**BBA LLB** **Second Semester** **Paper Code: BBA LLB**

**114 Paper: Financial Management**

**Objective:** Finance is the backbone of an organization and efficient management of finance is directly related to the efficient management of enterprise. The objective of this course is to acquaint the students with the overall framework of financial decision-making in a business unit.

**Unit-I: Introduction (Lectures-10)**

a. Introduction
b. Objectives of Financial Management
c. Scope and Functions of Financial Managers
d. Profit Vs Wealth Maximization,
e. Agency Costs,
f. Time Value of Money

**Unit-II: Capital Budgeting Decisions (Lectures-10)**

a. Capital Budgeting Decisions,
b. Nature of Investment Decisions,
c. Investment Evaluation Criteria: NPV, IRR, Profitability Index , Payback Period, Accounting Rate of Return

**Unit-III: Cost of Capital (Lectures-10)**

a. Meaning, Factors Affecting Cost of Capital, Significance
b. Capital Structure Theories: Concept of Value of Firm, Factors Determining Capital Structure, Financial Distress
c. Leverages: Meaning, Types, Significance
d. Dividend Policy: Definition and Types of Dividends, Determinants of Dividend Policy, Rights and Bonus Shares

**Unit-IV: Working Capital Management (Lectures-10)**

a. Significance of Working Capital Management
b. Types of Working Capital, Objectives of Inventory Management
c. Types of Inventory
d. Motives for Holding Cash
e. Objectives of Cash Management
f. Costs and Benefits of Accounts Receivable
g. Concept of Factoring

# FINANCIAL MANAGEMENT

## UNIT I

### Introduction

Financial Management means to procure and use funds in the most optimum manner. Procurement of funds should be timely so that it is readily available when it is required. Management of finance is crucial to an organization. If managed efficiently the organization will be profitable and also add value to its assets and create wealth for its shareholders. Therefore Financial Management is the study of sourcing, allocating, and using funds in the most efficient manner and asking the following questions:

- How to source funds?
- How to allocate them?
- How to use them?

According to **Dr. S. N. Maheshwari**,

"Financial management is concerned with raising financial resources and their effective utilization towards achieving the organizational goals."
Thus, financial management means:

• To collect finance for the company at a low cost and
• To use this collected finance for earning maximum profits.

It is clear that financial management is that specialized activity which is responsible for obtaining and affectively utilizing the funds for the efficient functioning of the business and, therefore, it includes financial planning, financial administration and financial control.

### Objectives of Financial Management

The objectives of Financial Management should have the characteristics of a clear, unambiguous and well defined goals. Its decisions should relate to the fact that a firm/company will have long term existence. Profit is a test of economic efficiency of an organization. Financial Management deals with efficient sourcing and utilizing funds but it goes beyond maximization of profits. It therefore has a qualitative and quantitative benefits in a firm.

Profit maximization is a narrow objective of financial management but wealth maximization can be called the comprehensive term that covers the objectives of financial management and is superior to profit maximization.

Since profit maximization concept has certain limitations and is narrow in approach wealth maximization is considered to be ultimate goal of financial management.

**Profit Maximization**

Profit Maximization helps an organization to find out whether it is able to cover it costs or not. However, it has some benefits and limitations:

**Benefits of Profit Maximization**

- It act as a barometer to an organization to find out whether the firm is running efficiently as a commercial enterprise or it is unable to meet its expenses.
- It provides information about company to people who would like to invest in it.
- If a firm is profitable then the company can decide to expand or diversify its business.

**Limitations of Profit Maximization**

- Profit maximization does not study the concept of time value of money.
- It concentrates towards providing a rosy picture to the third parties and public but it is not concerned with decision making for internal efficiency.
- It does not have techniques or theories through which it is able to analyze risks of firm.

**Wealth Maximization**

Wealth maximization is based on the principles of Financial Management. It is superior to profit maximization. It takes into account time value of money, cash flows, risk and return and considers only incremental cash flows of the organization.

**Benefits of Wealth Maximization**

- Maximization of share holder wealth analyzes the present value of the share and future values through the application of financial management principles.

- It applies time value of management through compounding and discounting techniques for single and multiple cash flows for future period or finding out the present value of a share.
- It applies to the cash flow concept which is according to the principles of financial management.

**Other objectives of Financial Management:**

The aims of financial management should be useful to the firm's proprietors, managers, employees and consumers. For this purpose the only way is maximisation of firm's value.

**The following aspects have place in maximising firm's value:**

**1. Rise in profits:**

If the firm wants to maximise its value, it should' increase its profits and revenues. For this purpose increase of sales volume or other activities can be taken up. It is the general feature of any firm to increase profits by proper utilisation of all opportunities and plans.

Theoretically, firm gets maximum profits if it is under equilibrium. At that stage the average cost is minimal and the marginal cost and the marginal revenues are equal. Here, we can't say the sales because there must be suitable market for the increased sales. Further, the above costs must also be controlled.

**2. Reduction in cost:**

Capital and equity funds are utilised for production. So all types of steps should be taken to reduce firm's cost of capital.

**3. Sources of funds:**

It should be decided by keeping in view the value of the firm to collect funds through issue of shares or debentures.

**4. Reduce risks:**

There won't be profits without risk. But for this reason if more risk is taken, it may become danger to the existence of the firm. Hence risk should be reduced to minimum level.

**5. Long run value:**It should be the feature of financial management to increase the long-run value of the firm. To earn more profits in short time, some firms may do the activities like releasing of low quality goods, neglecting the interests of consumers and employees.

These trials may give good results in the short run. But for increasing the value of the firm in the long run, avoiding; such activities are more essential.

**Scope and functions of financial management:**

The scope of financial management includes three groups. First – relating to finance and cash, second – rising of fund and their administration, third – along with the activities of rising funds, these are part and parcel of total management.

It can be said that all activities done by a finance officer are under the purview of financial management. But the activities of these officers change from firm to firm, it become difficult to say the scope of finance. Financial management plays two main roles, one – participating in funds utilisation and controlling productivity, two – Identifying the requirements of funds and selecting the sources for those funds. Liquidity, profitability and management are the functions of financial management.

**1. Liquidity:**

Liquidity can be ascertained through the three important considerations.

**i) Forecasting of cash flow:**

Cash inflows and outflows should be equalized for the purpose of liquidity.

**ii) Rising of funds:**

Finance manager should try to identify the requirements and increase of funds.

**iii) Managing the flow of internal funds:**

Liquidity at higher degree can be maintained by keeping accounts in many banks. Then there will be no need to depend on external loans.

**2. Profitability:**

While ascertaining the profitability the following aspects should be taken into consideration:

**i) Cost of control:**

For the purpose of controlling costs, various activities of the firm should be analyzed through proper cost accounting system,

**ii) Pricing:**

Pricing policy has great importance in deciding sales level in company's marketing. Pricing policy should be evolved in such a way that the image of the firm should not be affected.

**iii) Forecasting of future profits:**

Often estimated profits should be ascertained and assessed to strengthen the firm and to ascertain the profit levels.

**iv) Measuring the cost of capital:**

Each fund source has different cost of capital. As the profit of the firm is directly related to cost of capital, each cost of capital should be measured.

