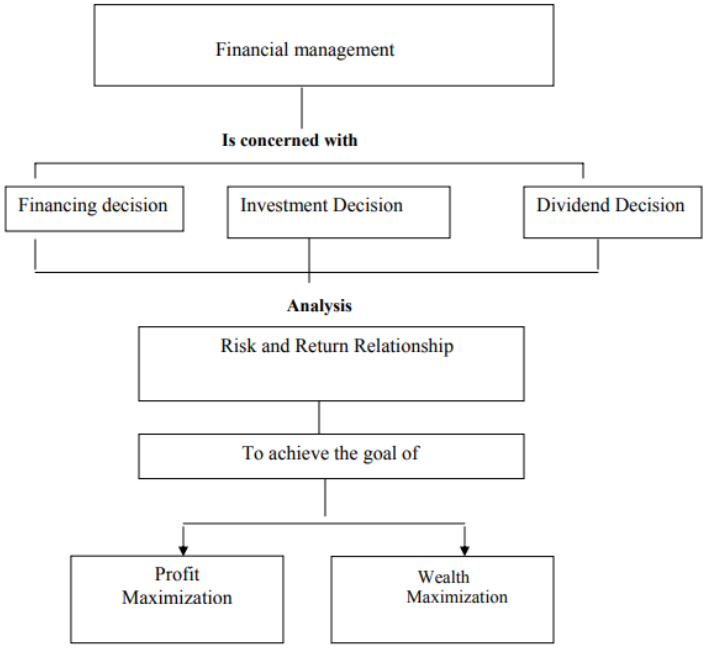
FINANCIAL MANAGEMENT

Finance is defined as the provision of money at the time when it is required. Every enterprise, whether big, medium, small, needs finance to carry on its operations and to achieve its target. In fact, finance is so indispensable today that it is rightly said to be the blood of an enterprise. Without adequate finance, no enterprise can possibly accomplish its objectives.

Meaning of Financial Management: Financial management refers to that part of the management activity, which is concerned with the planning, & controlling of firm's financial resources. It deals with finding out various sources for raising funds for the firm. Financial management is practiced by many corporate firms and can be called Corporation finance or Business Finance. Financial Management is the application of the general management principles in the area of financial decision-making, namely in the areas of investment of funds, financing various activities, and disposal of profits. Financial management is the art of planning; organizing, directing and controlling of the procurement and utilization of the funds and safe disposal of profits to the end that individual, organizational and social objectives are accomplished.



Functions of Financial Management:

A financial manager has to concentrate on the following areas of the finance function.

1. Estimating Financial Requirements: The first task of the financial manager is to estimate short term and long-term financial requirement of his business. For this purpose, he will prepare a financial plan for present as well as future. The amount required for purchasing fixed assets as well as the needs of funds for working capital has to be ascertained. The estimation should be based on the sound financial principles so that neither there are inadequate or excess funds with the concern. The inadequacy will affect the working of the concern and excess funds may tempt a management to indulge in extravagant spending.

2. Deciding Capital Structure: *The* capital structure refers to the kind and proportion of the different securities for raising funds. After deciding about the quantum of funds required it should be decided which type of security should be raised. It may be wise to finance fixed securities through long term debts. Long-term funds should be employed to finance working capital also. Decision about various sources of funds should be linked to cost of raising funds. If cost of rising funds is high, then such sources may not be useful. A decision about the kind of the securities to be employed and the proportion in which these should be used is an important decision which influences the short term and the long-term planning of the enterprise.

3. Selecting a Source of Finance: After preparing a capital structure, an appropriate source of finance is selected. Various sources from which finance may be raised, includes share capital, debentures, financial deposits etc. If finance is needed for short periods then banks, public's deposits, financial institutions may be appropriate. If long-term finance is required the share capital, debentures may be useful.

4. Selecting a Pattern of Investment: When fund have been procured then a decision about investment pattern is to be taken. The selection of investment pattern is related to the use of the funds. A decision has to be taken as to which assets are to be purchased? The fund will have to be spent first. Fixed asset and the appropriate portion will be retained for the working capital. The decision making techniques such as capital Budgeting, opportunity cost analysis may be applied in making decision about capital expenditures. While spending in various assets, the principles of safety, profitability, and liquidity should not be ignored.

5. Proper Cash Management: Cash management is an important task of financial manager. He has to assess the various cash needs at different times and then make arrangements for arranging cash. Cash may be required to make payments to creditors, purchasing raw material, meet wage bills, and meet day to day expenses. The sources of cash may be Cash sales, Collection of debts, Short-term arrangement with the banks. The cash management should be such that neither there is shortage of it and nor it is idle.

Any shortage of cash will damage the creditworthiness of the enterprise. The idle cash with the business mean that it is nit properly used. Through Cash Flow Statement one is able to find out various sources and applications of cash.

6. Implementing Financial Controls: An efficient system of financial management necessitates the use of various control devices. Financial control device generally used are;

- Return Investment
- Ratio analysis
- Break even analysis
- Cost control
- Cost and internal audit.

7. The use of various control techniques: This will help the financial manager in evaluating the performance in various Areas and take corrective measures whenever needed.

8. Proper use of Surpluses: The utilization of profits or surpluses as also an important factor in financial management. A judicious use of surpluses is essential for the expansion and diversification plans and also protecting the interest of the shareholders. The ploughing back of profit is the best policy of further financing. A balance should be struck in using the funds for paying dividends and retaining earnings for financing expansion plans.

