnings are examined as an important internal source of finance, with emphasis on their meaning, benefits, and limitations. The unit also introduces public deposits, including their features, regulatory requirements, and associated risks. Finally, the unit distinguishes between internal and external financing, highlighting their basic differences in terms of sources, cost, risk, ownership, control, and repayment obligations. Overall, the unit enables an understanding of how firms can evaluate and select appropriate sources of finance according to their financial requirements, cost considerations, risk, and long-term objectives.

Self-Assessment Question

1. What is meant by long-term sources of finance?
2. What are Equity Shares?
3. Mention any two features of Equity Shares.
4. What are Preference Shares?
5. Name any four types of Preference Shares.
6. What is a Debenture?
7. State any two differences between Debentures and Bonds.
8. What is meant by Retained Earnings?
9. What are Public Deposits?
10. Differentiate between Internal Financing and External Financing.

Assignments

1. Describe how long-term, medium-term, and short-term sources of funding are categorized. Talk about each source's suitability for a company's various financial needs.
2. Examine the characteristics, benefits, and drawbacks of preference and equity shares as corporate funding sources.
3. Describe the various kinds and characteristics of bonds and debentures. Examine the key distinctions between bonds and debentures as long-term financing options.
4. Discuss retained earnings and public deposits as sources of finance. Analyse their benefits, limitations, regulatory requirements, and risks to the firm.
5. Distinguish between internal and external financing. Analyse the factors that a firm should consider while choosing between internally generated funds and external sources of finance.

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Space for Learner Engagement for Objective Questions

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Unit 2

Institutional and Alternative Sources of Finance

Learning Outcomes

After completing this unit, learners will be able to:

- ◊ describe the nature, characteristics and uses of institutional borrowings
- ◊ distinguish between financial leasing and operating leasing and evaluate their advantages and limitations
- ◊ explain venture capital, its stages of financing, major features and contribution to start-ups
- ◊ describe commercial paper, including its features, eligibility considerations and benefits
- ◊ explain factoring and forfaiting and distinguish between the two forms of receivables financing
- ◊ discuss recent developments such as crowdfunding and fintech-based funding models

Background

As businesses grow and their operations become more complex, their financial requirements become increasingly diverse. Finance is needed not only to establish a business but also to acquire assets, meet working-capital requirements, expand operations, adopt new technologies, enter new markets and respond to changing business conditions. Traditional sources of finance may not always be sufficient or suitable to meet all these requirements because businesses differ in their size, financial strength, risk profile, cash-flow position and stage of development. For instance, a start-up may require risk capital to develop an innovative product or establish its market presence without the burden of immediate repayment, whereas an established company may require flexible and timely finance to

manage working-capital needs or undertake expansion. Similarly, businesses with limited collateral or short operating histories may face difficulties in obtaining conventional bank finance. Therefore, enterprises need to consider a wider range of financing options that can match the nature, purpose and duration of their financial requirements. Institutional and alternative sources of finance provide such options by enabling businesses to access funds through financial institutions, specialised investors, capital-market instruments, digital platforms and other innovative financing arrangements. The availability of these sources allows firms to select financing that is appropriate to their financial capacity, risk-bearing ability and stage of development.

A sound financing decision requires attention to the amount required, period of finance, cost of funds, repayment obligations, collateral requirements, risk exposure, effect on ownership and control, and the firm's ability to generate future cash flows.

Keywords

Institutional Finance; Commercial Banks; Development Financial Institutions; Term Loan; Working Capital Finance; Lease Financing; Financial Lease; Operating Lease; Venture Capital; Seed Funding; Commercial Paper; Factoring; Forfaiting; Receivables Financing; Crowdfunding; Fintech; Peer-to-Peer Lending; Digital Finance

Discussion

2.2.1 Institutional and Alternative Sources of Finance

Institutional sources of finance are funds provided through organised and regulated financial institutions such as commercial banks, development financial institutions and other recognised financial intermediaries. These institutions assess the borrower's creditworthiness, financial position, repayment capacity and security before providing finance. Institutional finance is commonly used for working capital, fixed assets, expansion and other business requirements.

Alternative sources of finance are financing methods that provide businesses with options beyond conventional bank borrowing and traditional share issues. They include venture capital, private equity, angel investment, crowdfunding, peer-to-peer lending, fintech-based finance, factoring, invoice discounting and other specialised arrangements.

These sources can be particularly useful for start-ups, innovative businesses, firms with limited collateral and businesses seeking flexible or technology-enabled funding.

Institutional and Alternative Sources of Finance

A. Institutional Sources of Finance

Institutional sources are provided by specialised financial institutions established to support business, industrial and developmental activities.

a. Commercial Banks – Provide term loans, working-capital finance, cash credit, overdrafts and other credit facilities.

b. Development Financial Institutions (DFIs) – Provide long-term finance for industrial, infrastructure and developmental projects.

c. NBFCs (Non-Banking Financial Companies) – Provide business loans, equipment finance, vehicle finance and other specialised credit facilities.

d. EXIM Bank – Provides financial assistance and support for international trade and export-import activities.

e. SIDBI – Supports micro, small and medium enterprises (MSMEs) through finance and development-oriented services.

f. NABARD – Provides finance and development support for agriculture and rural development.

g. Insurance Companies and Pension Funds – Invest long-term funds in bonds and other securities, thereby providing finance indirectly.

h. Mutual Funds and Investment Institutions – Invest in corporate debt and equity instruments, providing funds to businesses indirectly.

B. Alternative Sources of Finance

Alternative sources provide financing options beyond conventional bank loans and traditional share issues. They have become increasingly important with the growth of start-ups, digital financial markets and financial technology.

a. Venture Capital – Provides growth capital to start-ups and high-growth businesses, generally in exchange for an ownership stake.

b. Private Equity – Invests in companies with growth, expansion or restructuring potential, generally in return for equity ownership.

c. Angel Investors – Provide capital to early-stage businesses, often along with business knowledge, mentoring and professional networks.

d. Crowdfunding – Raises relatively small amounts from a large number of individuals or institutions, usually through online platforms.

e. Peer-to-Peer (P2P) Lending – Uses digital platforms to connect borrowers with individual or institutional lenders, subject to applicable regulation.

f. Fintech-based Financing – Uses technology, digital processes and alternative data to provide or facilitate business finance.

g. Leasing – Provides the right to use an asset for a specified period in return for periodic payments.

h. Factoring – Provides earlier access to cash by assigning or transferring eligible receivables to a factor.

i. Trade Credit – Allows a business to obtain goods or services from suppliers and pay at a later date.

j. Invoice Discounting – Provides finance against outstanding invoices while the business generally continues to manage the receivables.

k. Bootstrapping – Finances a business mainly through the promoter's own resources and internally generated cash flows, particularly during the start-up stage.

Institutional and alternative sources both widen the external financing choices available to enterprises. Institutional finance is generally channelled through recognised financial intermediaries, whereas alternative finance includes specialised investment arrangements and technology-enabled models that may offer different forms of risk sharing, repayment structures or access mechanisms.

The major sources covered in this unit are:

◊ Institutional borrowings from banks and development-oriented financial institutions.

◊ Venture capital for high-growth and innovative businesses with significant growth potential.

◊ Commercial paper as a short-term market instrument for eligible creditworthy issuers.

◊ Factoring and forfaiting for converting trade receivables into more immediate cash.

◊ Crowdfunding and fintech-based models that use digital platforms to connect businesses or projects with fund providers.

The suitability of each source differs. Long-term fixed assets may be financed through term loans or leases; rapidly growing start-ups may seek venture capital; short-term liquidity needs of strong companies may be supported through commercial paper; and receivables can be monetised through factoring or forfaiting.

2.2.2 Institutional Borrowings

Institutional borrowing refers to funds raised by a business from recognised financial institutions, mainly commercial banks and development-oriented financial institutions. Borrowing may be short term, medium term or long term depending on the purpose

of finance. Common forms include term loans, working-capital facilities, cash credit, overdrafts, bill finance and specialised project or equipment finance.

A loan creates a contractual obligation to repay principal and finance cost according to agreed terms. Therefore, institutional borrowing is especially appropriate when the enterprise has reasonably predictable cash flows and can service the debt without excessive financial strain.

Major Characteristics

- ◊ A definite financing arrangement exists between the borrower and the financial institution.
- ◊ Interest or another agreed financing charge is payable for the use of funds.
- ◊ Repayment is generally scheduled over an agreed period.
- ◊ The lender normally evaluates creditworthiness, cash flows, business prospects and security before sanctioning finance.
- ◊ Loans may be secured by collateral or may be extended on the basis of the borrower's credit strength and applicable lending norms.
- ◊ Borrowing does not normally dilute the ownership rights of existing shareholders, although it increases financial obligations.

Common Forms of Institutional Borrowing

a. **Term loans:** Medium- or long-term loans used for fixed assets, expansion, modernisation and capital expenditure.

b. **Working-capital finance:** Short-term facilities used to finance inventories, receivables and day-to-day operating requirements.

c. **Cash credit:** A working-capital facility allowing eligible borrowers to draw funds within an approved limit, subject to agreed conditions.

d. **Overdraft:** A facility allowing withdrawal beyond the balance available in an account up to a sanctioned limit.

e. **Bill or invoice finance:** Finance provided against eligible trade bills or invoices to improve liquidity.

f. **Project finance:** Finance structured around the cash-generating capacity and risks of a specific project.

Factors Considered Before Lending

Financial institutions normally assess the borrower's repayment capacity, financial statements, existing liabilities, cash-flow position, business prospects, management quality, industry conditions, purpose of borrowing, security available and compliance with applicable requirements. Credit assessment is intended to reduce default risk and ensure that the proposed debt is consistent with the firm's ability to repay.

Advantages

- ◊ Access to relatively large amounts of finance for eligible borrowers.
- ◊ Structured repayment schedules can make financial planning easier.
- ◊ Debt generally does not transfer ownership or voting rights to the lender.
- ◊ Different facilities can be matched to working-capital and investment requirements.
- ◊ Established institutional relationships may improve access to additional financial services.

Limitations

- ◊ Interest and repayment obligations continue even when business performance is weak.
- ◊ Security, guarantees, documentation or financial covenants may be required.
- ◊ Credit assessment and approval can take time.
- ◊ Excessive borrowing increases financial leverage and the risk of financial distress.
- ◊ Loan conditions may restrict certain business decisions.

Role of Financial Institutions

Financial institutions perform an important intermediary role by mobilising savings and directing funds towards productive economic activities. They evaluate borrowers, allocate credit, monitor repayment and provide payment, advisory and other financial services.

Role of Banks

- ◊ Mobilise deposits and transform savings into credit for households and businesses.
- ◊ Provide working-capital and term finance to enterprises.
- ◊ Support domestic and international trade through payment and trade-finance services.
- ◊ Provide guarantees, letters of credit and other contingent finance where appropriate.
- ◊ Offer digital banking and transaction services that improve the speed and convenience of financial operations.
- ◊ Monitor borrowers and assess credit risk, supporting disciplined allocation of financial resources.

Role of Development Financial Institutions

Development financial institutions support sectors, projects or activities that contribute to broader economic and developmental objectives. Their functions may include providing long-term finance, supporting infrastructure and industrial development, encouraging entrepreneurship, facilitating investment and offering technical or advisory support. They are particularly important where projects require long maturities, specialised appraisal or support that may not be fully met by conventional short-term lending.

2.2.3 Lease Financing

Lease financing is an arrangement under which the owner of an asset, called the lessor, gives another party, the lessee, the right to use the asset for an agreed period in return for periodic lease payments. Depending on the structure, ownership may remain with the lessor while the lessee obtains the economic use of the asset.

Leasing can be useful where a business needs equipment, vehicles, technology or other productive assets but prefers to avoid making the entire purchase price immediately. The economic objective is to obtain access to an asset while spreading payments over time.

Parties to a Lease

- ◊ Lessor: the owner or financing party that grants the right to use the asset.
- ◊ Lessee: the party that obtains and uses the asset in return for lease payments.
- ◊ Supplier or manufacturer: the party from whom the asset is sourced, where the lessor purchases the asset for leasing to the lessee.

Types of Lease Financing

Financial Lease

A financial lease is generally a long-term arrangement in which the lessee obtains substantially all of the economic benefits and risks associated with use of the asset, even though legal ownership may remain with the lessor during the lease period.

Operating Lease

An operating lease is generally shorter or more flexible than a financial lease and does not transfer substantially all of the risks and rewards of ownership to the lessee. The lessor may retain significant residual-value risk and may lease the asset again after the lease period.

Key Differences

- ◊ Financial lease: closer to long-term asset financing; operating lease: closer to temporary use of an asset.

- ◊ More of the asset's economic risks and rewards are associated with the lessee under a financial lease.
- ◊ The lessor generally retains greater residual-value exposure in an operating lease.
- ◊ Operating leases can be useful where assets are needed for a shorter period or become technologically obsolete quickly.
- ◊ Accounting treatment depends on the applicable accounting framework and the specific terms of the lease.

Advantages of Lease Financing

- ◊ Reduces the need for a large initial cash outflow.
- ◊ Can improve cash-flow management by spreading payments over the period of use.
- ◊ Can provide access to modern equipment without immediate ownership.
- ◊ Can be useful for assets subject to rapid technological change.
- ◊ Lease structures may be tailored to expected asset use and cash generation.

Disadvantages of Lease Financing

- ◊ Total cost may be higher than outright purchase in some circumstances.
- ◊ The lessee may face restrictions concerning use, maintenance or modification.
- ◊ Long-term lease commitments can reduce financial flexibility.
- ◊ Ownership benefits may not accrue to the lessee during the lease period.
- ◊ Early termination can involve additional costs depending on contractual terms.

2.2.4 Venture Capital

Venture capital is equity or equity-linked investment provided to businesses that have significant growth potential but also relatively high uncertainty and risk. It is particularly associated with innovative start-ups and emerging businesses whose future value is expected to increase as they develop products, customers and market presence.

Unlike a conventional loan, venture capital does not primarily depend on scheduled repayment of principal and interest. The investor generally seeks a return through appreciation in the value of the investment and may participate in strategic decisions, subject to the investment agreement.

Stages of Venture Capital Financing

1. Seed stage: developing an idea, prototype, initial product or proof of concept.

2. Startup stage: product development, market testing, initial hiring and commercial launch.
3. Early growth stage: increasing production, marketing, distribution and customer acquisition.
4. Expansion or growth stage: scaling into larger markets, additional capacity or new products.
5. Later stage: restructuring, pre-IPO development or preparation for an exit.

Features

- ◊ Equity-oriented financing rather than conventional secured debt.
- ◊ High-risk and potentially high-return investment.
- ◊ Focus on growth potential, innovation, scalability and management capability.
- ◊ Investor involvement may include mentoring, governance and strategic guidance.
- ◊ Investment is generally made with an expected exit through sale of shares, merger, acquisition or public offering.

Role in Start-ups

Venture capital can provide resources to firms that have limited collateral, short operating histories or uncertain early cash flows. Beyond money, venture investors may contribute industry contacts, managerial expertise, recruitment support, market knowledge and credibility. This can accelerate commercialisation and expansion.

Founders should recognise that venture capital involves sharing ownership and potentially some decision-making influence. Agreements should therefore clearly address valuation, governance, future funding, investor rights and exit arrangements.

2.2.5 Commercial Paper

Commercial paper (CP) is a short-term, unsecured money-market instrument issued by eligible and creditworthy entities to raise funds for short-term requirements. It is generally used by financially sound organisations as an alternative to some forms of short-term bank borrowing.

Because commercial paper is generally unsecured, the credit standing of the issuer is particularly important. Investors assess financial strength, liquidity, repayment capacity and market reputation.

Features

- ◊ Short-term source of finance.
- ◊ Normally unsecured, making credit quality important.