**3. Management:**

It is the duty of the financial manager to keep the sources of the assets in maintaining the business. Asset management plays an important role in financial management. Besides, the financial manager should see that the required sources are available for smooth running of the firm without any interruptions.

A business may fail without financial failures. Financial failures also lead to business failure. Because of this peculiar condition the responsibility of financial management increased. It can be divided into the management of long run funds and short run funds.

Long run management of funds relates to the development and extensive plans. Short run management of funds relates to the total business cycle activities. It is also the responsibility of financial management to coordinate different activities in the business. Thus, for the success of any firm or organization financial management is said to be a must.

**Profit Maximization v/s Wealth Maximization**

It is clear from the above discussion that the modern approach to financial management is to give

answers for three questions: where to invest and in what amount; how to raise; and when to pay dividends. It is generally agreed that the financial objective of the firm should be the maximization of owners' economic welfare. However, there is a disagreement as to how the economic welfare of the owners can be maximized. The two well known and widely discussed criteria in this respect are:

**1) Profit Maximization**

According to this concept, actions that increase the firm's profit are undertaken while those that decrease profit are avoided. The profit can be maximized either by increasing output for a given set of scarce input or by reducing the cost of production for a given output. The modern economics states that the profit maximization is nothing but a criterion for economic efficiency as profits provide a yardstick by which economic performances can be judged under condition of perfect competition. Besides, under perfect competition, profit maximization behavior by firms leads to an efficient allocation of resources with maximum social welfare. Since, the capital is a scarce material; the financial manager should use these capital funds in the most efficient manner for achieving the profit maximization. It is, therefore, argued that profitability maximization should serve as the basic criterion for the ultimate financial management decisions.

The profit maximization criterion has been ***criticized*** on the following grounds:

• ***Vagueness*** - One practical difficulty with profit maximization criterion is that the term profit is vague and ambiguous as it is amenable to different interpretations, like, profit before tax or after tax, total profit or rate of return, etc. If profit maximization is taken to be the objective, the Problem arises, which of these variants of profit to be maximized?

• ***Ignores the timing of benefits*** - A more important technical objection to profit maximization is that it ignores the differences in the time pattern of the cash inflows from investment proposals. In other words, it does not recognize the distinction between the returns in different periods of time and treat them at a par which is not true in real world as the benefits in earlier years should be valued more than the benefits received in the subsequent years.

• ***Ignores risk*** – It ignores the degree of certainty/ risk with which benefits can be obtained.

As a matter of fact, the more certain the expected return, the higher the quality of the benefits. Conversely, the more uncertain the expected returns, the lower the quality of benefits, which implies risk to the investors. Generally, the investors want to avoid risk. \Therefore, from the above discussion, it clear that the profit maximization concept is inappropriate to a firm from the point of view of financial decisions, i.e. investment, finance and dividend policies. It is not only vague and ambiguous but also it does not recognize the two basic aspects, i.e., risk and time value of money.

**2) Wealth Maximization**

The most widely accepted objective of the firm is to maximize the value of the firm for its owners. The wealth maximization goal states that *the management should seek to maximize the present value of the expected returns* of the firm. The present value of future benefits is calculated by using its discount rate (cost of capital) that reflects both time and risk. The discount rate is the rate that reflects the time and risk preferences of the suppliers of capital.

The next feature of wealth maximization criterion is that it takes; both the quantity and quality dimensions of benefits along with the time value of money. Other things being equal, income with certainty are valued more than the uncertain ones. Similarly, the benefits received in earlier period should be valued more than the benefits received in later period.

It is quite clear that the wealth maximization is, no doubt, superior to the profit maximization objective. The wealth maximization objective involves a comparison of present value of future benefits to the cash outflow. If the activity results in positive net present value, i.e. the present value of future stream of cash flows exceed the present value of outflows, reflecting both time and risk, it can be said to create wealth.

The objective of wealth maximization can also be explicitly defined by short-cut method symbolically as under:

$$W = \frac{A_1}{1+k} + \frac{A_2}{(1+k)^2} + \ldots\ldots + \frac{A_n}{(1+k)^n} - C_o$$

$$= \sum_{t=1}^{n} \frac{At}{(1+k)^t} - C_o$$

Where, A1, A2 ... A represent the stream of benefits (cash inflows) expected to occur on the investment project;
Co = cost of the project
k = the discount factor / capitalization rate
W = the net wealth of the firm (the difference between the present value of stream of expected benefits and the present value of cash outflow).

It is abundantly clear from the above discussion that the wealth maximization criterion recognizes the time value of money and also tackles the risk, which is ascertained by the uncertainty of the expected benefits. That is why, it is rightly said that maximization of wealth is more useful than minimization of profits as a statement of the objective of most business firms.

**AGENCY COSTS**

A type of internal cost that arises from, or must be paid to, an agent acting on behalf of a principal. Agency costs arise because of core problems such as conflicts of interest between shareholders and management. Shareholders wish for management to run the company in a way that increases shareholder value. But management may wish to grow the company in ways that maximize their personal power and wealth that may not be in the best interests of shareholders.

***EXAMPLES OF AGENCY COSTS***

Some common examples of the principal-agent relationship include: management (agent) and shareholders (principal), or politicians (agent) and voters (principal).

Agency costs are inevitable within an organization whenever the principals are not completely in charge; the costs can usually be best spent on providing proper material incentives (such as performance bonuses and stock options) and moral incentives for agents to properly execute their duties, thereby aligning the interests of principals (owners) and agents.

**Time Value of Money**

**Introduction**

Time Value of Money (TVM) is an important concept in financial management. It can be used to compare investment alternatives and to solve problems involving loans, mortgages, leases, savings, and annuities.

TVM is based on the concept that a dollar that you have today is worth more than the promise or expectation that you will receive a dollar in the future. Money that you hold today is worth more because you can invest it and earn interest. After all, you should receive some compensation for foregoing spending. For instance, you can invest your dollar for one year at a 6% annual interest rate and accumulate $1.06 at the end of the year. You can say that the **future value** of the dollar is $1.06 given a 6% **interest rate** and a one-year **period**. It follows that the **present value** of the $1.06 you expect to receive in one year is only $1.

A key concept of TVM is that a single sum of money or a series of equal, evenly-spaced payments or receipts promised in the future can be converted to an equivalent value today. Conversely, you can determine the value to which a single sum or a series of future payments will grow to at some future date.

**Simple and Compound Interest**

Interest is a charge for borrowing money, usually stated as a percentage of the amount borrowed over a specific period of time. **Simple interest** is computed only on the original amount borrowed. It is the return on that principal for one time period. In contrast, **compound interest** is calculated each period on the original amount borrowed **plus** all unpaid interest accumulated to date. Compound interest is always assumed in TVM problems.

**Present Value** is an amount today that is equivalent to a future payment, or series of payments, that has been discounted by an appropriate interest rate. The future amount can be a single sum that will be received at the end of the last period, as a series of equally-spaced payments (an annuity), or both. Since money has time value, the present value of a promised future amount is worth less the longer you have to wait to receive it..

**Future Value** is the amount of money that an investment with a fixed, compounded interest rate will grow to by some future date. The investment can be a single sum deposited at the beginning of the first period, a series of equally-spaced payments (an annuity), or both. Since money has

time value, we naturally expe t the future value to be greater than the present value. The difference between the two depends on the number of compounding periods involved and the going interest rate.

**Present value of a future sum**

The present value formula is the core formula for the time value of money; each of the other formulae is derived from this formula. For example, the annuity formula is the um of a series of present value calculations. The present value (PV) formula has four variables, each of which can be

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

The cumulative present value of future cash flows can be calculated by summing the contributions of $FV_t$, the value of cash flow at time $t$

$$PV = \sum_{t=1}^{n} \frac{FV_t}{(1+i)^t}$$

**Future value of a present sum**

The future value (FV) formula is similar and uses the same variables.

$$FV = PV \cdot (1-i)^n$$

**Present value of an annuity for n payment periods**

In this case the cash flow values remain the same throughout the n periods. Th e present value of an annuity (PVA) formula has four variables, each of which can be solved for:

$$PV(A) = \frac{A}{i} \cdot \left[1 - \frac{1}{(1+i)^n}\right]$$

To get the PV of an annuity due, multiply the above equation by (1 + *i*).

**Present value of a growing annuity**

In this case each cash flow grows by a factor of (1+g). Similar to the formula for an annuity, the present value of a growing annuity (PVGA) uses the same variables with the addition of *g* as the rate of growth of the annuity (A is the annuity payment in the first period). This is a calculation that is rarely provided for on financial calculators.

**Where i ≠ g :**

$$PV = \frac{A}{(i-g)}\left[1-\left(\frac{1-g}{1-i}\right)^{n}\right]$$

**Where i = g :**

$$PV = \frac{A \times n}{1-i}$$

To get the PV of a growing annuity due, multiply the above equatio by (1 + *i*).

**Present value of a perpetuity**

A perpetuity is payments of a set amount of money that occur on a routine basis and continues forever. When $n \to \infty$, the *PV* of a perpetuity (a perpetual annuity) formula becomes simple division.

$$PV(P) = \frac{A}{i}$$

Present Value of Interest Factor Annuity

$$A = P(1 + r/n)^{nt}$$

Example:

Investment *P* = $1000

Interest *i* = 6.90% Compounded Quarterly (4 Times in Year)

Tenure Years *n* = 5

$$1000 \times [1-.069/4)^{[5\ yrs \times 4\ qtrs\ in\ a\ year]} = 1000 \times (1-0.069/4)^{20} \approx 1407.84$$

**Present value of a growing perpetuity**

When the perpetual annuity payment grows at a fixed rate (g) the value is theoretically determined according to the following formula. In practice, there are few securities with precise characteristics, and the application of this valuation approach is subject to various qualifications and modifications. Most importantly, it is rare to find a growing perpetual annuity with fixed rates of growth and true perpetual cash flow generation. Despite these qualifications, the general approach may be used in valuations of real estate, equities, and other assets.

This is the well known Gordon Growth model used for stock valuation.

**Future value of an annuity**

The future value of an annuity (FVA) formula has four variables, each of which can be solved for: each of which can be solved for:

$$FV(A) = A \cdot \frac{(1+i)^N - 1}{i}$$

To get the FV of an annuity due, multiply the above equation by (1 + i).

**Future value of a growing annuity**

The future value of a growing annuity (FVA) formula has five variables, each of which can be solved for:

**Where i ≠ g :**

$$FV(A) = A \cdot \frac{(1+i)^n - (1+g)^n}{i-g}$$

**Where i = g :**

$$FV(A) = A \cdot n(1+i)^{n-1}$$

**UNIT II**

## Capital Budgeting Decisions

Capital budgeting is vital in marketing decisions. Decisions on investment, which take time to mature, have to be based on the returns which that investment will make. Unless the project is for social reasons only, if the investment is unprofitable in the long run, it is unwise to invest in it now.Often, it would be good to know what the present value of the future investment is, or how long it will take to mature (give returns). It could be much more profitable putting the planned investment money in the bank and earning interest, or investing in an alternative project.

Typical investment decisions include the decision to build another grain silo, cotton gin or cold store or invest in a new distribution depot. At a lower level, marketers may wish to evaluate whether to spend more on advertising or increase the sales force, although it is difficult to measure the sales to advertising ratio.

**Capital budgeting**, or **investment appraisal**, is the planning process used to determine whether an organization's long term investments such as new machinery, replacement machinery, new plants, new products, and research development projects are worth the funding of cash through the firm's capitalization structure (debt, equity or retained earnings). It is the process of allocating resources for major capital, or investment, expenditures. One of the primary goals of capital budgeting investments is to increase the value of the firm to the shareholders.

## Nature of Capital Budgeting Decisions

(1) Long term effect - Such decisions have long term effect on future profitability and influence pace of firm's growth. A good decision may bring good returns and wrong decision may endanger very survival of firm.

(2) High degree of risk - decision is based on estimated return. Changes in taste, fashion, research and technological advancement leads to greater risk in such decisions.

(3) Huge funds – large amount/funds are required and sparing huge funds is problem and hence decision to be taken after proper care/analysis

(4) Irreversible decision – Reverting back from a decision is very difficult as sale of high value asset would be a problem.

(5) Most difficult decision – decision is based on future estimates/uncertainty. Future events are affected by economic, political and technological changes taking place.

(6) Impact on firms future competitive strengths – These decisions determine future profit/ cost and hence affect the competitive strengths of firm.

(7) Impact on cost structure – Due to this vital decision, firm commits itself to fixed costs such as supervision, insurance, rent, interest etc. If investment does not generate anticipated profit, future profitability would be affected.

***Objectives of Capital Budgeting***

(1) Share holder's wealth maximization. In tune with objectives of financial management, its aim is selecting those projects that maximize shareholders wealth. The decision should avoid over/under investment in fixed assets.

(2) Evaluation of proposed capital expenditure – Capital budgeting helps in evaluating expenditure to be incurred on various assets to measure validity of each expenditure

(3) Controlling costs - by evaluating expenditure costs can be controlled.

(4) Determining priority – arranging projects in order of their profitability enabling the management to select most profitable project.

**Factors affecting Capital Budgeting Decisions**

(1) Technological changes – Before taking CBD, management will have to undertake in-depth study of cost of new product /equipment as well productive efficiencies of new as well as old equipment.

(2) Demand forecast – Analysis of demand for a long period will have to be undertaken before taking any capital budgeting decision.

(3) Competitive strategy – If a competitor is going for new machinery /equipment of high capacity and cost effective, we may have to follow that.

(4) Type of management – If management is innovative, firm may go for new equipments/ investment as compared to conservative management.

(5) Cash flow – cash flow statement or cash budget helps a firm in identifying time when a firm can make investment in CBD.

(6) Other factors- Like fiscal policy (tax concessions, rebate on investments) political salability.

**Nature of Investment Decisions**

There are many ways to classify investment. One classification is as follows:

• Expansion of existing business

• Expansion of new business

• Replacement and modernization.