- ◊ Usually issued by financially strong and eligible entities.
- ◊ Can provide access to money-market investors.
- ◊ The cost can be competitive for high-quality issuers.
- ◊ Used primarily for short-term funding and liquidity requirements.

Eligibility

Eligibility, issue procedure, minimum credit standards, maturity, denomination, disclosure and other conditions depend on the applicable regulatory framework. In India, commercial paper is governed by the regulatory framework applicable to money-market instruments, and issuers must satisfy conditions prescribed from time to time.

Benefits

- ◊ Diversifies short-term funding sources.
- ◊ May reduce dependence on bank working-capital finance for eligible issuers.
- ◊ Can offer competitive funding costs to strong borrowers.
- ◊ Provides flexibility in managing short-term liquidity needs.
- ◊ Helps established issuers access the broader money market.

Limitations

- ◊ Not suitable for weak or highly risky firms because market acceptance depends on credit quality.
- ◊ Generally short term and therefore unsuitable for financing long-term assets.
- ◊ Refinancing risk may arise when maturing paper must be replaced with new finance.
- ◊ Market conditions can affect availability and cost of issuance.

2.2.6 Factoring

Factoring is a financial service in which a business transfers or assigns eligible trade receivables to a factor to obtain quicker access to cash and, depending on the arrangement, services such as collection and receivables administration. The factor may provide an advance against invoices and subsequently collect amounts from customers.

Factoring improves liquidity because the seller does not have to wait until the normal credit period expires to obtain cash. The allocation of credit risk depends on whether the arrangement is with recourse or without recourse.

Types of Factoring

These types can also be combined in practice. For example, a factoring arrangement

may be both disclosed and without recourse. The most suitable form depends on the seller's liquidity needs, tolerance for credit risk, customer relationships and the cost of the arrangement. Factoring can be classified according to who bears the credit risk, whether the customer is informed about the arrangement and the nature of services provided. The major types are described below.

1. Confidential or undisclosed factoring: The factoring arrangement is not disclosed to the customer, subject to applicable law and contractual terms. The seller may continue to collect payments from customers and remit them to the factor as agreed. Example: A business obtains finance against selected receivables while continuing to communicate with its customers in the usual manner.

2. Disclosed factoring: The customer is informed that the receivable has been assigned or financed by a factor. The customer generally makes payment directly to the factor or as instructed under the agreement. Example: A retailer receives a notice that invoices raised by its supplier have been assigned to a factoring company.

3. Without-recourse factoring: The factor assumes the specified credit risk of customer non-payment, subject to contractual exclusions. Example: An exporter transfers eligible receivables without recourse, so the factor bears the agreed buyer-credit risk if the buyer fails to pay.

4. With-recourse factoring: The seller remains responsible for specified credit losses if the customer fails to pay, subject to the terms of the agreement. Example: A manufacturer assigns ₹10 lakh of invoices to a factor and receives an advance; if an eligible customer defaults, the manufacturer bears the agreed credit risk.

Benefits

- ◊ Can reduce administrative effort in collecting receivables.
- ◊ Can provide finance without relying only on conventional collateral.
- ◊ Supports sales on credit by converting receivables into earlier cash.
- ◊ Can help manage certain customer credit risks.

2.2.7 Forfaiting

Forfaiting is a form of receivables financing, particularly associated with international trade, in which an exporter sells eligible medium- or longer-term trade receivables to a forfaiter, normally on a without-recourse basis. The exporter receives funds earlier while the forfaiter obtains the right to receive future payments.

Forfaiting is useful where export transactions involve deferred payment terms and the exporter wants to remove specified payment risk and improve immediate liquidity.

Factoring and Forfaiting: Comparison

- ◊ Factoring is widely used for recurring trade receivables; forfaiting commonly

focuses on individual export transactions with deferred payment.

- ◊ Factoring is generally short term; forfaiting can cover medium- or longer-term receivables.
- ◊ Factoring may be domestic or international; forfaiting is strongly associated with international trade.
- ◊ Factoring can be with or without recourse; forfaiting is commonly structured without recourse.
- ◊ Factoring often covers a portfolio of invoices; forfaiting commonly focuses on specific eligible export receivables or payment instruments.
- ◊ Factoring may include collection and receivables administration; forfaiting is primarily focused on financing and transfer of specified receivables.

Crowdfunding

Crowdfunding is a method of raising funds from a large number of individuals or institutions, usually through an online platform. Instead of relying on one major financier, a business, project or creator may receive relatively small contributions from many participants.

- ◊ Donation-based crowdfunding: contributors provide funds without expecting a financial return.
- ◊ Reward-based crowdfunding: contributors receive a product, service or other non-financial benefit.
- ◊ Equity crowdfunding: investors receive an ownership interest, subject to the applicable legal framework.
- ◊ Debt or lending-based crowdfunding: funds are provided as loans with an expectation of repayment and, where applicable, a return.

Potential Advantages

- ◊ Broadens access to potential fund providers.
- ◊ May help entrepreneurs validate market interest before large-scale production.
- ◊ Can combine fundraising with marketing and community building.
- ◊ Provides an alternative when conventional financing is difficult to obtain.

Potential Limitations

- ◊ Fundraising success is uncertain and depends on campaign quality and public interest.
- ◊ Platforms may charge fees and impose eligibility requirements.

◊ Public disclosure of a business idea can create competitive or intellectual-property concerns.

◊ Fraud, information asymmetry and investor-protection issues require strong regulation and due diligence.

Recent Examples of Crowdfunding

1. India – Deepu Mallesh, Indian speed climber

Deepu Mallesh has used crowdfunding and community support to help finance international climbing competitions. His experience illustrates how crowdfunding can support talented individuals when conventional sponsorship is limited.

2. Creative and innovative projects

Creators and entrepreneurs can use crowdfunding to raise funds for new products, films, games, artistic projects and other innovative ideas, while also testing public interest.

3. Medical crowdfunding

Platforms such as Milaap and Ketto host campaigns in which individuals raise funds from the public for medical treatment and related expenses.

4. Social and charitable causes

Crowdfunding is also used to support education, community welfare, disaster relief, animal welfare and charitable initiatives.

5. Sports and education

Athletes and students may use online fundraising to meet competition, training, education or other development-related expenses.

Fintech-Based Funding Models

Fintech refers to the use of technology to deliver, improve or redesign financial services. In business finance, fintech platforms can use digital onboarding, electronic documentation, automated credit assessment, transaction data and alternative data sources to speed up financing decisions.

◊ Digital lending: online platforms facilitate credit applications, assessment and disbursement.

◊ Peer-to-peer lending: platforms connect borrowers and lenders, subject to applicable regulation.

◊ Invoice financing platforms: businesses obtain finance against eligible invoices or receivables.

- ◊ Supply-chain finance: technology connects buyers, suppliers and financiers to improve working-capital flows.
- ◊ Embedded finance: financing or payment services are integrated into non-financial digital platforms and workflows.
- ◊ Alternative-data credit assessment: transaction and operational data may complement conventional credit information, subject to legal and privacy requirements.

Benefits

- ◊ Faster application and processing in suitable cases.
- ◊ Greater convenience through digital interfaces.
- ◊ Potentially wider access for smaller businesses with limited conventional credit histories.
- ◊ Improved data-driven monitoring and cash-flow visibility.
- ◊ Integration of financing with payments, invoicing and other business processes.

Risks and Challenges

- ◊ Cybersecurity and data-protection risks.
- ◊ Dependence on platform technology and digital infrastructure.
- ◊ Algorithmic or data-quality problems in credit assessment.
- ◊ Regulatory and consumer-protection concerns.
- ◊ Potentially high financing costs or fees for higher-risk borrowers.

Major FinTech Firms in India

FinTech firm | Area of operation | Example of service

PhonePe | Digital payments and financial services | UPI payments, insurance, investments and lending

Razorpay | Business payments and financial infrastructure | Payment gateway, payment links, payouts, business banking and working-capital solutions

Zerodha | Digital investment and brokerage | Online trading, stocks, IPOs, mutual funds, ETFs and bonds

Policybazaar | Digital insurance marketplace | Online comparison and purchase of life, health, motor and other insurance products

CRED | Credit and bill-payment services | Credit-card bill payments, rewards and related financial services

Paytm | Digital payments and merchant services | UPI payments, bill payments, merchant payments and payment solutions

Lendingkart | Digital business lending | Online business loans and technology-enabled credit assessment for MSMEs

Pine Labs | Merchant commerce and payments | Online and in-store payments, payment gateways, merchant solutions and financing-related services

Note: The services listed are illustrative and may change as firms expand or modify their product offerings.

Choosing an Appropriate Source of Finance

No single source is universally best. A finance manager should match the source to the nature of the requirement and the firm's financial capacity.

- ◊ Purpose: match long-term assets with long-term funds and short-term operating needs with suitable short-term finance.
- ◊ Cost: consider interest, fees, discounts, transaction costs and the overall effective cost.
- ◊ Risk: evaluate repayment risk, refinancing risk, interest-rate risk and business volatility.
- ◊ Control: equity-oriented funding may affect ownership and governance, whereas debt normally preserves ownership but creates fixed obligations.
- ◊ Flexibility: examine prepayment, renewal, drawdown and restructuring provisions.
- ◊ Security: consider collateral, guarantees and other lender requirements.
- ◊ Cash-flow capacity: ensure expected operating cash flows can support financing commitments.
- ◊ Speed and accessibility: digital and alternative channels may be useful when timing is important, subject to cost and eligibility.

Summarised Overview

Institutional and alternative sources of finance provide businesses with multiple ways to meet short-term and long-term financial requirements. Institutional borrowing through banks and development financial institutions remains a major source of external finance because it can provide structured funding and a range of financial services. Lease financing allows firms to obtain the use of assets while spreading payments over time.

Venture capital is particularly important for innovative and high-growth start-ups because it combines risk capital with potential managerial and strategic support. Commercial paper is a short-term money-market instrument generally suited to financially strong eligible issuers. Factoring and forfaiting improve liquidity by converting trade receivables into earlier cash, with forfaiting being especially associated with international trade and deferred-payment export transactions.

Recent developments in crowdfunding and fintech-based finance have widened the range of financing channels and increased the role of digital platforms. At the same time, these models create concerns relating to credit risk, cybersecurity, data protection, transparency and investor protection. The central principle is to select finance that is appropriate in amount, maturity, cost, risk and flexibility for the specific business requirement.

Self-Assessment Question

1. Define institutional borrowing and state any four characteristics.
2. Explain the role of commercial banks in business finance.
3. What is lease financing? Distinguish between a financial lease and an operating lease.
4. Define venture capital and explain its major stages.
5. What is commercial paper? State its main features.
6. Define factoring and forfaiting.
7. State four differences between factoring and forfaiting.
8. What is crowdfunding? Explain its major forms.
9. What is fintech-based finance? Give suitable examples.

10. Why should the maturity of finance be matched with the purpose of funds?

Assignments

1. Discuss the role of financial institutions in mobilizing and allocating funds to businesses.
2. Critically evaluate lease financing as an alternative to outright purchase of business assets.
3. Explain the role of venture capital in start-up development and discuss its advantages and limitations.
4. Describe commercial paper as a source of short-term finance and discuss its suitability for different types of businesses.
5. Explain factoring and forfaiting and compare their applications in business finance.
6. Examine how crowdfunding and fintech-based financing are changing access to business finance.

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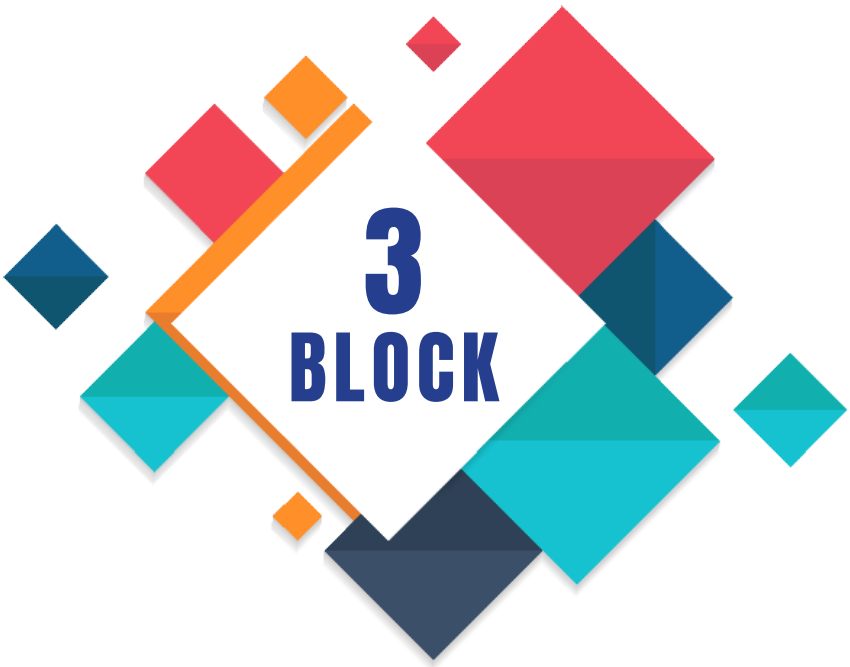


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Investment Decision

Unit 1 Long-Term Investment Decision

Learning Outcomes

After completing this unit, learners will be able to:

- ◊ state the importance of time value of money
- ◊ explain the importance and process of capital budgeting decisions
- ◊ apply capital budgeting techniques to evaluate investment proposals

Background

Imagine that you have ₹30 lakh to invest in a house property with the intention of letting it out. Would you simply choose the property that promises the highest rental income? Probably not. While expected return is an important consideration, you would also examine factors such as risk, safety of the investment, liquidity, investment period and the future cash flows that the property is expected to generate. Thus, choosing an investment involves evaluating several factors rather than looking at return alone.

Businesses face a similar but much more complex investment decision. A company may have several opportunities for committing its funds - for example, purchasing new machinery, acquiring land or a building, expanding production capacity, opening a new branch, replacing an existing plant, or undertaking a new business project. However, the funds available to the business are limited, and these investments generally involve substantial amounts of money that may remain committed for several years. Therefore, management must carefully evaluate factors such as the initial investment, expected future cash flows, project life, risk, time value of money and expected return before deciding whether a particular investment proposal should be accepted or rejected.

Such decisions relating to the evaluation and selection of long-term investment projects or assets are known as capital budgeting decisions. In this unit, we will examine the concept and importance of capital budgeting, estimation of project cash flows, and the major techniques used for evaluating investment proposals and making capital budgeting decisions.



Keywords

Time value of money, Capital budgeting decisions, Pay-back period, Accounting rate of return, Net present value, Profitability index, Capital rationing



Discussion

3.1.1 Investment Decision

Imagine that a company have two possible projects but the company can undertake only two, how would you select them? Would you consider only the amount of investment required, or also the future cash inflows from each project? Suppose Project A requires ₹5 crore and is expected to generate ₹8 crore over five years, while Project B requires ₹5 crore and is expected to generate ₹12 crore. Can we immediately conclude that Project B is better? Why? Would ₹1 crore received today have the same value as ₹1 crore received five years from now? What if Project B generates higher returns but also involves much higher risk? Would that affect your decision? How would you compare projects having different investment amounts, different lives and different patterns of cash flows? Investment decision provides answers to all these questions.

Investment decision deals with identifying the various investment avenues to where funds could be invested based on analysis of the risk return characteristics. The decision helps to channelize the funds in different long term and short-term avenues so as to generate maximum possible return at a certain level of risk.

Similar to individuals investing in different avenues such as gold, property, mutual funds, fixed deposits etc., businesses also need to invest their funds into different projects and assets such as opening a new branch, purchasing own property, machinery, bringing up with new products and so forth.