*Expansion and diversification*

A company may add capacity to its existing product lines to expand existing operations. For example, the Gujarat state fertilizer company (GSFC) may increase its plant capacity to manufacture more urea. It is an example of related diversification. A firm may expand its activities in a new business. Expansion of a new business requires investment in new products and a new kind of production activity within the firm. If a packaging manufacturing company invests in a new plant and machinery to produce ball bearing, which the firm has not manufactured before, this represents expansion of new business or unrelated diversification. Sometimes a company acquires existing firms to expand its business. In either case, the firm makes investment in the expectation of additional revenue. Investments in existing or new products may also be called as revenue-expansion investments.

*Replacement and modernization*

The main adjective of modernization and replacement is to improve operating efficiency and reduce costs, cost savings will reflect in the increased profits, but the firm's revenues may remain unchanged. Assets become outdated and obsolete with technological changes. The firm must decide to replace those assets with new assets that operate more economically. If a cement company changes from semi-automatic drying equipment to fully automatic drying equipment, it is an example of modernization and replacement. Replacement decisions help to introduce more efficient and economical assets and therefore, are also called cost-reduction investments however; replacement decisions that involve substantial modernization and technological improvement expand revenues as well as reduce costs.

**Investment Evaluation Criteria / The Major Capital Budgeting Techniques**

A variety of measures have evolved over time to analyze capital budgeting requests. The better methods use time value of money concepts. Older methods, like the payback period, have the deficiency of not using time value techniques and will eventually fall by the wayside and are replaced in companies by the newer, superior methods of evaluation.

1. **Payback Period**
   It is the length of time that it takes to recover your investment. For example, to recover $30,000 at the rate of $10,000 per year would take 3.0 years. Companies that use this method will set some arbitrary payback period for all capital

budgeting projects, such as a rule that only projects with a payback period of 2.5 years or less will be accepted. (At a payback period of 3 years in the example above, that project would be rejected.) The payback period method is decreasing in use every year and doesn't deserve extensive coverage here.

2. **Profitability Index (PI)**
   It is also known as profit investment ratio (PIR), is the ratio of payoff to investment of a proposed project. It is a useful tool for ranking projects because it allows you to quantify the amount of value created per unit of investment. The ratio is calculated as follows

$$\text{PI} = \frac{\text{Present Value of Cash Inflows}}{\text{Present Value of Cash Outflows}}$$

Assuming that the cash flow calculated does not include the investment made in the project, a profitability index of 1 indicates breakeven. Any value lower than 'one' indicates that the project's PV is less than the initial investment. As the value of the profitability index increases, so does the financial attractiveness of the proposed project.

Rules for selection or rejection of a project:

If PI > 1 then accept the project

If PI < 1 then reject the project

**3. Accounting Rate of Return**

It is also known as the Average rate of return. ARR is a financial ratio used in capital budgeting. The ratio does not take into account the concept of time value of money. ARR calculates the return, generated from net income of the proposed capital investment. The ARR is a percentage return. Say, if ARR = 7%, then it means that the project is expected to earn seven cents out of each dollar invested.

If the ARR is equal to or greater than the required rate of return, the project is acceptable. If it is less than the desired rate, it should be rejected. When comparing investments, the higher the ARR, the more attractive the investment. Over one-half of large firms calculate ARR when appraising projects.

**ARR = Average Profit / Average Investment**

**4. Net Present Value**

Using a minimum rate of return known as the hurdle rate, the net present value of an investment is the present value of the cash inflows minus the present value of the cash outflows. A more common way of expressing this is to say that the net present value (NPV) is the present value of the benefits (PVB) minus the present value of the costs

**(PVC) NPV = PVB – PVC**

The purpose of the capital budgeting analysis is to see if the project's benefits are large enough to repay the company for (1) the asset's cost, (2) the cost of financing the project, and (3) a rate of return that adequately compensates the company for the risk found in the cash flow estimates. Therefore, if the NPV is:

• Positive, the benefits are more than large enough to repay the company for (1) the asset's cost, (2) the cost of financing the project, and (3) a rate of return that adequately compensates the company for the risk found in the cash flow estimates.

• Zero, the benefits are barely enough to cover all three but you are at breakeven - no profit and no loss, and therefore you would be indifferent about accepting the project.

• Negative, the benefits are not large enough to cover all three, and therefore the project should be rejected.

**5. Internal Rate of Return (IRR)**

The Internal Rate of Return (IRR) is the rate of return that an investor can expect to earn on the investment. Technically, it is the discount rate that causes the present value of the benefits to equal the present value of the costs. The IRR method is actually the most commonly used method for evaluating capital budgeting proposals. This is probably because the IRR is a very easy number to understand because it can be compared easily to the expected return on other types of investments (savings accounts, bonds, etc.). If the internal rate of return is greater than the project's minimum rate of return, we would tend to accept the project. The calculation of the IRR, however, cannot be determined using a formula; it must be determined using a trial-and-error technique.

**PRACTICAL PROBLEMS**

Q.1 Project has the following patterns of cash flows:

| Year | Cash Flows (Rs in Lacs) |
|---|---|
| **0** | **(10)** |
| **1** | **5** |
| **2** | **5** |
| **3** | **3.08** |
| **4** | **1.20** |

**What is the IRR of this project?**

Solution: To determine the IRR, we have to compare the NPV of the project for different rates of interest until we find that rate of interest at which the NPV of the project is equal to zero.

**Step 1** Find the average annual net cash flow based on given future net cash inflows. = (5 + 5 + 3.08 + 1.20)/4 = 3.57

**Step 2** Divide the initial outlay by the average annual net cash inflows i.e. 10/3.57 = 2.801

**Step 3** From the PVIFA table, it is found that interest rate is nearly equal to 2.801 in 4 years i.e. the duration of the project. In this case the rate of interest will be equal to 15%.

We use 15% as the initial value for starting the hit and trial process and keep trying at successively higher rates of interest until we get an interest rate at which the NPV is zero.

NPV at r = 15% will be equal to: = -10 + (5*.0870) + (5*.756) + (3.08*.658) + (1.2*.572) = 0.84

NPV at r = 16 % will be equal to: = -10 + (5*.862) + (5*.743) + (3.08*.641) + (1.2*.552) = .66

NPV at r = 18% will be equal to: = -10 + (5*.848) + (5*.719) + (3.08*.0609) + (1.2*.516) = .33

NPV at r = 20% will be equal to: = -10 + (5*.833) + (5*.694) + (3.08*.609) + (1.20*.482) = 0

We find that at r= 20%, the NPV is zero and therefore the **IRR of the project is 20%.**

## UNIT III

## COST OF CAPITAL

### MEANING

Cost of capital is the minimum required rate of return a project must earn in order to cover the cost of raising fund being used by the firm in financing of the proposal. It may be defined in two phase i.e. operational term and economic term. As per operational term, it refers to the discount rate that would be used in determining the present value of the estimated future cash proceeds and eventually deciding whether the project is worth undertaking or not.

### FACTORS AFFECTING COST OF CAPITAL

The elements in the business environment that cause a company's cost of capital to be high or low determine the cost of capital of any firm.

These factors are:

1. **General Economic Conditions** The general economic conditions determine the demand for and supply of capital within the economy as well as the level of expected inflation. This economic variable is reflected in the risk less rate of return. This rate represents the rate of return on risk free investments such as the interest rate on short-term government securities.

2. **Risk and Cost of Capital** High-risk investments only make the investors attractive to purchase the security. The risk elements are composed of five aspects that are closely intertwined.

These are - (a) **Financial Risk**- refers to the proportion of debt and equity with which a firm is financed.

(b) **Business Risk**- refers to the variability in return of assets and is affected by the company's investment decision.

(c) **Purchasing Power Risk**- refers to the change in purchasing power of money measured by price level changes.

(d) **Money Rate Risk**- refers to the premium in the yield demanded by suppliers of capital to cover the risk of an increase in future interest rate. (e) Market/Liquidity Risk- refers to the ability of a supplier of fund to sell his holding quickly.

3.**Floating Cost**

Floating cost is the cost of marketing new securities. It includes legal fees, printing expenses, underwriting commission etc. They are called floating because they incurred in floating new securities. It is also called underwriting cost or issuance cost. These costs directly influence the cost of capital. High floating cost leads to higher cost of capital.

**Significance of Cost of Capital**

Computation of cost of capital is a very important part of the financial management to decide the capital structure of the business concern.

**Importance to Capital Budgeting Decision**

Capital budget decision largely depends on the cost of capital of each source. According to net present value method, present value of cash inflow must be more than the present value of cash outflow. Hence, cost of capital is used to capital budgeting decision.

**Importance to Structure Decision**

Capital structure is the mix or proportion of the different kinds of long term securities.

A firm uses particular type of sources if the cost of capital is suitable. Hence, cost of capital helps to take decision regarding structure.

**Importance to Evolution of Financial Performance**

Cost of capital is one of the important determine which affects the capital budgeting, capital structure and value of the firm. Hence, it helps to evaluate the financial performance of the firm.

**Importance to Other Financial Decisions**

Apart from the above points, cost of capital is also used in some other areas such as, market value of share, earning capacity of securities etc. hence,it plays a major part in the financial management.

**Capital Structure Theories**

Capital structure means the pattern of capital employed in the firm. It is a financial plan of the firm in which the various sources of capital are mixed in such proportions that those provide a distinct capital structure most suitable for the requirement of the firm.

Theories of capital structure are as follows:-

1. Net Income theory.

2. Net Operating Income theory.

3. Traditional theory.

4. Modigliani – Miller theory.

**Net Income (NI) Theory:-**

This theory was propounded by David Durand. According to this theory a firm can increase the value of the firm and reduce the overall cost of capital by increasing the proportion of debt in its capital structure to the maximum possible extent. As debt is cheaper source of finance, it results in a decrease in overall cost of capital leading to an increase in the value of the firm as well as market value of equity shares.

Assumptions:

1. The cost of debt is cheaper than the cost of equity

2. Income tax has been ignored

3. The cost of debt capital and cost of equity capital remains constant i.e. with the increase in debt capital the risk perception of creditors and equity investors does not change.

4. Total value of firm = Market value of Equity + market value of debt.

Or V = S +D Market Value of share (S); S = NI/Ke

Or

_ (EBIT-I)/Ke

Where; NI = Earnings available for equity

shareholders EBIT = Earnings before interest and

Tax

Ke = Cost of Equity Capital.

The overall cost of capital or capitalization

ratio: Ko = EBIT/ V

Ko = Overall cost of capital

**Net Operating Income (NOI) Theory**

This theory has also been propounded by David Durand. This theory is just opposite that of Net Income Theory. According to this theory, the total market value of the firm (v) is not affected by the change in the capital structure and the overall cost of capital (Ko) remains fixed irrespective of the debt-equity mix. According to this theory there is nothing like optimum capital structure.

Assumptions:-

1. The split of total capitalization between debt and equity is not essential or irrelevant.

2. At every level of capital structure business risk is constant; therefore, the rate of capitalization also remains constant.

3. The rate of debt capitalization remains constant.

4. There are no corporate taxes.

5. With the use of debt funds which are cheaper, the risk of shareholders increases, which in turn results to increase in the equity capitalization rate. Hence debt capitalization rate remains constant.

Computation:-

Value of the Firm = EBIT/Ko  Or V = S + D

Or S = V – D  Cost of Equity Capital = Ke = EBIT - I /S (where I =Interest on debt)

**Modigliani – Miller Theory:-**

This theory was propounded by Franco Modigliani and Merton Miller (generally referred to as M-M) who are Nobel Prize winners in financial economies.

They have discussed their theory in two situations:

(i) When there are no corporate taxes, and
(ii) When there are corporate taxes.

**(i) <u>In the Absence of Corporate taxes:-</u>**

As per Modigliani – Miller if there are no corporate taxes than the changes in the capital structure of any firm do not bring any change in the overall cost of capital and total value of firm. The reason is that though the debt is cheaper to equity with increased use of debt as a source of finance, the cost of equity

increases and the advantage of low-cost debt is offset equally by the increased cost of equity. According to this theory, two identical firms in all respect, except their capital structure, cannot have different market value or cost of capital due to arbitrage processes. For example, suppose the capital structure of company comprises of equity share capital of Rs 10, 00, 00 and 6% debentures of Rs 20, 00, 00. If the average rate of return on total capital employed is 10%, the company will earn a profit of Rs. 30,000 (10% on 30, 00, 00). Out of this profit, the company will have to pay leaving a balance of (1800/10,0,0x100) Which is the company succeeds in paying more dividend on equity shares capital with the use of borrowed capital such a situation in any business is known as 'trading on equity'.

**Assumptions**:-

- The capital market is perfect.
- There is no transaction cost.
- All the firms can be divided in homogeneous risk classes.
- There is no corporate tax.
- All the profits of the firm are distributed.
- Individual investors can easily get loans on the same terms and conditions as firm can.

**ii.)When Corporate Taxes Exist:-**

The basic theory of Modigliani- Miller that the changes in the capital structure do not affect the total value of the firm and overall cost of capital is not true in the presence of corporate taxes. Corporate taxes are reality; therefore, they changed their basic theory in the year 1963. They accepted this fact that for corporate tax determination of interest is a deductible expenditure than the cost of debt is low. Therefore if any firm uses debt in its capital structure it leads to reduction in the overall cost of capital and increase in the value of the firm. They accepted that the total value of a leveraged firm is high than the non- leveraged firm.