All business must undertake this decision with due care and concern since an incorrect decision will adversely affects the long term growth and profitability.

The main long term goal of all business organisations would be to achieve maximum

organisational growth, earn profit and gain success. For the purpose of achieving the aforesaid goals, businesses might have to take risky decisions. Project proposals such as opening a new branch, buying a new machinery, purchasing an own property etc. requires substantial amount of money. However a delay in taking decision to invest in the best proposal may cause the available funds to remain idle, resulting in lost opportunities. Due to inflation, it would costs more to the business if the same proposal is to be implemented a year later. This occurs as a result of a concept called time value of money.

3.1.2 Time Value of Money

Assume that your friend, Manu owes you a sum of ₹1,00,000 and that he is postponing the repayment even after your repeated reminders. You could have invested the fund in any investment avenue and could have earned a return if it was received on time. If the return offered is 10%, you would have obtained a sum of ₹10,000 as your returns at the end of the year. However, if Manu repays the amount only after one year, you lose the opportunity to earn that ₹10,000 during the year. Time value of money focuses on this concept which states that a penny received today has more value than that received tomorrow. It is so because, the amount received today could be invested to fetch additional returns.

Let's understand the concept of time value of money using another example. Imagine that you are planning to buy a scooter costing ₹1,00,000. If you postpone your purchase, you would have to pay ₹1,20,000 the next year for the same scooter. This emphasises the fact that you can buy only fewer items in future with the same amount of money that you have today. The concept of time value of money states that the purchasing power of money decreases over a period of time.

Reasons for time value of money

Let's examine the reasons for considering time value of money.

a. Future uncertainties create risk. In the above example, if Manu, who owes you money, becomes bankrupt, it is likely that you will lose the amount. Hence, it is always better to ensure that you receive money at the earliest.

b. People give more priority on spending their money to satisfy their present needs rather than postponing their requirements for future.

c. Any amount that is received today has more value than that received tomorrow since the money that is received today could be reinvested in income generating sources.

Techniques of time value of money

a. Compounding technique

Based on the previous example, assume that your friend Manu, who is now unable to repay your money worth ₹1,00,000 agrees to repay the amount the next year along with

interest at 10%. So, the next year, you will be getting a sum of ₹1,10,000 (additional return of 10% of 1,00,000). Here you are assured of getting more money in the future which will compensate your waiting time of one year. This technique of determining the future value of present sum of money is called compounding technique.

The formula to compute the future value is as follows:

$FV_n = PV_0 (1+i)^n$

Where,

FV_n is the future value of money of period n

PV_0 is the present value of money

i is the interest rate

On applying the equation in the above example, the future value after one year will be:

$FV_1 = 1,00,000 (1+0.10)$

$= ₹1,10,000$

The future value after 5 years will be:

$FV_5 = 1,00,000 (1+0.10)^5$

$= 1,00,000 (1.10)^5$

$= ₹1,61,051$

This implies that, if you invest a sum of ₹1,00,000 today, you will be getting a sum of ₹1,61,051 after 5 years assuming the rate of interest as 10%.

b. Discounting or Present value technique

The technique of determining the present value of future sum of money is called discounting technique. What would you do if Manu, instead of repaying ₹1,00,000 today, makes an offer to pay you ₹1,05,000 the next year? In order to take a decision, you must to compute the present value of the future sum.

The formula to compute present value is as follows:

$$PV = \frac{FV}{(1+i)^n}$$

On applying the equation in the above example assuming that there is 10% as discount rate,

$$PV = \frac{1,05,000}{(1+0.10)^1}$$

$= ₹95,455$

Here, it implies that ₹1,05,000 to be received after one year is worth only ₹95,455 today. Therefore, you can reject the offer made by Manu since you could earn a return of 10% the next year if you invest the amount today.

Understanding of time value of money is essential for businesses especially at the time of taking decisions that have long term implications. Business may use compounding and discounting techniques to compute the present value and future value of cash flows before considering long term financial decisions or capital budgeting decisions. Now let's learn more about capital budgeting.

3.1.3 Capital Budgeting

Decision to invest in project proposals such as opening a new branch, purchasing own property, adding new products to the product line and so forth involves substantial sum of money, hence its impact lasts for long term. Capital budgeting decisions are such long term decisions that involves huge amount of funds and the benefits derived as the outcome of such decisions would last for many years. Since it involves substantial amount of funds, decisions once taken cannot be cancelled or reversed. Capital budgeting decisions involve commitment of funds for meeting capital expenditure requirements. Hence it can also be called as capital expenditure decisions.

Need for capital budgeting

a. Capital budgeting decisions will have an impact on the long term growth and profitability of firms. An incorrect decision would be disastrous and would even affect the survival of firms.

b. Capital budgeting decisions are those that deal with large amount of funds. Hence proper planning and allocation are essential since commitment of funds is made for a long term.

c. It involves investing in long term permanent assets. Any incorrect decision would result in huge loss since disposal of these assets would incur loss to firms. Hence capital budgeting decisions are irreversible.

d. High risk is involved in taking capital budgeting decisions since the decision involves huge fund allocation, and the decisions once taken are irreversible.

e. The benefits derived from capital budgeting decisions are expected to be received over a series of years.

Process of capital budgeting

Capital budgeting is a complex activity as it affects the long term growth and profitability of business. The process involved in capital budgeting are as follow:

a. The first process is to identify all the available investment proposals. The proposals from top management, department heads, workers, and all others who are concerned with the functioning of the business could be considered.

b. The next step is to eliminate the unfeasible proposals through preliminary screening by the expenditure planning committee.

c. All the available proposals obtained after screening shall be evaluated. The risk return characteristics are analysed to identify the best ones.

d. After carefully evaluating the proposals, the proposals must be ranked for fixing priorities. Proposals are ranked in such a way that the most feasible proposal will be ranked one, the next best feasible as rank two and so on.

e. The proposals are then kept aside for the final approval and are included in the capital expenditure budget.

f. After approving the proposal, it must be implemented. Techniques such as PERT and CPM could be deployed while implementing the proposal so as to avoid spending unnecessary costs and time.

g. The actual costs incurred and the budgeted should be compared to conduct a performance review of the decision undertaken. The actual and expected returns are also compared to analyse discrepancies if any and corrective measure could be taken.

Methods of capital budgeting / Project Evaluation Techniques

The financial resources of a business would be limited but there will be n number of investment proposals. Therefore, a proper evaluation of profitability of investment proposals is highly required in order to opt the best proposal from among the available ones. The methods of capital budgeting could be classified into two- traditional methods and time-adjusted methods. We'll look into the various traditional and time adjusted methods under capital budgeting.

a. Traditional methods

Traditional methods are those methods that do not take for consideration the time value of money for evaluating the proposals. The main traditional methods of capital budgeting is as follows:

i. Pay-back period method

Imagine that there are two project proposals, A and B, requiring an investment of ₹10,00,000. Project A is expected to generate return of ₹1,00,000 annually and Project B is expected to generate return of ₹2,00,000 per annum. Which proposal will you choose? It is obvious that you would choose proposal B since it offers more cash inflow annually. By selecting proposal B, you would get back your initial investment of ₹10,00,000 in 5 years (10,00,000/2,00,000). Whereas if you choose project A, it would require 10 years (10,00,000/1,00,000) to get back your initial investment.

Thus the period of time taken to obtain the amount initially invested from its expected cash inflows is called pay-back period. The best proposal for a business would be the one which offers lowest pack-back period. The calculated pay-back period is compared with the pre-determined standard at the time of evaluating a single proposal.

The proposal would be accepted only if the calculated pay-back period is shorter than the pre-determined. This method is also known as pay out method or pay off method.

The formula to calculate pay-back period when the annual cash inflow is even is:

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

The formula to calculate pay-back period when the annual cash inflow is uneven is:

$$\text{Pay-back period} = E + \frac{B}{C}$$

Where,

E is the number of years immediately preceding the year of recovery

B is the balance amount of investment to be received

C is the savings during the final recovery

Illustration 3.1.1

The initial investment required for a project proposal is ₹10,00,000. It is expected to generate inflows as follows:

1st year- ₹2,00,000

2nd year- ₹3,00,000

3rd year-₹4,00,000

4th year- ₹2,00,000

Find out the pay-back period.

$$\text{Pay-back period} = E + \frac{B}{C}$$

$$= 3 + \frac{1,00,000}{2,00,000}$$

= 3 years and 6 months

The proposal requires 3 years and 6 months to recover the initial investment of ₹10,00,000

The pay-back period method helps in saving time and cost since it is easy to calculate. But a major limitation is that it does not consider the time value of money. Also it does not consider the cash inflow after the years of pay-back period.

Accounting Rate of Return method

This method depicts the relationship between net profit after tax and depreciation and total investment made in a proposal. It is also known as average rate of return

method. The formula to compute average rate of return is:

$$\text{Average rate of return} = \frac{\textbf{\textit{Net profit after tax and depreciation}}}{\textbf{\textit{Net investment}}} * 100$$

Under this method, the project proposal offering highest average rate of return would be selected. If there is only a single project, the calculated return is compared to the expected return and the proposal would be accepted if the actual is higher than the expected return.

Illustration 3.1.2

Determine the average rate of return for a project proposal that requires investment of ₹10,00,000. The proposal is expected to generate profits after tax and depreciation as follows- ₹50,000 during the first year, ₹50,000 during the second year, ₹60,000 during the third year, and ₹80,000 during the fourth year.

$$\text{Average rate of return} = \frac{\textbf{\textit{Net profit after tax and depreciation}}}{\textbf{\textit{Net investment}}} * 100$$

$$= \frac{\mathbf{50,000 + 50,000 + 60,000 + 80,000}}{\mathbf{10,00,000}} * 100$$

$$= 24\%$$

The proposal could be accepted if the expected rate of return is less than 24%, and otherwise rejected.

Similar to pay-back period method, the accounting rate of return method is also easy to calculate since the profit after tax and depreciation would be readily available from the book of accounts. But this method also does not consider the time value of money. It does not consider the cash inflow from the investment proposal.

b. Time adjusted method

As mentioned earlier, traditional methods do not consider the time value of money. Time adjusted methods overcome this limitation. Interest factor and return post pay-back period is considered under this method. It is also known as Discounted method. The main discounted methods of capital budgeting are as follows:

i. Net Present Value (NPV) method

The difference between the present value of cash inflow and cash outflow is taken to compute the Net Present Value (NPV). By computing the present value of cash inflow and outflow during the entire life of the proposal, this method takes into consideration the time value of money. Step by step procedure is followed for computing the NPV.

Steps to compute NPV

◊ The initial step to compute NPV is to select an appropriate discount rate. It should be the minimum rate of return expected by the investor

- ◊ Calculate the present value of cash outflow. Cash outflow, in normal case would be the initial investment made for the project proposal
- ◊ Calculate the present value of cash inflows.
- ◊ The difference between the present value of cash inflow and present value of cash outflow would be the NPV of the proposal.
- ◊ The project proposal offering the highest positive NPV could be selected. In the case of single proposal, the proposal could be accepted if the NPV computed is positive, otherwise rejected.

Illustration 3.1.3

Calculate NPV assuming discount rate of 10%.

	Project A	Project B
Initial investment	₹2,00,000	₹2,00,000
Expected life	5	5
Scrap value	₹10,000	₹20,000

Profit before tax and depreciation are:

Year	Project A	Project B
1	₹40,000	₹40,000
2	₹60,000	₹50,000
3	₹80,000	₹50,000
4	₹1,00,000	₹80,000
5	₹1,00,000	₹85,000

Solution:

Computation of NPV of Project A

Year	Cash inflow	PV at 10% (table value)	PV of cash inflow
1	₹40,000	0.909	₹36,360
2	₹60,000	0.826	₹49,560
3	₹80,000	0.751	₹60,080
4	₹1,00,000	0.683	₹68,300
5	₹1,00,000	0.621	₹62,100
5 (scrap value)	₹10,000	0.621	₹6210
			₹2,82,610

PV of all cash inflows	=	₹2,82,610
LessPV of initial investment		₹2,00,000
		₹82,610

Computation of NPV of Project B

Year	Cash inflow	PV at 10% (table value)	PV of cash inflow
1	₹40,000	0.909	₹36,360
2	₹50,000	0.826	₹41,300
3	₹50,000	0.751	₹37,550
4	₹80,000	0.683	₹54,640
5	₹85,000	0.621	₹52,785
5 (scrap value)	₹20,000	0.621	₹12,420
			₹2,35,055

PV of all cash inflows	=	₹2,35,055
LessPV of initial investment		₹2,00,000
		₹35,055

Here, the NPV of Project A is higher than B. Hence Project A should be selected.

The main advantage of NPV method is that it considers the time value of money and also the cash inflow throughout the expected life of the project proposal. But the computation is complex which is a limitation of this method. There is difficulty in determining the discount rate also. Another limitation is that there is difficulty in comparing projects with unequal lives and unequal cash outflow.

ii. Internal Rate of Return (IRR) method

This method was developed by Joel Dean. As per this method, there will be a discount rate where the sum of discounted cash inflow and cash outflow will be the same. Such a rate is called internal rate of return. Since NPV is the difference between the present value of cash inflow and cash outflow, at IRR, the net present value would be 0. The method is otherwise known as yield method, trial and error method, discounted rate of return method etc. This method is also called trial and error method because; unlike in the case of NPV method where discount rate is pre-determined, in IRR method the discount rate is obtained using trial and error. As the discount rate is determined internally, the method is called internal rate of return.

The proposal would be accepted where the computed IRR is greater than or equal to the expected rate in the case of single proposal, and otherwise rejected. In the case of multiple proposals, the proposal offering highest IRR would be selected.

The formula to compute IRR is as follows:

$$\text{IRR} = \text{Lower rate} + \frac{\textit{NPV at lower discount rate}}{\textit{Difference in calculated PV}} * \text{Difference in rate}$$

Illustration 3.1.4

Determine the IRR with the following information.

The initial investment is ₹6,00,000. The expected life of the asset is 4 years.

The expected cash inflow over the years is as follows:

₹1,50,000 for the first year, ₹2,00,000 for the second year, ₹3,00,000 for the third year, ₹2,00,000 for the fourth year

Solution:

Initially we have to compute the present value of cash inflows of all the four years. For this, we arbitrarily assume the discount rate as follows. Let's arbitrarily take 12% as the discount rate.

Year	Cash inflow	PVF at 12%	PV
1	1,50,000	0.892	1,33,800
2	2,00,000	0.797	1,59,400
3	3,00,000	0.711	2,13,300
4	2,00,000	0.635	1,27,000
			6,33,500

Now that we have obtained the present value of cash inflows over 4 years at discount rate of 12%, the next step is to compute the NPV. For that, we deduct the PV of cash outflow from inflow.

NPV= ₹6,33,500 - ₹6,00,000

= ₹33,500

Here we have obtained a positive NPV. So we have to take a higher discount rate than 12% arbitrarily. If the NPV obtained was negative, we would have to select a discount rate which is lower than the current rate. Now let's assume the discount rate as 14% and prepare the cash flow table.

Year	Cash inflow	PVF at 14%	PV
1	1,50,000	0.877	1,31,550
2	2,00,000	0.769	1,53,800
3	3,00,000	0.674	2,02,200
4	2,00,000	0.592	1,18,400
			6,05,950

Again we must calculate the NPV at 14% discount rate.

NPV= ₹6,05,950 - ₹6,00,000

= ₹5,950

Here also the NPV is positive. So again we have to take a higher discount rate than 14% arbitrarily. Now let's assume the discount rate as 15% and prepare the cash flow table.

Year	Cash inflow	PVF at 15%	PV
1	1,50,000	0.869	1,30,350
2	2,00,000	0.756	1,51,200
3	3,00,000	0.657	1,97,100
4	2,00,000	0.571	1,14,200
			5,92,850

Again we must calculate the NPV at 15% discount rate.