Computation:-

Value of Unlevered firm (Vu) = $Vu = EBIT (1 – T)/ Ke$

Where:

Vu = Earning after tax but before Interest

Ke = After tax equity capitalization Rate

Value of levered firm

(Vl) = Vl = Vu + DT or EBIT (1 - T) /Ke+ DT

Where: D = Amount of Debt T = Tax Rate

**Traditional Theory:-**

The traditional theory is a mid-path between Net Income theory and Net Operating Income theory. According to this theory the cost of debt capital is lower than the cost of equity capital, therefore a firm by increasing the proportion of debt capital in its capital structure to a certain limit can reduce its overall cost of capital and can raise the total value of the firm. But after certain limit the increase in debt capital leads to rise in overall cost of capital and fall in the total value of the firm. A rational or appropriate mix of debt and equity minimizes overall cost of capital and maximizes value of the firm. Thus this theory accepts the idea of existence of optimum capital structure. Ezra Solomon has explained the effects of changes in capital structure on the overall cost of capital (Ko) and the total value of firm (V) in the following stages: First Stage: In the beginning the use of debt capital in the capital structure of the firm results in fall of overall cost of capital and increases the total value of the firm because in the first stage cost of equity remains fixed rises slightly and use of debt is favorably treated in capital market. Second State: In this stage beyond a particular limit of debt in the capital structure, the additional of debt capital will have insignificant or negligible effect on the value of the firm and the overall cost of capital. It is because the increase in cost of equity capital, due to increase in financial risk, offsets the advantage of using low cost of debt. Therefore during this second stage the firm can reach to a point where overall cost of capital is minimum and the total value of the firm is maximum.

**Third Stage**:

If the proportion of debt capital in the capital structure of the firm increases beyond an accepted limit this dead to increase in the overall cost of capital and fall in the total value of the firm because the financial risk rises rapidly which results into higher cost of equity capital which cannot be offset led by low debt capital cost. Hence, the total value of the firm will decrease and the overall cost of capital will increase.

**Financial Distress**

**Costs of financial distress** are costs associated with a company that is having difficulty meeting its obligations.

Costs of financial distress include the following:

- Opportunity cost of not making optimal decisions
- Inability to negotiate long-term supply contracts.

- Loss of customers.

- The expected cost of financial distress increases as the relative use of debt financing increases.
    - This expected cost reduces the value of the firm, offsetting, in part, the benefit from interest deductibility.
    - The expected cost of distress affects the cost of debt and equity.

## FACTORS DETERMINING CAPITAL STRUCTURE

All the factors which affect its capital structure should be considered at the time of its formation. Generally factors affecting capital structure are divided in two categories, namely

(A) Internal factors, and

(B) External Factors

**Factors Affecting Capital Structure**

| Internal factors | External Factors |
|---|---|
| Size of business | Capital Market Conditions |
| Nature of business | Nature of Invertors |
| Regularity of Income | Policy of financial Institutions |
| Assets Structure | Taxation Policy |
| Age of Firm | Government Control |
| Attitude of Management | Cost of Capital |
| Freedom of Working | Seasonal Nature |
| Desire to control | Economic Fluctuations |
| Future plans | Nature of competition |

Period and Purpose of Financing

Operating Ratio

Trading on Equity

**Concept of Value of the firm**

The value of the firm depends on the earnings of the firm and the earnings of the firm depends on the investment decision of the firm. The earnings of the firm depends upon the investment decision of the firm. The earnings of the firm are capitalized at a rate equal to the cost of capital in order to find out the value of the firm. Thus, the value of the firm depends on two basic factor the earnings of the firm and the cost of capital.

The operating profit of the firm i.e the EBIT is divided among three main claimants

i) The debt holders who receive their share in the form of interest.
ii) The government which receives its share in the form of taxes
iii) The shareholders who receive the residual.

So, the EBIT is a pool which is to be divided among the claimants. The investments decisions of the firm determine the size of the EBIT pool while the capital structure mix determines the way it is to be sliced.

The total value of the firm is the sum of its value to the debt holders and to its shareholders and is determined by the amount of EBIT going to them respectively.

The investment decision can therefore increase the value of the firm by increasing the size of EBIT whereas the capital structure mix can affect the value only by reducing the share of EBIT going to the government in the form of taxes.

The overall cost of capital of the firm i.e the weighted average cost of capital, WACC , depends upon the specific cost of capital of individual sources in the total capital structure of the firm. One financing mix or capital structure is represented by one WACC which may change whenever there is a change in a financing mix. So a firm can change its WACC by changing the financing mix and can thus affect the value of the firm.

## LEVERAGE

MEANING

Leverage means the employment of assets or funds for which the firm pays a fixed cost or fixed return. The fixed cost or return may be thought of as the fulcrum of a lever. In mechanics the leverage concept is used for a technique by which more weight is raised with less power. In financial management the leverage is there an account of fixed cost. If any firm is using some some part of fixed cost capital than the firm has leverage which can be used for raising profitability and financial strength of firm.

### Operating Leverage

Operating leverage is defined as the ability to use fixed operating costs to magnify the effect of changes in sales on its operating profits. If the fixed operating costs are more as compared to variable operating costs, the operating leverage will be high and vice-versa. Thus, the term 'Operating leverage' refers to the sensivity of operating profit to changes in sales. For example, if the sales increase by say 20% and the operating profit increases by 100% it is a case of high operating leverage.

**Computation of Operating leverage:** -

**Operating Leverage** = Contribution/operating profit OR

= Sales – Variable cost /Contribution – Fixed Cost

**Degree of Operating Leverage (DOL):** - The degree of operating leverage may be defined as the percentage change in operating profits resulting from a percentage change in sales

• On two levels of sales for comparison:-

**Degree of operating leverage (DOL)** = Percentage change in profits /Percentage change in sales

On one level of sales:- **DOL = Contribution/EBIT**

When the profits increase with the increase in sales it is called favorable operating leverage.

Utility of operating leverage: - Operating leverage helps in capital structure decisions and play a vital role in formulation of an optimum capital structure. It is most helpful in long term profit planning as it is useful in taking decisions regarding capital expenditure. It is true to say that operating leverage is basically used in taking capital budgeting decisions.

## FINANCIAL LEVERAGE

Financial leverage arises from the presence of fixed financial costs in the income stream of the firm or due to presence of fixed return securities in the capital structure of the company. Fixed cost securities are debentures and preference share. Thus financial leverage is defined as, 'the firm ability to use fixed financial cost to magnify the effect of changes in earnings before interest

and tax (EBIT) on firm's earnings per share (EPS. Financial leverage may be favorable or

unfavorable. If the earnings made by the use of fixed interest bearing securities is more than their fixed costs. The firm is considered to have 'favorable financial leverage' or trading on equity. If the firm earns less than the cost of borrowed funds, the firm is said to have an 'unfavorable financial leverage'.

**Computation of Financial leverage:-**

**Financial leverage** = Earnings before interest and tax /Earnings before tax but after profit

**Degree of Financial leverage (DFL):** -

(a) On one level of profit: DFL = EBIT /Operating Profit

EBT

(b) On two level of profit for comparison: DFL = %Change in EPS /% Change is EBIT

**COMBINED LEVERAGE**

The combined leverage may be defined as the relationship between contribution and the taxable income; it is the combined effect of both the leverage.

**Computation of Combined leverage**: -

**Combined Leverage = Operating Leverage X Financial Leverage.**

Or **Contribution X EBIT Or Contribution**
**EBIT EBT EBT**

Degree of Combined Leverage (DCL): -

DCL = DOL x
DFL

DCL = % change in EPS / % change in Sales

***Significance of Leverages***

Measurement of Operating Risk Operating risk refers to the risk of the firm not being able to cover its fixed operating costs. Since

operating leverage depends on fixed operating costs, larger fixed operating costs indicates higher degree of operating leverage and thus, higher operating risk.