NPV = ₹5,92,850 - ₹6,00,000

= - ₹7,150

Here we have received a negative NPV. And it is found that the cash outflow of ₹6,00,000 falls between the 14% discount rate (6,05,950) and 15% discount rate (5,92,850), i.e., between a positive NPV (₹5,950) and negative NPV (- ₹7,150).

Now, we have to apply the formula:

IRR= Lower rate + $\frac{\textbf{\textit{NPV at lower discount rate}}}{\textbf{\textit{Difference in calculated PV}}}$ * Difference in rate

$$= 14\% + \frac{5950}{5950-(-7150)} * 15\% - 14\%$$

$$= 14\% + \frac{5950}{5950 + 7150} * 1\%$$

$$= 14.45\%$$

The IRR obtained is 14.45%. If the expected rate is higher than this, you could reject the proposal, otherwise accept.

The internal rate of return method also considers time value of money. And consider the cash inflow over the entire life of the proposal similar to NPV method. But the calculation of IRR method is very complex since the discount rate is computed using trial and error method. Hence when you have project proposals having different life span, scale of operation, and timing of cash flow, the NPV and IRR method would give contradictory results.

iii. Profitability Index (PI)

Another time discounted method capital budgeting is profitability index method. It is also known as benefit-cost ratio. Similar to other time adjusted method, this method also shows the relationship between the present value of cash inflows and cash outflow. But unlike other methods, this method is a relative measure that expresses the relationship in per rupee or percentage. Therefore NPV would be positive when PI is greater than 1 rupee or 100 percentage and vice-versa. The proposals would be accepted of the value of profitability index is greater than 1 (in rupee) or 100 (in percentage), and otherwise rejected. In the case of multiple proposals, the proposal with higher profitability index would be selected.

The formula to compute profitability index is:

$$PI = \frac{PV\ of\ cash\ inflows}{PV\ of\ cash\ outflow}$$

Illustration 3.1.5

Compute the profitability index with the following information assuming the discount rate to be 12%.

The initial investment is ₹6,00,000. The expected life of the asset is 4 years.

The expected cash inflow over the years is as follows:

₹1,50,000 for the first year, ₹2,00,000 for the second year, ₹3,00,000 for the third year, ₹2,00,000 for the fourth year

Solution:

Initially, we have to compute the present value of cash inflows over the period of 4 years assuming the discount rate as 12%.

Year	Cash inflows	PV factor	PV
1	1,50,000	0.892	1,33,800
2	2,00,000	0.797	1,59,400
3	3,00,000	0.711	2,13,300
4	2,00,000	0.635	1,27,000
			6,33,500

Now let's compute the NPV.

Total present value = 6,33,500

Less

Cash outflow 6,00,000

33,500

The NPV obtained is positive which implies that profitability index would be greater than 1 (in rupee) or 100 (in percentage).

Next, we can calculate the profitability index,

$$PI = \frac{PV\ of\ cash\ inflows}{PV\ of\ cash\ outflow}$$

$$= \frac{6,33,500}{6,00,000}$$

=1.05

The profitability index is 1.05 or 105%. Since the calculated value exceeds 100%, we could accept the proposal.

As profitability index is a relative measure, it is easy to rank projects especially when the project proposals differ in terms of its costs. Since it is also a time adjusted method, it suffers from all the limitations similar to that of other time adjusted methods.

When it comes to capital budgeting, as mentioned before business come across plenty of investment opportunities, but they lack adequate financial resources to invest in all the best proposals. This is where the importance of the concept of capital rationing occurs.

Comparative Table of Capital Budgeting Techniques

Technique	Basic Approach	Time Value of Money?	Cash Flows Considered	Decision Rule		
Payback Period (PBP)	Measures the time required to recover the initial investment	No	Cash flows until investment is recovered	Accept if payback ≤ target period		
Discounted Payback Period (DPP)	Calculates payback using discounted cash flows	Yes	Discounted cash flows until recovery	Accept if DPP ≤ target period		
Accounting Rate of Return (ARR)	Measures average accounting profit as a percentage of investment	No	Accounting profits	Accept if ARR ≥ target ARR		
Net Present Value (NPV)	Compares PV of cash inflows with initial investment	Yes	All relevant project cash flows	Accept if NPV > 0	Directly measures value addition	Requires estimation of cash flows and discount rate
Profitability Index (PI)	Ratio of PV of future cash inflows to initial investment	Yes	All relevant project cash flows	Accept if PI > 1	Useful when capital is limited	Can be less straightforward for mutually exclusive projects
Internal Rate of Return (IRR)	Finds the discount rate at which NPV becomes zero	Yes	All relevant project cash flows	Accept if IRR > required return	Expresses return as a percentage	Can produce multiple IRRs or conflict with

3.1.4 Capital Rationing

A business would have n number of investment opportunities such as introduction of new products, purchasing own property, opening a new branch and so forth. But most of the time, they cannot implement all the proposals due to inadequacy of funds. Such a situation is called capital rationing. In such situations, what should the businesses do?

The business must ration its available funds.

In order to perform capital rationing, business must first rank the proposals by adopting any time adjusted return methods. The business must implement the proposals one by one until the funds are completely exhausted. This is how capital rationing is to be performed.

Thus, in this unit we have dealt with the concept of capital budgeting and all the traditional and time adjusted methods that comes under capital budgeting. In the forthcoming unit, we'll focus on the short term decisions under investing decision or the working capital decisions.

Objectives of Capital Rationing

The following are the main objectives of capital rationing:

a. To ensure effective utilisation of funds in the best project proposals

b. To invest funds in most profitable projects after ranking them based on its profitability

c. To increase the wealth of the shareholders and value of the firm

d. To prevent wastage of funds by eliminating less profitable projects

e. To control risks in investment

Capital rationing converts the capital-budgeting problem into an optimisation problem, where the financial manager must allocate scarce funds among competing invest opportunities while seeking to maximise the firm's value.

Summarised Overview

Investment decision deals with identifying the various investment avenues to where funds could be invested based on analysis of the risk-return characteristics. Time value of money is an important concept to be considered while taking investment decisions. Time value of money concept depicts that a penny received today has more value than that received tomorrow. It lays the foundation for capital budgeting. Capital budgeting decisions involve commitment of funds for meeting capital expenditure requirements. There are two methods to capital budgeting- traditional methods and time-adjusted methods. Traditional methods never consider the time value of money whereas time-adjusted methods consider it. Pay-back period and Accounting rate of return are the methods that come under traditional method. Net present value method, Internal rate of return, and profitability index methods comes under the time adjusted return method. Business will have plenty of investment opportunities, but they lack adequate financial resources to invest in all the best proposals. Business should ration its capital to overcome such a situation.

Self-Assessment Question

1. What is investment decision?
2. Which profit is used to compute the average rate of return?
3. How is profitability index different from net present value method?
4. How will you take accept/reject decision in the case of pay-back period method?
5. What is accounting rate of return?

Assignments

1. A project proposal requires investment of ₹5,00,000 and is expected to generate inflows of ₹1,00,000 during the first year, ₹1,50,000 during the second year, ₹2,00,000 during the third year, and ₹1,00,000 during the fourth year. Find out the pay-back period.

2. Write a short note on the contradiction in result under net present value method and internal rate of return method.

3. Explain the methods under capital budgeting.

4. Differentiate between traditional methods and time adjusted methods.

5. Compute the profitability index with the following information assuming the discount rate to be 12%.The initial investment is ₹60,000. The



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Space for Learner Engagement for Objective Questions

Learners are encouraged to develop objective questions based on the content in the paragraph as a sign of their comprehension of the content. The Learners may reflect on the recap bullets and relate their understanding with the narrative in order to frame objective questions from the given text. The University expects that 1 - 2 questions are developed for each paragraph. The space given below can be used for listing the questions.

Unit 2

Short-Term Investment Decision

Learning Outcomes

After completing this unit, learners will be able to:

- ◊ explain the meaning and objectives of working capital management
- ◊ identify the various sources of working capital
- ◊ analyse the techniques of cash, recievables and inventory management
- ◊ apply working capital management principles to solve relevant problems

Background

Mr. Ram, who runs a grocery business and sells goods both for cash and credit.

What happens if he makes ₹1 lakh in credit sales but fails to collect the money on time? Will he have enough cash to pay his suppliers? If supplier payments are delayed, will suppliers continue to provide goods on credit?

Similarly, what if Ram maintains excessive inventory? His funds may remain unnecessarily blocked in stock. What if he maintains too little inventory? He may lose sales because products are unavailable.

These situations show that sales and profit alone are not sufficient for the smooth functioning of a business. A finance manager must ensure adequate liquidity while avoiding excessive funds being locked in cash, receivables and inventory.

Therefore, the finance manager must address important questions such as:

- ◊ How much cash should be maintained?
- ◊ How much credit should be given and how quickly should receivables be collected?

- ◊ How much inventory should be maintained and when should it be replenished?
- ◊ When and how should suppliers be paid?
- ◊ How can liquidity be maintained without compromising profitability?

These questions form the core of Working Capital Management.

Thus, working capital management is the systematic management of cash, receivables, inventory and short-term liabilities to ensure the smooth continuity of business operations while maintaining an appropriate balance between liquidity, profitability and risk.



Keywords

Working capital, Gross working capital, Net working capital, Accounts receivable, Inventory, Credit policy



Discussion

In the previous unit, we have learnt long-term financial decision-making through capital budgeting, where the focus was on investing in long-term assets.

Therefore, in addition to capital budgeting decisions, firms must make appropriate short-term financial decisions relating to cash, receivables, inventory and short-term liabilities. The systematic management of these short-term financial resources is known as Working Capital Management, which is the focus of this unit.

3.2.1 Working Capital Management

Investments channelised into short term assets or current assets are called working capital. Current assets include cash, accounts receivable, inventory and so forth. These assets keep on revolving or circulating throughout the lifetime of business, i.e., cash gets converted into inventory, inventory gets converted into debtors, and debtors in turn gets converted into cash. This cycle repeats. Hence working capital is also known as circulating capital, revolving capital, or short term capital. Adequate amount of working capital is required to ensure uninterrupted production. Inadequacy of working capital would lead to stoppage of production and adversely affects the smooth conduct

of business. Whereas, over use of working capital would enhance the liquidity but would affect the profitability of business. As the name itself suggest, working capital management is the management of all the components belonging under working capital such as cash, inventory, and receivables.

There are two components to working capital-gross working capital and net working capital. The amount that is invested in all the current assets by a business is termed as gross working capital. And the amount of total current assets after reducing all the current liabilities is called the net working capital.

Gross working capital = Sum of all current assets

Net working capital = Current assets – Current liabilities

Objectives of working capital management

Working capital management is required to meet the daily requirements of an organisation. The key objectives include:

a. Parity between liquidity and profitability

It helps a business to maintain high level of liquidity if it holds more cash balance. But it also deprives the chance of the business to earn returns if such funds were invested in short term investment avenues which adversely affects profitability. Similarly, if the business invests more on short term sources and holds less amount of cash balance, it may affect the ability of business to meet its immediate cash requirements. In such cases, there would be high profitability but low liquidity. To overcome both troubles, maintaining an adequate balance between liquidity and profitability is essential.

b. Procurement of inventory

Working capital is needed to procure inventory in the form of raw materials, spare parts etc.

c. Meeting expenses

Working capital is essential to meet the payment requirements of an organisation such as the payment of rent, salary, wages, interest and so forth.

d. Fulfilment of daily requirements

Working capital is required to meet the daily office requirements and overheads.

e. Offering credit

Credit sales act as an important element to increase the sale of a business. But while offering goods on credit, funds get blocked in the hands of debtors. Adequate working capital is required during that period to meet the day-to day business requirements.

We have studied the concept and objectives of working capital management. But from where does business raise working capital? We'll now examine the different sources of working capital.

Sources of working capital

The following are some of the sources from where working capital could be raised.

a. Factoring- Assume that you run a business which offers goods more for credit sale than on cash basis. What will you do if your credit customers fail to make payment on time? You would face fund shortage. At this situation, you can seek the help of factoring services offered by financial institutions. They will make immediate payment to you and will agree to collect funds from your credit customers in return for a service fee. This process is known as factoring. It helps business to raise funds that can be utilised for meeting day-to-day operations.

b. Trade credit- The credit offered by suppliers of goods to the business is called trade credit. The businesses need not have to make immediate payment for the goods that they have purchased. Postponement of immediate payments thus acts as a source of working capital.

c. Advance payment from customers- Business might have some regular customers who make frequent purchases. Some of them would make their payment in advance for the following month or year. This also acts as a source of working capital as the businesses are getting payment in advance from their customers. Business could use such funds for meeting daily requirements.

d. Commercial paper- Some companies that are financially sound would issue promissory notes to investors. Here investors are not given any collateral as security, and hence it is called as unsecured. It helps in raising short term funds by companies but is risky for the investors since it is an unsecured source of fund.

e. Short term credit from financial institutions- Financial institutions offer short term loans to businesses which have to be repaid within a time span of one year. Financial institutions normally charge an interest while offering such loans. Banks also offer the facilities of bank overdraft, cash credit etc. which also acts as an immediate source of fund.

f. Retained earnings- Retained earnings are usually kept aside by business for meeting its future requirements. But at the time of emergency, retained earnings also act as a source for meeting daily requirements.

g. Bill discounting- The bills received from customers could be discounted with banks. The business need not have to wait till maturity for obtaining payment. At the time of maturity, the bank will collect payment from customers directly.

h. Accrued payments- Some expenses are paid only after they are incurred. Examples of such expenses include rent, salary, wages etc. This also acts as an immediate source of fund.

Apart from the above-mentioned sources, business could also use a part of its long term sources such as equity shares, preference shares, debentures and so forth for meeting its emergency working capital requirements.

As mentioned earlier, working capital includes investment in current assets such as cash, inventory, and receivables. So the management of working capital include the management of cash, management of receivables, and management of inventory. We'll look into each of them in detail.

3.2.2 Management of Cash

Which is the most liquid asset in a business - an asset that can be converted into cash quickly with little or no loss in value?

The answer is cash, because it is already in the form of money and requires no conversion. Suppose you invest 80% of your salary in long-term assets to earn higher returns, leaving very little cash readily available. Suddenly, a medical emergency arises, requiring immediate funds. Since most of your money is locked in long-term investments, you may face a liquidity shortage, isn't it?

This illustrates the importance of maintaining adequate cash and liquid resources to meet unexpected financial needs and contingencies.

Similarly, for any business to maintain liquidity, maintaining sufficient cash is required. Liquid funds are required for meeting expenses such as rent, salary, wages, stationery, and other office expenses. In this context, cash includes cash in hand, cash at bank, and marketable securities. All business tries to attain a proper balance between liquidity and profitability to ensure smooth working capital management.

Motives for holding cash

Businesses hold cash with the following three motives:

a. Transaction motive

For smooth conduct of business, meeting of anticipatory payments is necessary. Anticipatory payments include meeting expenses such as rent, salary, wages, stationery, and other office expenses. To maintain cash for transaction motive, estimation of expected payments and receipts is needed. If the expected payments are greater than receipts, then the business should add more funds as liquid cash and vice versa.

b. Precautionary motive

Keeping aside cash as a buffer for meeting unforeseen future contingencies is called precautionary motive. The amount of funds to be kept aside for this motive depends upon the ability to raise short term funds and also on the cash inflows of business. The funds kept for precautionary motive could be invested in investment avenues that offer high liquidity though the returns might have to be compromised.

c. Speculative motive

Suppose that a supplier gives an offer to a business that the goods would be offered at 50% discount if they purchase the goods in bulk quantities. Here the business should have adequate funds to claim such an offer. The purpose of maintaining cash for taking advantage of such unexpected opportunities are called speculative motive.

These are the main motives why businesses hold cash. Management of cash requires following step by step procedure. Let's try to understand the facets of cash management.

Steps in management of cash

The following are the steps in cash management.

a. Cash planning

"Plan and control the use of cash"- this is something which all of us might have heard since childhood from our elders. Majority of you might have obtained advices to limit your expenses by bifurcating your needs and wants and properly plan while spending.

Similarly, cash planning is an inevitable process in cash management for business. Business should plan their cash inflow and outflow in order to avoid surplus and deficits of cash.

b. Cash forecasting and budgeting

After careful planning of the cash inflow and outflow, it should be summarised in the form of a cash budget.

Along with the preparation of cash budgets, short term and long term forecasting of cash is also important to estimate the short term and long term financial requirements.

Cash forecasting could be done with the help of several methods such as- receipt and disbursement method, and adjusted net income methods. In receipt and disbursement method, all the receipts and payments are estimated to maintain adequate cash balance. This helps to avoid shortage of funds and idle funds. The adjusted net income method takes into account the source and use of funds and ensure that business maintain sufficient cash balance.

c. Managing cash collection and disbursements

Under this step, business tries to speed up the cash collection and postpone the cash payments. This process would help business to maintain sufficient cash balance regularly.

Business uses the following methods to speed up their cash collection:

i. Prompt reminders to credit customers- business must try to receive payment from their credit customers on time. For this, sending of timely reminders, offering cash discount for advance payment and prompt payments etc. could be done.

ii. Reducing float- Decentralisation of collection procedure would help to reduce the processing time taken to convert cheque into cash. It helps to reduce postal float, lethargy float, and bank float, which altogether is known as deposit float.

iii. Concentration banking- it is the process of offering many collection centres rather than a single collection centre. This method also helps to reduce deposit float.

iv. Lock box system- Under this system, customers will be asked to deposit their cheques in a post box. The post box owned by the post office will be taken for hire by business for this purpose and will be operated by a local bank. The local bank will do the processing and credit the amount to the business's account.

Business uses the following methods to postpone their cash payments-

i. Delaying payments till last date

ii. Payments would be made through modes other than cash like cheque, demand draft etc. so that the payments can be postponed. It helps to make use of deposit float.

iii. Postponing of payments is also performed by adjusting the payrolls. Those employees who were paid daily or weekly could be converted as monthly payments.

iv. Limiting the payments to a single point through centralisation would also help to decelerate cash payments

d. Determination of optimum cash balance

As mentioned earlier, maintaining a balance between liquidity and profitability is vital. Determining of an optimum cash balance suitable for business is required for establishing parity between liquidity and profitability.

Two approaches to determine optimum cash balance are- cash budget and the usage of minimising cash models. The preparation of cash budgets deals with creating a summary statement of the probable cash receipts and cash disbursements of the business over a year. It helps to maintain optimum cash balance by avoiding shortage and surplus of funds.

Optimum cash balance could be determined by using the following models:

i. Baumol's model- This is a model developed by Willian J Baumol. This model states that cash balance should be maintained similar to that of an inventory model. Similar to Economic Ordering Quantity model in inventory management, according to this model the optimum balance will be the balance at which the total of cash holding cost and transaction cost are minimum.

The formula to compute optimum cash balance under this model is:

$$C = \sqrt{\frac{2A * F}{O}}$$

Where,

C is the optimum cash balance

A is annual/monthly cash disbursement

F is the fixed cost for each transaction

O is the opportunity cost for holding cash

The major limitation of this model is that it assumes certainty in the size and timing of cash flows.

ii. Miller and Orr model- This model is also known as stochastic or irregular model. This model is based on two control limits and a return point. If the cash balance of the business rises and touch the upper limit, the excess cash must be invested in marketable securities so that the balance will touch the return point. And if the cash balance of the business falls and touch the lower limit, the investments in marketable securities must be sold so that the balance will again reach the return point. Here the upper limit and lower limit depends upon the transaction cost, the interest rates and the standard deviation of net cash flow. The difference between both limits is called spread. The formula to compute the spread is

$$Z = \left(\frac{3}{4} * \frac{Transaction\ cost * variance\ of\ cash\ flow^{\frac{1}{3}}}{interest\ rate}\right)$$

Where,

Z= spread

$$\text{Return point} = \text{Lower limit} + \frac{Z}{3}$$

Variance of cash flow= standard deviation^2

The advantage of this model is that it does not assume certainty in the size and timing of cash flow.

e. Investment of surplus funds

This is the final step in the process of management of cash. It deals with the parking of surplus funds of business into various return generating short term sources such as treasury bills, commercial papers, certificate of deposits, money market mutual funds and so forth. Investments should be done in such a way that it offers liquidity, profitability and marketability.

These are the important aspects to be considered while a business manages its cash. Now let's move on to the next head, the management of receivables.

3.2.3 Management of Receivables

From the previous discussion you might have gained an understanding of the management of cash. Now let's examine the main component of working capital management, which is the management of receivables.

What do you mean by receivables? In simple terms they are the debtors created

out of credit sale of a business. They owe money to business. It is known as accounts receivables, trade receivables, customer receivables, or book debts. They are considered as a current asset of the business.

Management of receivables deals with the promotion of sales, prompt collection of receivables, and ensuring that the benefits of credit sales exceeds the cost of funding that additional credit. For example, you run a business and conducts a credit sale of Rs. 5,00,000 monthly. Here the amount of credit sale done is blocked in the hands of credit customers. So for meeting you working capital requirements, you might have to depend on short term credit sources. Here proper receivables management will ensure that the benefit created from credit sale exceeds the cost of raising funds from an alternate source. Hence, from this, you might have got an idea that there are some costs involved in managing receivables. Let's now identify the different costs involved in maintaining receivables.

Costs of maintaining receivables

The following are the costs related to maintaining of receivables.

a. Capital cost- As mentioned in the previous example, you must have to pay interest for raising short term credit that are actually blocked in the hands of your credit customers, such additional costs incurred to finance receivables is called capital costs. Funds could be raised from internal sources also, which incur opportunity costs.

b. Collection costs- Business would incur various expenses in connection with their credit sale. They have to ensure that they send frequent reminders to customers of payment dues, or setting up lockbox system, or have to appoint collection agents for timely collection of dues, or offer cash discounts for prompt payments and so forth. All these costs that are related to collection of payment dues are called collection costs.

c. Defaulting costs- this can otherwise be termed as bad debts. There are chances that some debts become bad and companies are forced to write off such debts. Such costs arising from non-payment of dues from credit customers are called defaulting costs.

Apart from the above mentioned costs, there are certain under costs also in connection with the receivables management such as administration cost, production cost, selling cost, delinquency costs and so forth.

Factors affecting the size of receivables

The size of receivables varies from business to business. This difference is due to various factors that affects the size of the receivables. It includes-

a. Amount of credit sales-The size of receivables depends on the amount of credit sales. For some business, majority of its sale would be credit sales whereas it will be very small for some others. The size of receivables increase with increase in credit sales.

b. Credit policy- business that adopts strict credit policy would have fewer receivables than those businesses that offer lenient credit policy.

c. Expansion plans of business- if a business tends to expand further, they might tend to follow a liberal credit policy so as to attract more customers by offering credit sales and vice-versa.

d. Efforts undertaken for collection of receivables- if more efforts are put in for the collection of receivables, the size of receivables could be reduced.

e. Nature of customers- business having credit worthy customers who offers prompt repayment tend to offer more credit sales and thus the size of receivables of such organisations would be more compared to others.

f. Terms of trade- it includes the length of credit and cash discounts allowed to customers. If the length of credit given to customers is more, the size of receivables would also increase and vice-versa.

Dimensions of receivables management

There are three dimensions of receivables management. They are:

a. Setting up of credit policy

Framing up a proper credit policy suitable for the business is very important. Credit policy contain written guidelines stating the terms and conditions of credit sales, the minimum criteria a customer should possess to obtain goods on credit, methods of collecting payment from credit customers, and also the actions to be performed in case of defaults from customers.

Some of the key elements of a credit policy include:

i. Credit standard- it is the minimum criteria a customer should possess to obtain goods on credit. It is also known as quality of trade account.

ii. Credit analysis- it deals with the risk on accounts receivable. It deals with the ability of customers to pay back the debts on the basis of which the customers could be classified as good, bad and marginal accounts.

iii. The methods of collecting payment from credit customers and its procedure

iv. Length of credit period- time allowed for customers within which the credit customers must repay the debt due from them. Some business offers cash discount if customers make payment before the expiry of their credit period as part of accelerating cash collection.

v. Discount period- it is the length of time within which the customers are allowed cash discounts if payment is made within that period. A business following strict credit policy would tend to offer only a shorter discount period, whereas business adopting liberal credit policy would offer more discount period to its customers.

b. Execution of credit policy

Before granting credit to all the customers, the credit worthiness of the customers should be considered. It forms a part of the execution of credit policy. It includes the following-

i. Evaluating the credit worthiness of customers applying for credit. Information about such customers should be collected from all possible sources such as banks, financial statements, trade references etc. to determine their credit worthiness.

ii. After obtaining credit information about customers, credit analysis is to be conducted. It deals with the risk on accounts receivable. It deals with the ability of customers to pay back the debts on the basis of which the customers could be classified as good, bad and marginal accounts.

iii. After comparing the credit worthiness and credit risks of customers from the above steps, credit decision could be taken by the business, i.e., whether to offer goods on credit or not.

iv. Raising funds through factoring- funds that are blocked as a result of credit sale need to be arranged from alternate sources. Factoring acts as a good source of raising such short term funds.

c. Formation and execution of collection policy

Credit policies of businesses vary from one to another. Some business follows a strict credit policy while other follows liberal policies. The terms of credit would be rigid for business which follows strict credit policies. Strict credit policies are characterized by complex credit analysis, strict cash collection mechanism, fewer discount periods, shorter length of credit policies and so forth. Whereas liberal credit policies are characterized by simple credit analysis, lenient cash collection mechanism, more discount period, more length of credit policies and so forth.

Irrespective of the nature of credit policies, all businesses must adopt a few practices as part of its debt collection mechanism. It includes sending frequent reminders to customers, maintaining frequent contact with customers over telephone or through direct visits, seeking the assistance of collection agents and also adopting legal actions against defaulters.

Management of receivables is an inevitable part of management of working capital. It has a direct impact on the liquidity and profitability of businesses. Too much reliance towards receivables is riskier for business since huge amount of funds get tied up as accounts receivable. And too few receivables would reduce the overall sales of businesses thereby affects profitability. Hence business should handle receivables with due care and diligence.

Since we have covered the two main components on working capital management, let's now focus on the next and the last important part of working capital management, which is the management of inventory.

3.2.4 Management of Inventory

It is essential for all business to manage its inventory properly to ensure smooth functioning. The term inventory comprises of raw materials, spare parts, consumables, work in progress, and finished goods. Every business must strive to maintain an optimum quantity of inventory. If there is shortage, it would interrupt the production, and excessive inventory would lead to blockage of funds in inventory, damage of goods that are perishable in nature, excessive storage costs and so forth.

While understanding about the management of cash, we have dealt with the motives of holding cash. Here we shall focus on the motives for holding inventory.

Motives of holding inventory

a. Transaction motive- It deals with holding inventory for the purpose of ensuring smooth and uninterrupted flow of production.

b. Precautionary motive- Suppose that a strike happens in your supply chain and you are unable to procure raw materials for your business. Such a situation would result in stoppage of production if you haven't stored adequate inventory to meet such unforeseen contingencies. Storing inventory to meet such unforeseen contingency is included in precautionary motive.

c. Speculative motive- you might have to purchase bulk quantities to avail trade discounts and offers from suppliers. It would also help to overcome price fluctuations. Thus storing inventory to grab such opportunities is speculative motive.

Now let's examine the different costs or risks related to holding inventory.

Costs/Risks of holding inventory

The following are the costs/risks involved in holding inventory:

a. Capital costs- funds that get blocked in inventory needs to be arranged from internal or external sources. If funds are arranged from internal sources, there will be opportunity costs. And if funds are arranged from external sources, business would incur fixed financial obligation.

b. Storage and handling costs- Goods need to be stored properly in warehouses which would incur storage fees, handling fees, insurance etc.

c. Price decline- there is chances that the market price of inventory may decline due to increased competition, increased supply of the goods, depression and so forth. Here, the price you have paid for purchasing the inventory would be higher than the current market price which occurred as a result of price decline in the market.

d. Risk of obsolescence- technology, customer tastes and preferences etc. are fast changing. It may result in your inventory becoming obsolete in the market.

e. Deterioration in quality- long storage and improper handling of goods can affect the quality of goods. Goods that are of perishable nature cannot be stored for too long.

All these risks must be taken into consideration while managing inventory. Inventory management therefore, refers to managing the procurement, storage, handling and accounting of inventory.

Objectives of inventory management

The following are the objectives of inventory management-

a. It ensures uninterrupted production by offering the supply of inventory on a regular basis

b. It ensures that the business do not over stock inventory thereby saves costs.

c. It ensures that there is no shortage of inventory

d. It helps to offer quality products to customers by reducing the risk of deterioration in the quality of inventory

e. It ensures that the goods are restocked on time and also avoids order duplication

Techniques of inventory management

The following are the main techniques of inventory management.

a. Determination of stock level

Maintaining optimum level of inventory is always required to avoid under stocking and over stocking. The following are the important stock levels that businesses must consider while managing inventory.

i. Minimum level- It is the least quantity the business should always possess. It would lead to stoppage of production if stock falls below this level.

Minimum level = Reorder level – (Normal consumption * normal re-order period)

ii. Reorder level- Businesses place fresh order with the suppliers when the stock reaches this level. It is a level that falls between the minimum and maximum levels.

Reorder level= maximum consumption * maximum reorder period

iii. Maximum level- it is the maximum level of stock that business must maintain at one point of time. Any stock stored beyond this level leads to over stocking.

Maximum level= Reorder level + Reorder quantity – (Minimum consumption * Minimum reorder period)

iv. Danger level- In any situation, the level of stock should never fall beyond this level. Arrangements should be taken to restock the materials to avoid stoppage of production.

Danger level = Average consumption * Maximum reorder period for emergency purchase

v. Average level- it is quantity of stock to be maintained on an average.

Average level = Minimum stock level + $\frac{1}{2}$ Reorder quantity

b. Determination of safety stock

Safety stock is that stock which businesses maintain to use at the time of unanticipated circumstances. The opportunity cost of stock out and the carrying costs must be considered while fixing safety stock. Maintaining safety stock at lower level could reduce the carrying cost but it could incur higher opportunity cost and vice versa. Hence an optimum level must only be maintained.

c. Ordering systems of inventory

Reorder point is affected by factors like economic order quantity, lead time, average consumption rate, nature of consumption etc. Lead time is the time taken between initiating procurement and the delivery of the order. The main three types of ordering systems are economic order quantity system, periodic order system, and perpetual ordering system.

d. Economic Order Quantity (EOQ)

We have already studied Baumol's model of cash management. Economic Order Quantity acted as the base for that model. EOQ is the optimum quantity of stock to be purchased at a given time.

It includes two cost components- ordering costs, and carrying costs. Ordering costs, as the name suggest, is the cost related to ordering the stock such as telephone expense, stationery expenses, postal expenses, transportation expenses etc. Carrying costs includes the cost of storing and holding inventory such as insurance, godown rent etc. At EOQ, the total of ordering costs and carrying costs would be minimum.