Measurement of Financial Risk Financial risk refers to the risk of the firm not being able to cover its fixed financial costs. Since financial leverage depends on fixed financial cost, high fixed financial costs indicates higher degree of operating leverage and thus, high financial risk. High financial leverage is good when operating profit is rising and bad when it is falling.

Managing Risk
Relationship between operating leverage and financial leverage is multiplicative rather than additive. Operating leverage and financial leverage can be combined in a number of different ways to obtain a desirable degree of total leverage and level of total firm risk.

Increase Profitability
Leverage is an effort or attempt by which a firm tries to show high result or more benefit by using fixed costs assets and fixed return sources of capital. It insures maximum utilization of capital and fixed assets in order to increase the profitability of a firm, It helps to know the reasons not having more profit by a company.

Designing Appropriate Capital Structure Mix

To design an appropriate capital structure mix or financial plan, the amount of EBIT under various financial plans, should be related to earning per share. One widely used means of examining the effect of leverage to analyze the relationship between EBIT and earning per share.

**Dividend Policy**
**Definition:**

Dividend is divisible profit distributed amongst members/shareholders of a company in proportion to shares in the manner as prescribed under law. A dividend cannot be declared unless:

1. Sufficient profit is there in a company.
2. It has been recommended by Board of Directors.
3. Its acceptance has been given by the shareholders in Annual General Meeting (AGM)

**TYPES OF DIVIDEND**

I. Type of Security – Preference Dividend, Equity Dividend

II. Timings of Dividends – Interim Dividend, Regular Dividend

III. Mode of Payment – Cash, Stock dividend (Bonus), Script or Bond.

**DETERMINANTS OF DIVIDEND POLICY**

The main determinants of dividend policy of a firm can be classified into:

1. **Dividend payout ratio**
   Dividend payout ratio refers to the percentage share of the net earnings distributed to the shareholders as dividends. Dividend policy involves the decision to pay out earnings or to retain them for reinvestment in the firm. The retained earnings constitute a source of finance. The optimum dividend policy should strike a balance between current dividends and future growth which maximizes the price of the firm's shares. The dividend payout ratio of a firm should be determined with reference to two basic objectives – maximizing the wealth of the firm's owners and providing sufficient funds to finance growth. These objectives are interrelated.
2. **Stability of dividends**
   Dividend stability refers to the payment of a certain minimum amount of dividend regularly. The stability of dividends can take any of the following three forms: a. constant dividend per share b. constant dividend payout ratio or c. constant dividend per share plus extra dividend
3. **Legal, contractual and internal constraints and restrictions**
   Legal stipulations do not require a dividend declaration but they specify the conditions under which dividends must be paid. Such conditions pertain to capital impairment, net profits and insolvency. These restrictions may cause the firm to restrict the payment of cash dividends until a certain level of earnings has been achieved or limit the amount of dividends paid to a certain amount or percentage of earnings. Internal constraints are unique to a firm and include liquid assets, growth prospects, financial requirements, availability of funds, earnings stability and control.
4. **Owner's considerations**
   The dividend policy is also likely to be affected by the owner's considerations of the tax status of the shareholders, their opportunities of investment and the dilution of ownership.
5. **Capital market considerations**
   The extent to which the firm has access to the capital markets, also affects the dividend policy. In case the firm has easy access to the capital market, it can follow a liberal dividend policy. If the firm has only limited access to capital markets, it is likely to adopt a low dividend payout ratio. Such companies rely on retained earnings as a major source of financing for future growth.
6. **Inflation**

With rising prices due to inflation, the funds generated from depreciation may not be sufficient to replace obsolete equipments and machinery. So, they may have to rely upon retained earnings as a source of fund to replace those assets. Thus, inflation affects dividend payout ratio in the negative side.

7. **Liquidity position**
   In tight liquidity position, instead cash dividend, bonus shares or scripts/bonds are issued.
8. **Trade Cycle**
   In boom conditions, higher profits are there and hence high dividend.

**RIGHTS AND BONUS SHARES**

**Bonus shares** means new shares given free of cost to all the existing shareholders of the company, in proportion to their holdings. For example, a company announcing bonus issue of 1:5, is issuing one (new) bonus share for every five shares held by the shareholders of the company.

**Rights issues** are a proportionate number of shares available to all the existing shareholders of the company, which can be bought at a given price (usually at a discount to current market price) for a fixed period of time. For example, a company announcing rights issue of 2:3 at Rs. 100 per share (current share price Rs. 130 per share), is issuing two (new) rights shares for every three shares held by the shareholders of the company at Rs. 100 per share. The rights shares can also be sold in the open market. If not subscribed to, the rights shares lapse on closure of the offer.

## UNIT IV

### SIGNIFICANCE OF WORKING CAPITAL MANAGEMENT

It is a fund needed to fulfill the operating cost of a concern. Each and every business concern should have adequate funds to meet its day-to-day expenses and to finance current asset viz., debtors, receivables and inventories. The funds tied up in current assets are known as working capital funds. The funds invested in these current assets keep revolving and are being constantly converted into cash and this cash in again converted into current assets. Therefore, working capital is also known as circulating capital, 'revolving capital,' 'short term capital', or liquid capital.

Prompt payment to supplies & benefit of cash/ trade discount.

- Increase in good will/ image
- Easy loans from banks
- Increase in the efficiency of employee's executives/ directors.
- Increase in the productivity as well as profitability

### TYPES OF WORKING CAPITAL

**Gross working capital** – Refers to firms investments in current assets which are converted in to cash during an accounting year such as cash, bank balance, short term investments, debtors, bills receivable, inventory, short term loans and advances etc.

**Net working capital** – Refers to difference between current assets and current liabilities or excess of total current assets over total current liabilities.

**Regular or permanent working capital** – Refers to minimum amount which permanently remain blocked and cannot be converted in to cash such as minimum amount blocked in raw material, finished product debtors etc.

**Variable or temporary working capital** – Refers to amount over and above permanent working capital i e difference between total working capital less permanent working capital.

**Seasonal working capital** - Refers to capital required to meet seasonal demand e.g. extra capital required for manufacturing coolers in summer, woolen garments in winter. It can be arranged through short term loans.

**Specific working capital** – Refers to part of capital required for meeting unforeseen contingencies such as strike, flood, war, slump etc.

### OBJECTIVES OF INVENTORY MANAGEMENT

### INVENTORY MANAGEMENT

It means efficient management/ control of capital invested in inventory for obtaining maximum return by keeping inventory costs at minimum.

### Objectives of Inventory Management

The main objective of inventory management is to maintain inventory at appropriate level to avoid excessive or shortage of inventory because both the cases are undesirable for business. Thus, management is faced with the following conflicting objectives:

1. To keep inventory at sufficiently high level to perform production and sales activities smoothly.
2. To minimize investment in inventory at minimum level to maximize profitability.

**Other objectives o inventory management are explained a under:-**

- To ensure that the supply of raw material & finished goods will remain continuous so that production process is not halted and demands of customers are duly met.
- To minimize carrying cost of inventory.
- To keep investment in inventory at optimum level.
- To reduce the losses of theft, obsolescence & wastage etc.
- To make arrangement for sale of slow moving items.
- To minimize inventory ordering costs.