The formula to compute EOQ is

$$EOQ = \sqrt{\frac{2A * O}{i}}$$

Where,

A is the annual rupee consumption

O is the cost of placing an order

I is the carrying cost per unit

e. ABC analysis

Under this technique, goods are classified into three groups based upon the extent to which control has to be applied. The classification is as follows:

i. A- Those goods that require most control is classified in this category. The quantity of goods would be small but its value is very high. Hence adequate control over utilisation of such goods is essential to reduce wastage.

ii. C- Those goods that require the least control is classified in this category. The quantity of goods would be large but its value is very less. Hence only limited control needs to be exercised.

iii. B- Those category of goods where the level of control falls between A and C is included under this category. It is because the quantity of this category of goods normally matches its value.

The technique is also known as control by importance and exception or proportional value analysis. This technique is usually applied for controlling raw materials.

f. VED analysis

Under this technique, goods are classified into three groups based upon the importance in production. This technique is usually used in the case of spares. The classification is as follows:

i. V-Goods that fall under this category are called vital goods. Adequate quantity of these goods a must be maintained at all times. Any shortage of vital goods could lead to immediate stoppage of production.

ii. E- Goods that fall under this category are called essential goods. Sufficient quantity of these goods a must be maintained to ensure uninterrupted production. Continuous shortage of these goods for over a week could lead to stoppage of production.

iii. D- Goods that fall under this category are called desirable goods. Fewer quantities of these goods a must only are maintained, since production is not much affected by these goods.

g. Efficiency ratio

Efficiency ratios are commonly known as inventory turnover ratios or stock velocity ratios. It is used to ensure the effective utilisation of inventory. The calculated ratio is compared with the previous year's ratio or with competitor's ratio to determine if the inventory is efficiently utilised or not.

The formula to compute the ratio is:

$$\text{Inventory turnover ratio} = \frac{\textit{Cost of Goods sold}}{\textit{Average inventory}}$$

Or

$$\text{Inventory turnover ratio} = \frac{\textit{Net sales}}{\textit{Average inventory}}$$

Now let's compute the average time required for clearing the stock. That time period is called inventory conversion period. The formula to compute the inventory conversion period is:

$$\text{Inventory conversion period} = \frac{\textit{Days in a year}}{\textit{Inventory turnover ratio}}$$

h. Aging schedule of inventory

It is essential for business to identify the stock that is slow moving. This purpose is served by the aging schedule of inventory. Here, the inventories are classified based on the period of holding.

i. Classification and coding on inventories

Large businesses are likely to offer multiple products. Hence, they would have different kinds and types of inventories. A proper classification and coding of the inventory is essential for easy identification and recording. Inventories could be classified based on its nature or based on its use in the business into different divisions and sub-divisions. Coding involves assigning short names, numbers, or symbols to inventories. It could be done alphabetically or numerically.

j. Preparation of inventory reports

For an effective inventory management, submission of reports regarding the stock position of inventory is essential. Hence it should be done periodically so that the management can take corrective measures if there exist any flaws in managing the inventory.

k. Determination of lead time

Lead time is the time taken between initiating purchase and the delivery of the order. The lower the lead time, the lower is the quantity of stock to be maintained at a given time and vice-versa.

Lead time could be classified into two- administrative lead time and producer's lead time. Administrative lead time is the time taken between initiating a purchase and placing an order. It is connected with the people who handle material procurement. Producer's lead time is the time taken between placing an order and the delivery of the order. It is also called delivery lead time.

l. Perpetual inventory system

Under this system, the process of stock verification would be carried out throughout the year. It is helpful in determining the quantity of stock, value of materials procured, issued and the balance available at store. A systematic record on stock position is maintained under this method. Hence inventory report can be prepared anytime if this system is maintained.

m. Just in Time (JIT) system

It is a system of controlling the inventory which ensures that the stock is readily available as and when required. Establishing a good rapport with suppliers is essential if business follows this technique of inventory management. It was developed in Japan by Toyota Company. This technique ensures the supply of right products at the right time and at the right place and thereby ensures uninterrupted production.

These are the main tools and techniques adopted in management of inventory by businesses. So with this, we have now completed the concept of working capital management decisions. We'll examine the other two important decisions under financial management- financing decision and dividend decision in the forthcoming block.



Summarised Overview

Investments channelized into short term assets or current assets are called working capital. There are two components to working capital-gross working capital and net working capital. The amount that is invested in all the current assets by a business is termed as gross working capital. The management of working capital include the management of cash, management of receivables, and management of inventory. Management of cash ensures a proper balance between liquidity and profitability to ensure smooth working capital management. Business must try to accelerate the collection and decelerate the payments. Management of receivables deals with the promotion of sales, prompt collection of receivables, and ensuring that the benefits of credit sales exceeds the cost of funding that additional credit. The base of receivables management lies on the formulation and execution of credit policy. Inventory management refers to managing the procurement, storage, handling and accounting of inventory. EOQ system, VED analysis, JIT system, ABC analysis, perpetual stock taking etc. are some of the key techniques of managing inventory. These are the main concepts of short term decisions.

Self-Assessment Question

1. Explain the meaning of accounts receivable.
2. What do you mean by management of inventory?
3. Explain the various techniques that come under management of inventory.
4. Briefly explain the models of cash management.
5. What are the main factors that affect the management of receivables?

Assignments

1. What is JIT?
2. What is working capital?
3. Explain the concept of management of receivables.
4. Differentiate between gross working capital and net working capital.
5. Briefly explain the concept of management of cash.

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4
BLOCK

Finance Decision

Unit 1

Capital Structure

Learning Outcomes

After completing this unit, learners will be able to:

- ◊ explain the meaning of capital structure
- ◊ identify the factors influencing an optimum capital structure
- ◊ describe and compare the major theories of capital structure

Background

Suppose a company requires ₹50 lakh to finance a new investment project. It may raise the funds through retained earnings, equity shares, debt, or a combination of these sources. The key financial decision is not merely how much to raise, but what proportion should come from equity and debt. While equity does not involve compulsory interest payments, additional equity may dilute existing ownership and control. Debt may offer tax advantages but creates fixed obligations for interest and principal repayment and can increase financial risk.

The proportion or mix of equity and debt used to finance a firm's long-term capital is known as its capital structure. There is no single debt–equity ratio that is ideal for all firms. The appropriate mix depends on factors such as cost of finance, business and financial risk, taxation, profitability, cash flows, growth opportunities and market conditions. Let us examine the concept of capital structure and its various dimensions in detail in this unit.

Keywords

Capital structure, Optimum capital structure, Net Income approach, Net operating income approach, MM theory, Arbitrage, Intermediate approach

Discussion

4.1.1 Meaning of Finance Decisions

n the previous block, we have dealt with the investment made through capital budgeting decisions. Have you ever thought from where such money for investment is raised? Long term funds can be raised from a wide range of sources such as issue of equity shares, issue of debentures, long term loans from financial institutions, issue of preference shares, use of retained earnings and so forth. How would companies decide from which source to raise funds from? It depends upon the financing decisions taken up by the companies. Financing decisions deals with taking decisions regarding the proportion of debt and equity to be employed in the overall capital of companies. It involves identification of the various sources from where funds could be raised and its proportion. Financing decisions aims to establish parity between risk and return. It can otherwise be said that financing decisions deals with decisions relating to a company's capital structure.

Components of Capital	Company A (IT)	CompanyB(Automobile)	Company C (Diversified)
Equity Share Capital	₹20,000 crore	₹8,000 crore	₹75,000 crore
Debt	₹10,000 crore	₹1,00,000 crore	₹1,50,000 crore
Retained Earnings	₹80,000 crore	₹50,000 crore	₹2,00,000 crore
Total Capital	₹1,10,000 crore	₹1,58,000 crore	₹4,25,000 crore
Predominant Source	Retained Earnings	Debt	Retained Earnings

Before going further, let us compare the capital structure of three major companies operating in different sectors. The table shows that companies do not depend on the same sources of finance in the same proportion. Company A, an IT company, can rely considerably on retained earnings because an IT business generally requires less investment in physical assets compared with capital-intensive industries. Company B, being an automobile company, requires substantial investment in manufacturing facilities, machinery, technology and other fixed assets. Therefore, debt forms a relatively important part of its capital structure. Company C operates on a very large scale across several capital-intensive businesses, and its financing requirements are met through a combination of retained earnings, equity and debt.

The comparison shows that the capital structure of a company differs according to the nature and requirements of its business. There is no single capital structure that is suitable for all companies. The choice between equity, debt and retained earnings is influenced by several factors such as nature of business, size of the company, stability of earnings, cost of finance, financial risk, availability of funds, growth opportunities, tax considerations and the financial policy of the management. Thus, a company should select a suitable combination of different sources of finance according to its own circumstances.

4.1.2 Optimum capital structure

Capital structure refers to the combination of various long-term funds employed in the overall capital of a company. It could be equity share alone, debt funds alone, or mix of equity, and debt, or mix of equity, debt, preference shares, and retained earnings etc. Over dependence on one particular source would become disastrous. Hence it is necessary for all companies to determine its optimum capital structure. Optimum capital structure is the best combination of debt and equity used by a company to finance its business activities. There is no particular proportion of funds which is optimum for all the companies. It varies from one to another depending upon many factors. The following points must be considered while determining optimum capital structure:

a. Cost of capital: Companies must ensure that the cost of funds are lower than the return on investment

b. Tax benefits: Companies must ensure that they take the advantage of tax deduction by using debt adequately in the total capital.

c. Flexibility: A good capital structure would be flexible enough to incorporate changes in the company's financial requirements.

d. Financial Risk: Adequate care should be undertaken not to bear excessive financial and business risk.

e. Control: Dilution of control should be considered while depending on the issue of equity as a source of fund.

As mentioned before, we cannot determine an optimum proportion of debt and equity that applies to all companies. Instead we could fix a range within which the proportion could be maintained. For instance, if the average debt equity mix followed in a particular industry is 1:1, companies falling under the industry would set a range as 0.6:1 and 1.4:1. This means that the company may use debt ranging from ₹0.60 to ₹1.40 for every ₹1 of equity, depending on its financial requirements and other relevant factors. Thus, instead of following one fixed debt–equity ratio, companies may operate within an acceptable range.

4.1.2.1 Factors affecting capital structure

The following factors affect a company's capital structure.

i. Trading on equity- It means the use of debt along with equity in a company's capital. The cost of debt and the expected earning must be considered before deciding the proportion of debt in the total capital.

ii. Expected growth of the firm- More debt could be used if the company is expected to grow further with stable sales.

iii. Size of business- A large company with stable earnings could rely more on debt since it would able to meet its fixed financial obligations compared to a small company with unstable returns.

iv. Cost of capital- In order to minimize the overall cost of capital, funds should be raised from different sources. Cost of debt capital is lower than equity and thereby it helps in lowering the overall cost of capital.

v. Dilution of control- the use of debt should be increased if the company owners fear dilution of control. Reliance on equity leads to dilution of control.

vi. Floatation costs- the cost of raising funds through debt is cheaper than that of equity. Hence firms can take advantage of this cheaper source of fund up to desirable limits.

vii. Risk tolerance- the risk is likely to be higher with increased use of debt. Hence the employment of debt should be based on the ability to bear business risk and financial risk.

viii. Cash inflows- A firm with stable cash inflow would be able to meet its fixed financial obligations promptly. Such firms could take advantage of debt without much risk when compared to firms having unstable cash flows.

ix. Legal requirements- the rules and regulations formulated by government also affects the debt equity mix.

x. Flexibility- Capital structure should be flexible so as to incorporate changes. It should not be rigid.

These are some of the main factors which affect the capital structure of companies. Apart from the above factors, provision for future requirements, requirements of

investors, personal considerations, stage of business life cycle etc. could also be considered while framing the capital structure.

4.1.3 Theories of capital structure

Theories of capital structure explain how the choice between debt and equity and financing influences a firm's overall cost of capital and market values. Different theories offer different perspectives on whether an appropriate mix of debt and equity can maximise firm value and minimise the cost of capital. The major theories of capital structure are discussed below.

4.1.3.1 Net Income Approach

This approach to capital structure was developed by David Durand. It is also known as Fixed k_e theoy. First let's go through the assumptions of this theory-

i. Cost of debt (kd) is lower than the cost of equity (ke)

ii. There are no taxes

iii. There will be no change in the risk perception of investors even if debt is employed

iv. Cost of debt and cost of equity are constant

This theory states that by using more debt in the capital structure, companies could increase its value and reduces the overall cost of capital (ko). According to this theory, capital structure is relevant and it can affect the value of the firm. The argument supporting the theory is that debt, being a cheaper source of fund, if employed could reduce the overall cost of capital and thereby increases the company's value. This is depicted in the figure below.

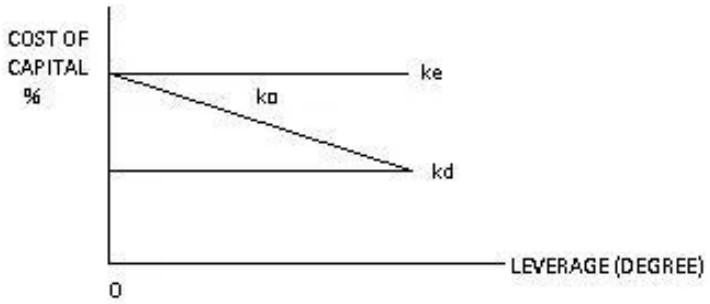


Fig 4.1.1 Net Income Approach

The formula to compute the value of the company and the overall cost of capital is as follows:

Value of the firm = Market value of equity shares+ Market value of debt

$$\text{Overall cost of capital} = \frac{\textit{Earning before Interest and Tax}}{\textit{Value of the firm}}$$

4.1.3.2 Net Operating Income Approach

This approach was also developed by David Durand. The main assumptions are:

i. The net operating income is capitalised by the market using overall cost of capital

ii. Overall cost of capital and cost of debt is constant

iii. There are no corporate taxes

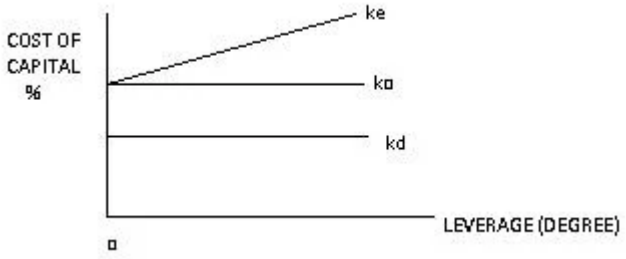


Fig 4.1.2 Net Operating Income Approach

According to this approach, the cost of capital remains constant irrespective of the sources of finance and therefore the value of the company is not affected by its capital structure. Those who favour this approach argue that the financial risk of the company increase with increase in the use of debt. This will increases the cost of equity and the cost of debt remains constant since the increase in the financial risk affects only the equity shareholders and not the lenders of debt funds. Therefore the decrease in overall cost of capital resulting from the use of debt is off-set by the increase in cost of equity and thereby the overall cost of capital and the value of the company is unaffected by the change in capital structure.

The formula to compute the value of the company under this approach is:

$$\text{Value of the firm} = \frac{\textit{Earning before Interest and Tax}}{\textit{Overall cost of capital}}$$

Market value of equity shares= Value of the firm – Market value of debt

4.1.3.3 Traditional approach

This approach was developed by Ezra Solomon. It is also known as intermediate approach since it acts as a balance between the Net Income and the Net Operating Income theories. This theory states that an optimum mix between the employment of debt and equity in the total capital would help to lower the overall cost of capital and increase the value of the company. The theory explains three stages as follows:

i. Increasing value- It is the initial stage. Debt being a cheaper source, by using

more debt in the capital structure, companies could increase its value and reduces the overall cost of capital.

ii. Optimum value- At this stage, the value of the company would be at its maximum and the overall cost of capital would be at its minimum.

iii. Declining value- Here the value of the company starts reducing with additional use of debt as financial risk of the company increase with increase in the use of debt beyond optimum level.