**Types of Inventory:**

1. **Raw Materials** – Raw materials are important for obvious reasons such as the production of goods. The raw goods are what comes from your suppliers and their suppliers. If you do not have a system in place that grants visibility of raw materials, you cannot accurately gauge what you will produce over the next quarter or year. A company can go bankrupt if it doesn't properly manage its raw-material inventory. For example, a multi-billion dollar business had to shut down business and halt production for four days because they ran out of pallets on which to store and ship their supply. Pallets are very important for shipping and manufacturing companies and if they are ignored, then the business suffers.
2. **Work in Progress** – The second type of inventory is com posed of the goods currently being produced in your, or a contract manufacturer's company. Because many companies used to overlook this element, Enterprise Resource Planning (ERP) systems have been implemented to completely track all goods, those even being converted from raw to production, to accurately track profits and assist in the planning of future raw-material purchases.
3. **Finished Goods** – This type of inventory is usually controlled by your distributors or by your warehouse. For companies that have many distributors of their product it is important for them to know how much of their product is on the market. Especially when in the case of car manufacturers. It is hard to manufacture for multiple distributors when there is no visibility of your finished goods.

4. **Service Inventory** – Distribution inventory barely holds a candle compared to the difficulties of service industry, on of the most difficult of the five types of inventory. Crucial to business, service inventory needs proper management. Global mandates such as recycling and energy regulations need to be managed. You can gather information about failed products, using failure analysis to design better products and be able to leverage parts sales.

5. **Transportation** – A supply train of different inventories connected by transportation is the traditional definition of a supply chain, although this has changed now though. Talk to an accountant about the product in-transit and he or she will let you know that the products are in the books or in the books of your trading partners. Accounting for about 5% to 20% of your inventory, this often goes overlooked because the inventory cannot be seen. Being on a plane, truck, or boat does not erase it from your inventory and in-transit inventory is very important to keep track of. If shipments are delayed near the end of accounting periods and there is not appropriate visibility of those products you may receive a supply shipment at the end which would destroy your revenue because in-transit revenue was not accounted for.

## MOTIVES FOR HOLDING CASH

- **Transaction motive**: - Refers to cash required for making payments like wages, operating expenses, taxes, dividend, interest etc.

- **Precautionary motive:** - To make payment for unpredictable contingencies like strike, lockout, fire, sharp rise in prices etc.

- **Speculative motive: -** To take advantages of unexpected opportunities e.g. purchase of raw material at reduced prices on cash basis, buying securities at time when prices have fallen.

## OBJECTIVES OF CASH MANAGEMENT

- Ensuring availability of cash as per payment schedule
- Minimize amount of idle cash
- Effective control of cash (Maximizing interest on cash/funds not required immediately by the firm).

### Accounts Receivables

Accounts receivable describes the amount of cash, goods, or services owed to a business by a client or customer. The manner in which the collection of outstanding bills are handled, especially in a small business, can be a pivotal factor in determining a company's profitability. Getting the sale is the first step of the cash flow process, but all the sales in the world are of little use if monetary compensation is not forthcoming. Moreover, when a

business has trouble collecting what it is owed, it also often has trouble paying off the bills (accounts payable) it owes to others.

**Cost And Benefits of Account Receviables Management**

Accounts receivable management places a buffer between you and your customers in all aspect of invoicing, from creating the invoice to collecting the invoice, allowing you the ability to concentrate on your core business without putting customer relationships at risk.

1. Accounts receivable management can save the small business staffing expense by largely eliminating this function from its "to do" list. Individuals handling this function can be re-tasked in duties that will generate revenue. In some circumstances, a reduction in staff may be the optimum choice.
2. Accounts receivable management is typically a less costly arrangement than securing a working capital loan from your local bank. The credit worthiness of your customers is the driving factor … not the credit worthiness of your business. This makes the transaction far less cumbersome in terms of documentation.
3. Accounts receivable management will keep the small business on the right side of the law in terms of federal and state regulations. While a creditor has some leeway in pursuing its own collection activity, there are laws at the state and federal level that may elude the small business owner and create a financial maelstrom of legal fees, penalties and fines for any missteps.
4. Accounts receivable management offers the business a reliable cash flow scenario. This allows the business an enhanced opportunity to realize its goals.
5. Accounts receivable management is a service that provides centralized control over customer invoicing. This means eliminating oversights and errors, assuring accurate invoicing for the benefit of both the customer and the business.
6. Accounts receivable management provides customer account reconciliation as a matter of course. No more fumbling through stacks of invoices to answer a customer inquiry.
7. Accounts receivable management firms routinely prepare customer statements. These help not only the customer, but also your business. As any business person knows, excellent record keeping is at the heart of any successful enterprise.

## Concept of Factoring

**Factoring** is a financial transaction whereby a business sells its accounts receivable (i.e. invoices) to a third party (called a factor) at a discount.

The three parties directly involved are: the one who sells the receivable, the debtor (the account debtor, or customer of the seller), and the factor. The receivable is essentially a financial asset associated with the debtor's liability to pay money owed to the seller (usually for work performed or goods sold).

In "advance" factoring, the factor provides financing to the seller of the accounts in the form of a cash "advance," often 70-85% of the purchase price of the accounts, with the balance of the purchase price being paid, net of the factor's discount fee (commission) and other charges, upon collection from the account client. In "maturity" factoring, the factor makes no advance on the purchased accounts; rather, the purchase price is paid on or about the average maturity date of the accounts being purchased in the batch.

Factoring can be **classified** in the following ways:

• **Without Recourses Factoring**: This type of factoring is also known as full factoring. In without recourse factoring factor bears all the risks of non-payment by the customer. The factor cannot recover any amount from the selling company. Thus, it results into the outright buying of selling company's receivables by the factor.

• **With Recourses Factoring**: In this type of factoring the selling company bears the risks of non-payment by the customer. The factor is only entitles to recover the funds advanced by him from the selling company

The three main factoring services are:

- Credit insurance – with recourse and without recourse
- Financing
- Debt collection and Administration

## Advantages of Factoring

- Improve cash flows.
- Savings on internal administration costs
- Useful for small and fast growing organizations who credit department may not be able to keep up
- Reduction in the need of day to day management control.

## Disadvantages of Factoring

- It is more costly than an efficient run internal credit control department.
- Factoring has bad reputation associated with failing companies and this may cause customers to be concerned that the company has cash flow problems/failing hence they may not feel confident to continue business.
- Difficult to revert to an internal credit control
- Factors are more aggressive towards the company's customers because there main concern is collection and not customer care.

**References**


- Pandey IM ( 2010) Financial Management 10 th Edition , Vikas Publishing House.
- R.P Rustagi Edition : 2nd Revised Edition, September 2011; Jain Book Depot.
- Preeti Singh Fundamentals of Financial Management Ane Books Pvt Ltd, 2009
- Khan M.Y And Jain (2012) Financial Management 6 th Edition Tata Mc Graw Hill Company.
- Prasanna Chandra (2012) Financial Management : Theory and Practice, 8 th Edition Tata Mc Graw Hill.