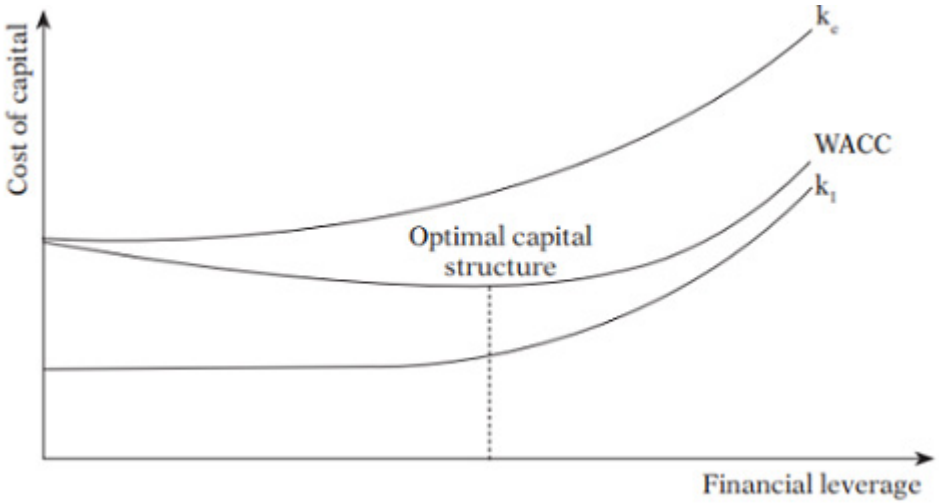


Fig 4.1.3 Traditional Approach

4.1.3.4 MM approach

This approach was developed by Modigliani and Miller, hence the name MM hypothesis. This approach is classified into two:

i. In the absence of tax or Proposition I

In the absence of tax, similar to that of Net Operating Income approach, MM approach also states that the value of the firms falling in the same risk class is not affected by its capital structure. This occurs as a result of arbitration process. Suppose that there are two firms, Firm X and Firm Y having market values of ₹20,00,000 and ₹40,00,000 respectively. These two firms are similar in all aspects. The only difference is in its capital structure. Firm X relies more on equity whereas Firm Y relies more on debt. In which firm will you invest?

According to this approach, if there are two firms identical in all respects except its capital structure having different market value, then investors will engage in arbitrage process by purchasing the shares of company with higher market value and selling the other and thereby restore equilibrium. In the above example, investors would purchase the shares of Firm Y and sell the shares of Firm X until the market value of both become equal.

The theory also states that investors could use personal leverage against corporate leverage. Personal leverage of home-made leverage means the ability of investors to invest in a company using borrowed funds. For instance, in the above example, Firm X is a low debt firm. Here if the investor invest in this firm using borrowed funds, he is said to use if personal leverage.

The following are the assumptions:

- ◊ The capital market is perfect
- ◊ There are no corporate taxes
- ◊ Investors are rational
- ◊ The expected earnings of all companies belong to homogeneous risk class
- ◊ 100 percent payout to shareholders
- ◊ Capitalization rate is the cut-off point of investment.

The formula to compute the value of the firm as per this approach is:

$$\text{Value of the firm} = \frac{\textit{Net Operating Income}}{\textit{Capitalisation rate}}$$

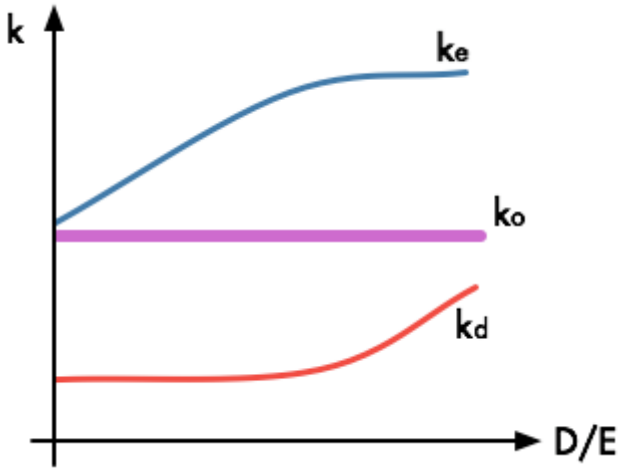


Fig 4.1.4 MM Approach - In the absence of tax

As per this approach, the cost of debt increases when debt is used beyond a limit and cost of equity will fall. It is so because, at extreme situations the debt holders own some of the company's assets and thereby assumes a part of financial risk. Hence cost of debt increases and cost of equity decreases beyond that limit.

ii. In the presence of tax or Proposition II

In the presence of tax, MM approach states that the value of the firm is affected by its capital structure. It is similar to that of Net Income approach. The use of debt, having tax advantage, would help to lower the overall cost of capital and thereby increase the

value of the firm. The formula to compute the value of the firm as per this approach is as follows:

Value of the unlevered firm = $\frac{\textbf{\textit{Earnings before interest and tax}}\ (1 - \textbf{\textit{tax rate}})}{\textbf{\textit{Capitalisation rate}}}$

Value of the levered firm = Value of unlevered firm-Discounted present value of tax savings

MM approach suffers from some criticisms. The unrealistic assumption of a perfect capital market is the first criticism. The next is the difficulty of substituting personal leverage with corporate leverage. Another one is the difference in lending rate and borrowing rate for firms in perfect capital market.

These are the main theories of capital structure. With this, we have completed the next main decision of financial management, the financing decision. The next unit deals with the last scope of financial management, which is the dividend decision.

Table 4.4.1 Theories of Capital Structure

Points of Comparison	Net Income (NI) Approach	Net Operating Income (NOI) Approach	Traditional Approach	Modigliani and Miller (MM) Approach
Basic idea	Capital structure is relevant. A company can increase its total value by using more debt in its capital structure.	Capital structure is irrelevant. The total value of the company does not change with changes in the debt-equity mix.	Capital structure is relevant within certain limits. A proper combination of debt and equity can minimise the overall cost of capital.	Under the basic MM approach without taxes, capital structure is irrelevant, assuming perfect capital markets and other specified conditions.
Cost of Debt (Kd)	Remains constant as the proportion of debt increases.	Remains constant as the proportion of debt increases.	Initially remains constant, but may increase when excessive debt increases financial risk.	Remains constant under the basic assumptions of the theory.
Cost of Equity (Ke)	Remains constant, irrespective of the increase in debt.	Increases as the proportion of debt increases because shareholders face greater financial risk.	Initially remains constant or increases slowly, but rises more rapidly when debt becomes excessive.	Increases with the use of debt to compensate shareholders for the additional financial risk.

Effect of Debt on Firm Value	Firm value increases as the company uses more debt because debt is cheaper than equity.	Firm value remains constant regardless of the debt-equity mix.	Firm value initially increases with debt, reaches an optimum level, and may decrease if debt becomes excessive.	Firm value remains constant regardless of the debt-equity mix under the basic MM assumptions without taxes.
Weighted Average Cost of Capital (WACC)	Decreases as the proportion of debt increases.	Remains constant regardless of the debt-equity mix.	Initially decreases, reaches a minimum at the optimum capital structure, and may increase thereafter.	Remains constant regardless of the debt-equity mix under the basic MM assumptions without taxes.
Relevance of Capital Structure	Relevant - the choice of debt and equity affects the value of the firm.	Irrelevant - the choice of debt and equity does not affect the value of the firm.	Relevant - an optimum combination of debt and equity can maximise firm value.	Irrelevant under the basic assumptions without taxes; relevant when corporate taxes are introduced, because interest on debt provides a tax shield.

Summarised Overview

Financing decisions deals with decisions relating to the capital structure of companies. Capital structure refers to the combination of various long-term funds employed in the overall capital of a company. It is necessary for all companies to determine its optimum capital structure. There is no particular proportion of funds which is optimum for all the companies. It varies from one to another depending upon many factors. Factors such as trading on equity, cost of capital, size of the firm, dilution of control, risk tolerance etc. affect capital structure. There are many theories related to capital structure. Net Income approach states that capital structure is relevant since it can affect the value of the firm. Net operating income contradicts this theory by stating that capital structure is irrelevant. MM approach explains capital structure in two situations- when there is absence of tax, and when there is presence of tax. Traditional approach is a compromise between Net Income and Net Operating Income approach.

Self-Assessment Question

1. Explain traditional approach of capital structure.
2. What are assumptions under Net Income approach?
3. How is the value of the firm computed under Net Operating Income approach?
4. What are the criticisms of MM approach?
5. Explain the different theories of capital structure.

Assignments

1. What is financing decision?
2. Explain MM approach.
3. Briefly explain the factors affecting capital structure of a firm.
4. Compare Net Income approach and Net Operating income approach.
5. What all factors should be considered while determining an optimum capital structure?

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Suggested Reading

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Unit 2

Dividend Decision

Learning Outcomes

After completing this unit, learners will be able to:

- ◊ gain familiarity with the concept of dividend
- ◊ develop an understanding of dividend decision
- ◊ attain knowledge about the different dividend policies
- ◊ learn about the various dividend distribution theories

Background

Ms. Thara, an IT professional receives ₹1,00,000 as monthly salary. She can either spend the whole amount that she receives as salary to meet her needs and wants. Or she can keep aside a portion of her salary and invest it in any source to meet her future requirements and spend the rest. The decision to save and spend depends on her long term financial objectives.

Similarly, businesses also generate profits from its operations every year. The profits so generated could be wholly distributed as returns to the shareholders, or could be kept aside as reserve for future business expansion, or a part could be kept as reserve and the remaining could be distributed as dividend. This decision depends on various factors.

The decision regarding how much of the profit is to be distributed to the shareholders and how much to be retained is called dividend decision. In this unit, we will examine the concept of dividend decision and the various dividend decision theories.

Keywords

Dividend, Dividend decision, Dividend policy, Walter's approach, Gordon's approach, MM approach, Bonus issue

Discussion

4.2.1 Introduction to Dividend Decisions

The final part on the scope of financial management is dividend decision. Why do people invest in equity shares or preference shares of a company? What is the return they could obtain from such investment? Investors expect to get dividend or capital gain while investing in equity shares or preference shares. Company distributes a portion of their profit to the shareholders. That part of profit is known as dividend. Dividend is known to be an appropriation of profit and not a charge against profit. It is so because, a company offers dividend to its shareholders only if there is profit. It is not considered as a fixed financial obligation like interest on debt funds. Hence it is not a charge against profit.

As mentioned in the example, a business can either distribute its profit or it can retain the profit for meeting requirements for its future expansion. Take the example of a company that generates a profit of ₹60,00,000 annually. The company distributes 50% of the profit to its shareholders and retains the remaining as its reserve. If the company continues this practice for n number of years, it could achieve a substantial amount as its reserve which they could use for meeting future requirements. The company also satisfies its shareholders by distributing a portion for them too. Thus dividend decision deals with the decision regarding the amount of profits which are to be distributed as dividend and the amount of profits which are to be retained by the company. Dividend policies are framed based on the dividend decisions of a company. It states how much of the company's profits are to be distributed and how much to be retained in the company.

While investing, what the investors consider is how much of the earnings of the company are distributed as dividend. It could be determined using dividend payout ratio. The formula to compute the dividend payout ratio is as follows:

$$\text{Dividend Payout Ratio} = \frac{\textit{Dividend per share}}{\textit{Earnings per share}}$$

If the dividend payout ratio of a company is 100%, it means that the company distributes all of its earnings as dividend. Hence the retention ratio will be:

Retention ratio = 100- Dividend Payout Ratio

The preference of investors over dividend varies from one to one. Those investors who prefer current dividend would invest in companies offering higher dividend payout ratio. While those investors, who prefer capital gains, would prefer lower dividend payout ratio. Such investors would invest assuming that, by offering a lower payout ratio the earnings are retained with the objective of meeting future growth prospects and thereby the market value of shares would further increase.

Similar to capital structure, the dividend policies adopted by different companies would be different because of various factors affecting dividend policy. Let's examine the factors that affect dividend policies.

4.2.2 Factors affecting dividend policy

The following are some of the factors that affect a dividend policy:

a. Legal restriction- There is certain restrictions imposed by the Companies Act which restricts the distribution of dividend. Companies must consider that aspect while distributing dividend.

b. Pattern of earnings- The stability of earnings affects the dividend payout. A company with stable earnings could offer higher dividend payout ratio when compared to a company having uneven cash inflows.

c. Requirement of investors- shareholders when investing in a company may have varied requirements. Some expects dividend whereas some shareholders expects capital gain. Dividend policy should be framed in such a way so as to satisfy such requirements.

d. Future expansion needs- Companies should keep aside major portion of its profit as reserve rather than distributing as dividend if the company has future expansion and growth requirements to be undertaken.

e. Dilution of control- if a company distributes more as dividend, it might have to raise funds from alternative sources than depending on its retained earnings. The alternative sources could be issue of equity shares which would lead to dilution of control. Hence this factor should also be considered while setting dividend policy.

f. Age of the company- It would be advisable for new companies to retain its profit for future requirements. Whereas companies that have years of experience and goodwill could distribute dividend as it would further enhance the market value of its shares.

g. Nature of industry- Companies belonging to industry having steady demand could opt for higher payout ratio compared to companies that belong to other industries.

h. Economic cycle- companies would opt to retain its profit during economic slowdown when there is depression, inflation etc. It would act as a buffer at the time of emergencies.

These are some of the factors that affect the dividend policies of companies. Apart from the above factors such as taxation policy, stability of dividend, availability of liquid resources, state of capital market, contractual restrictions would also affect the dividend decision.

4.2.2.1 Forms of dividend

The forms of dividend deal with the mode through which dividends are paid. The different forms of dividend are:

a. Cash dividend- the dividends are paid in the form of cash. It is practised by firms having high liquidity.

b. Scrip dividend- At times, companies lack liquid funds and they would prefer to postpone its dividend payment. Under such circumstances, scrip dividend or bond dividends are issued. The bond acts a guarantee for future dividend payments and the investors also get interest on their bonds.

c. Stock dividend- it is also called bonus issue or capitalisation of reserves. This form of dividend is usually used at the time of capital restructuring of companies. Under this form of dividend, the existing shareholders are issues additional shares instead of cash dividend based on the current proportion of shares that they hold. It is a way of converting the company's reserves into share capital and hence it will not affect the total value of the firm.

4.2.3 Types of dividend policy

Investors make investments with the expectation of returns. The return expectation of investors varies from one another. Some prefers to have a fixed amount received on a regular basis, whereas others prefer returns in the long run in the form of capital gains. Based on such expectation, there are different policies. The different types of dividend policy are:

a. Regular dividend policy - As mentioned above, some investors would prefer to get dividend on a regular and continuous basis. Such policies where dividends are paid at usual rates regularly to the investors are called regular dividend policy.

b. Stable dividend policy - Some investors expects to receive a minimum amount on a regular basis. Such policies that offer consistent dividend regularly are called stable dividend policy. It includes:

i. Constant dividend per share- Under this type of dividend policy, a fixed dividend per share is offered to investors irrespective of the earnings of the companies. Such companies usually depend on creating dividend equalisation reserves for meeting their payment obligation.

ii. Constant payout ratio- this dividend policy is based on the earnings of the company, where the investors will be paid a fixed percentage of its earnings. Companies usually prefer this policy whereas investors do not. If there is loss

or lesser earnings, companies could pay dividend accordingly hence it will not affect the liquidity of companies. But it is not much advantageous for investors.

iii. Stable rupee dividend plus extra dividend-under this policy, the company will offer a stable dividend to investors regularly. And the investors are also paid extra dividend in the years where the company earns higher profits.

c. **Irregular dividend policy** - as the name itself suggests, the policy that offers dividend payments on an irregular basis is called irregular dividend policy. Companies with uncertain cash flows and less liquid funds usually rely on this policy.

d. **No dividend policy** - Some investors prefer capital gains over dividend. Such policies where dividends are not issued are called no dividend policy. Companies having future expansion requirements or less liquid funds may rely on this policy.

4.2.4 Dividend models

Different experts have different views on dividend policy. Some experts opine that a dividend decision is relevant and thus it affects the value of the firm. Whereas, some others contradict this point of view by stating the irrelevance of dividend decision. Let's now try to understand the different dividend models.

4.2.4.1 Walter's model

This model was developed by James E Walter. According to this model, dividend decision is relevant and can affect the value of the firm and wealth of shareholders. The main assumptions of this theory are:

i. All financial requirements are met from internal sources of the firm

ii. The internal rate of return (IRR) and the cost of capital are constant

iii. The earnings per share and dividend is constant

iv. Firms either retains or distributes the whole amount of its earnings

v. Firms have perpetual life

Walter's model classified firms as follows on the basis of the relationship between the return on investment (IRR) and the cost of capital.

i. Growth firms- In the case of growth firms, Walter suggested that retaining the earnings would help to increase the market value of the firms since the rate of return of such firms are greater than the cost of capital. Hence he advocated for 0% dividend payout for such firms. It is based on the assumption that shareholders could earn more returns by retaining the earnings within the company itself rather than claiming dividend and investing it in external sources that offer lesser returns.

For example, suppose:

- ◊ Rate of return on retained earnings (r) = 18%
- ◊ Cost of equity (Ke) = 12%

Here,

$$r > K_e$$

The company can earn 18% by reinvesting retained earnings, while shareholders require only 12%. Therefore, it is beneficial for the company to retain a larger portion of its earnings rather than distribute them as dividends.

ii. Normal firms- The rate of return and the cost of capital is the same in the case of normal firms. Such firms could either distribute the whole amount of earnings as dividend or could retain the whole. It is so because, the shareholder would obtain the same rate of return as offered by the firm even if they invest it in external sources. Hence such firms could opt for 100% or 0% dividend payout ratio as it will not affect the market value of the firm.

For example:

- ◊ Rate of return (r) = 12%
- ◊ Cost of equity (Ke) = 12%

Here,

$$r = K_e$$

If the company retains ₹4 and invests it at 12%, it earns:

$$₹4 \times 12\% = ₹0.48$$

The shareholders also require a return of 12%. Therefore, the return earned by the company on retained earnings is exactly equal to the return expected by shareholders.

In this situation, retaining earnings or distributing them as dividends does not affect the value of the firm according to Walter's Model.

iii. Declining firms- In the case of declining firms, the rate of return would be lower than the cost of capital. Hence it would be appropriate for such firms to opt for 100% dividend payout since the shareholders could reinvest the amount of dividend in other external sources that offers more returns. Hence 100% payout ratio would be the optimum ratio as it to help such firms increase its market value.

For example:

- ◊ Rate of return (r) = 8%
- ◊ Cost of equity (Ke) = 12%

Here,

$$r < K_e$$

Suppose the company retains ₹4 and invests it at 8%:

$$₹4 \times 8\% = ₹0.32$$

The company earns only ₹0.32 on the ₹4 retained. However, shareholders require a return of 12%. Therefore, the company is earning less from reinvesting the money than shareholders could reasonably expect to earn elsewhere at the same level of risk.

In this situation, the company should distribute a larger proportion of its earnings as dividends rather than retaining them.

The formula to compute the value of a share based on this model is as follows:

$$\text{Price of equity share} = \frac{\textbf{\textit{Dividend per share}}}{\textbf{\textit{Cost of equitycapital} - \textbf{\textit{Expected growth rate of earnings}}}}$$

Although Walter's model stated the relevance of dividend decision it suffered from some criticisms. The main criticism was the assumption of raising funds only from internal sources and non-reliance on external financing which is not a practical point of view. Another criticism was regarding the constant rate of return and constant cost of capital which could lead a company in taking erroneous policies.

Type of Firm	Relationship	Dividend Policy	Effect on Firm Value
Growth Firm	r > Ke	Retain more earnings and pay lower dividends	Retention increases firm value
Normal Firm	r = Ke	Dividend policy does not significantly affect firm value	Firm value remains unchanged
Declining Firm	r < Ke	Pay higher dividends and retain less	Higher dividends increase firm value

4.2.4.2 Gordon's model

This model was developed by Myron Gordon. Similar to Walter's model, Gordon's model also opined that dividend decision is relevant and will affect the market value of the firm. The main assumptions of this model are:

i. Firms are all equity firms

ii. External funds are not utilised

iii. The rate of return and cost of capital are constant

iv. The retention rate once decided by the firm remains constant

v. Growth rate is constant

vi. There are no corporate taxes

vii. The cost of capital is greater than the growth rate

viii. The firm has long life

This model states that, for firms having higher rate of return than its cost of capital, the firm's price per share increases when there is a decrease in the dividend payout ratio, with the retention ratio increasing. The model suggested that there is no optimum payout ratio if the rate of return of a firm and its cost of capital are same and the firm's price per share remains the same. And, in the case of firms were, the cost of capital exceeds the rate of return, the firm's price per share increases if there is an increase in the dividend payout ratio. This is known as the basic valuation model developed by Gordon.

The formula to compute the value of a share based on this model is:

$$\text{Price of equity share} = \frac{\textit{Earnings Per Share}\ (1 - \textit{Retention ratio})}{\textit{Cost of equity capital} - \textit{Growth rate}}$$

Later, Gordon developed a revised model criticising his basic models assumption of the constant rate of return and the constant cost of capital which is not practical. The revised model was named as Bird in the hand approach and it states the relevance of dividend policy even when the rate of return and the cost of capital of a firm are same. This revised model was based on the following two assumptions of the behaviour of investors.

i. The investors try to avoid risk

ii. Investors prefer near dividend than distant capital gain due to the fear of uncertainty.

Suppose that there are two firms, Firm A and Firm B similar in all aspects. Firm A offers more dividend than firm B. Which firm will you prefer for investing? According to what this model suggests, investors would be willing to pay higher price for firms offering higher dividend than other firms. It is because of the element of uncertainty of future. Increase in retention ratio involves increased uncertainty of future, and thus the cost of capital also increases. This leads to lower share price and vice-versa. Thus distant dividend would be discounted at a higher rate than near dividend.

◊ Bird in the hand approach

4.2.4.3 Modigliani Miller's irrelevance model

As the name suggest, this model was developed by Modigliani and Miller. This model is based on the theory of irrelevance which states that dividend decision is irrelevant and it does not affect the value of the firm. The main assumptions of this approach are:

i. The capital market is perfect where securities could be bought and sold freely

ii. The investors are rational

iii. Investors have complete information about the company

iv. There are no taxes and floatation costs

v. The tax rate of dividend and capital gain are same

vi. Investors do not consider the future uncertainty and risk.

According to this model, the earning capacity of the firm and the investment policy could only affect the value of the firm and that dividend policy has no role in it. The argument favouring this concept is that, if a firm distributes its earnings as dividend, it may rely on external sources to raise funds. Even though the distribution of dividend may increase the market price of share, the reliance on external financing increases the cost of capital and thereby reduce the market price of the firm's shares. Hence the market price of the firm's shares remains unaffected.

This model suffers from many criticisms due to some of its assumptions being not practical. In practise, taxes do exist, and the dividend and capital gains are taxed differently which is a drawback of this model. The assumption stating the absence of floatation cost is another criticism since floatation costs are incurred while raising funds from external sources. Neglecting the risk and uncertainty in the minds of investors would also lead to erroneous results. Another criticism is the availability of information about firms would not be the same for all stakeholders. Information could be more accessible to insiders of the firm than the public.

These are the three important dividend models that state the relevance and irrelevance of dividend decision. Thus with this, we have completed all the key areas coming under the scope of financial management.

Table 4.2.1 Dividend Models

Points of Comparison	**Walter's model**	**Gordon's model**	**MM approach**
Basic idea	Dividend policy affects the value of the firm. Investors prefer dividends when the return on investment is lower than the cost of equity.	Dividend policy affects the value of the firm. Investors generally prefer current dividends because of the uncertainty associated with future returns.	Dividend policy is irrelevant to the value of the firm under the assumptions of the model.
Relationship between dividend and investment decision	Dividend decision and investment decision are closely related. Retained earnings are used for investment.	Dividend decision and investment decision are closely related. Retained earnings provide funds for future investment.	Dividend decision and investment decision are independent under the basic assumptions.

Role of Retained Earnings	Retained earnings are an important source of finance. The firm should retain earnings when the return on investment is greater than the cost of equity.	Retained earnings are important for financing profitable investments.	Retained earnings do not affect firm value because shareholders can create their own desired dividend pattern by buying or selling shares.
Effect of Dividend on Firm Value	Dividend policy affects firm value. Higher dividends can increase or decrease firm value depending on the relationship between r and Ke.	Higher dividends can increase firm value because investors prefer certain current dividends to uncertain future gains.	Dividend policy does not affect firm value. Firm value depends mainly on investment decisions and earning capacity.
Investor Preference	Investors prefer dividends when r < Ke and retained earnings when r > Ke.	Investors prefer current dividends because they are more certain than future capital gains.	Investors are indifferent between dividends and capital gains under perfect capital-market assumptions.
Relevance of Dividend Policy	Relevant	Relevant	Irrelevant
Main distinguishing feature	Focuses on the relationship between return on investment (r) and cost of equity (Ke).	Based on the bird-in-the-hand argument—current dividends are considered less risky than future capital gains.	Based on the dividend irrelevance proposition and the idea of homemade dividends.

Summarised Overview

Dividend decision deals with the decision regarding the amount of profits which are to be distributed as dividend and the amount of profits which are to be retained by the company. There are many factors which affect dividend decision such as requirements of investors, legal restrictions, future expansion requirements, liquidity of the firm and so forth. Dividend is the return investors obtain through investing in equity shares or preference shares. The different forms of dividend include cash dividend, scrip dividend, and bonus issue. The different types of dividend policies include regular dividend policy, stable dividend policy, irregular dividend policy, and no dividend policy. The three main models based on dividend decision are- Walter's model, Gordon's model and MM irrelevance model. Walter's model and Gordon's model stated the theory of relevance of dividend decision whereas Modigliani and Miller stated the theory of irrelevance of dividend decision affecting the value of shares of a firm.

Self-Assessment Question

1. Why is bonus issue called as capitalisation of reserves?
2. What do you mean by dividend decision?
3. What are the different types of dividend policies?
4. Explain Walter's dividend model.
5. What are the various factors affecting dividend decision?

Assignments

1. Briefly explain the scope of financial management.
2. Explain the theory of irrelevance.
3. Differentiate between cash dividend and scrip dividend
4. What are the criticisms of MM irrelevance model?
5. Explain bird in the hands approach.

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Space for Learner Engagement for Objective Questions

Learners are encouraged to develop objective questions based on the content in the paragraph as a sign of their comprehension of the content. The Learners may reflect on the recap bullets and relate their understanding with the narrative in order to frame objective questions from the given text. The University expects that 1 - 2 questions are developed for each paragraph. The space given below can be used for listing the questions.

SREENARAYANAGURU OPEN UNIVERSITY

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Name : …….....

Model Question Paper- set-I

Second Semester Master Of Business Administration Degree Examination

Discipline Core Course

M25BS05DC Financial Management

(CBCS - UG)

2025 -26 - Admission Onwards

Time: 3 Hours Max Marks: 70

Section A

Answer any five of the following questions in one or two sentences each. Each question carries 2 marks. (2 x 5 = 10)

1. What is Wealth Maximisation?
2. Define Financial Planning.
3. What is Capital Structure?
4. What is the Pay-back Period?
5. What is Net Present Value (NPV)?
6. Define Net Working Capital.
7. What is Venture Capital?
8. What is Capital Rationing?

Section B

Answer any six of the following questions. Each question carries 5 marks.

(5 x 6 = 30)

9. Explain the major functions of Financial Management.

10. Distinguish between financial planning and financial forecasting.

11. Explain the institutional and alternative sources of finance available to business organisations.

12. Calculate the pay-back period of a project using the following information. Initial Investment: ₹6,00,000.

Year	Cash Inflow (₹)
1	1,50,000
2	2,00,000
3	2,50,000
4	1,50,000

13. Explain the factors influencing the capital structure of a company.

14. A company has current assets of ₹8,00,000 and current liabilities of ₹5,00,000.

    a. Calculate the gross working capital and net working capital of the company.

    b. Explain the significance of maintaining adequate working capital in a business organisation.

15. Explain the concept of the time value of money and its significance in financial decision-making.

16. Explain the major motives for holding cash in a business organisation.

17. Discuss the advantages and limitations of the pay-back period method of capital budgeting.

18. What is financial leasing? Explain its major features.

Section C

Answer any two of the following. Each question carries 15 marks. (15 x 2 = 30)

19. Explain the concepts of profit maximisation and wealth maximisation. Distinguish between these two objectives of Financial Management.

20. Explain the traditional and time-adjusted methods of capital budgeting. Discuss the major methods under each category.

21. Calculate the Net Present Value (NPV) of the following project using a discount rate of 10%. Advise whether the project should be accepted if the acceptance criterion is a positive NPV. Initial Investment: ₹5,00,000.

Year	Cash Inflow (₹)	Present Value Factor at 10%
1	1,50,000	0.909
2	1,80,000	0.826
3	2,00,000	0.751
4	1,50,000	0.683

22. Explain working capital management. Discuss the management of cash, receivables and inventory.

SREENARAYANAGURU OPEN UNIVERSITY

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Name : …….....

Model Question Paper- set-II

Second Semester Master Of Business Administration Degree Examination

Discipline Core Course

M25BS05DC Financial Management

(CBCS - UG)

2025 -26 - Admission Onwards

Time: 3 Hours Max Marks: 70

Section A

Answer any five of the following questions in one or two sentences each. Each question carries 2 marks. (2 x 5 = 10)

1. What is Profit Maximisation?
2. What is a Dividend Decision?
3. Define Capital Budgeting.
4. What is the Accounting Rate of Return (ARR)?
5. What is the Profitability Index (PI)?
6. Define Gross Working Capital.
7. What is Factoring?
8. What is an Operating Lease?

Section B

Answer any six of the following questions. Each question carries 5 marks.

(5 x 6 = 30)

9. Explain the scope of Financial Management.
10. Explain the major components of a financial plan.

11. What is Commercial Paper? Explain its major features.

12. Calculate the pay-back period of a project using the following information. Initial Investment: ₹8,00,000.

Year	Cash Inflow (₹)
1	2,00,000
2	2,50,000
3	3,00,000
4	1,50,000

13. Explain the Net Income (NI) and Net Operating Income (NOI) approaches to capital structure.

14. Explain the major objectives of working capital management.

15. Calculate the Accounting Rate of Return (ARR) using the initial investment method from the following information: Initial Investment: ₹4,00,000; Average Annual Profit after Depreciation and Tax: ₹80,000.

16. Explain the major stages of venture capital financing.

17. Discuss the advantages and limitations of the Net Present Value (NPV) method of capital budgeting.

18. Explain the factors to be considered while formulating a credit policy for receivables management.

Section C

Answer any two of the following. Each question carries 15 marks. (15 x 2 = 30)

19. Explain the various sources of business finance available to an organisation. Discuss their major features.

20. Explain the major theories of capital structure.

21. Calculate the Net Present Value (NPV) of the following project using a discount rate of 12%. Advise whether the project should be accepted if the acceptance criterion is a positive NPV. Initial Investment: ₹6,00,000.

Year	Cash Inflow (₹)	Present Value Factor at 12%
1	2,00,000	0.893
2	2,50,000	0.797
3	2,50,000	0.712
4	2,00,000	0.636

22. Explain the importance of financial planning and discuss the steps involved in the financial planning process. Distinguish between financial planning and financial forecasting.

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