Objectives of the Financial Management:

The main objective f a business is tom maximize the owner's economic welfare. Financial management provides a framework for selecting a proper course of action and deciding a commercial strategy. The objectives can be achieved by:
(i) Profit maximization
(ii) Wealth maximization

Profit Maximization: Profit earning is the main aim of every economic activity. A business being an economic institution must earn profit to cover its costs and provide funds for growth. No business ca survives without earning profit. Profit is a measure of efficiency of a business enterprise. Profit also serves as a protection against risks which cannot be ensured.

Arguments in favor of Profit Maximization-

- When profit earning is the aim of the business then the profit maximization should be the obvious objective.
- Profitability is the barometer for measuring the efficiency and economic prosperity of a business enterprise, thus profit maximization is justified on the ground of the rationality.
- Profits are the main source of finance for the growth of the business. So a business should aim at maximization of the profits for enabling its growth and development.
- Profitability is essential for fulfilling the social goals also. A firm by pursuing the objectives of profits maximization also maximizes the socio-economic welfare.
- A business may be able to survive under unfavorable condition only if it had some past earnings to rely upon.

Arguments against of Profit Maximization-

1. It is precisely defined. It means different things for different people. The term 'Profit' is vague and it cannot be precisely defined. It means different things for different people. Should we mean

- Short term profit or long-term profit?
- Total profit or earning per 9 shares?
- Profit before tax or after tax?
- Operating profit or profit available for the shareholders?

2. It ignores the time value of money and does not consider the magnitude and the timing of earnings. It treats all the earnings as equal though they occur in different time periods. It ignores the fact that the cash received today is more important than the same amount of cash received after, say, three years.

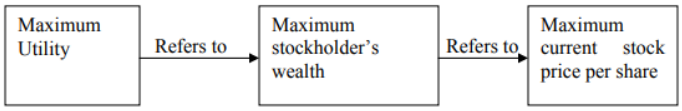
3. It does not take into consideration the risk of the prospective earnings stream. Some projects are more risky than others. Two firms may have same expected earnings per share, but if the earning stream in one is more risky the market share of its share will be comparatively less.
4. The effect of the dividend policy on the market price of the shares is also not considered in the objective of the profit

maximization. In case, earnings per share is the only objective then the enterprise may not think of paying dividends at all because it retains profits in the business or investing them in the market may satisfy this aim.

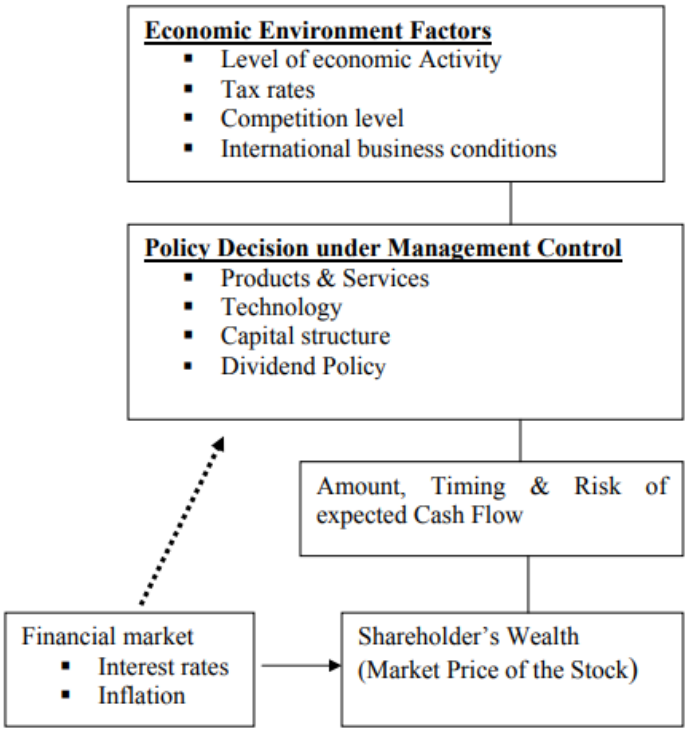
Wealth Maximization: Financial theory asserts that the wealth maximization is the single substitute for a stake holder's utility. When the firm maximizes the shareholder's wealth, the individual stakeholders can use this wealth to maximize his individual utility. It means that by maximizing stakeholder's wealth the firm is operating consistently toward maximizing stakeholder's utility. A stake solder's wealth in the firm is the product of the numbers of the shares owned, multiplied within the current stock price per share.

Stockholder's current wealth in the firm = (No. Of shares owned) * (Current stock price per share)-

Higher the stock price per share, the greater will be the shareholder's wealth. Thus a firm should aim at maximizing its current stock price, which helps in increasing the value of shares in the market.



Factors affecting the Stock Prices-



Implication of the wealth maximization:

- The Concept of wealth maximization is universally accepted, because it takes care of interest of financial institution, owners, employees and society at large.
- Wealth maximization guides the management in framing the consistent strong dividend policy to reach maximum returns to the equity holders.
- Wealth maximization objective not only serves the interest of the shareholder's by increasing the value of their holdings but also ensures the security to the lenders.

Criticism of wealth maximization:

- It is a prescriptive idea. The objective is not descriptive of what the firm actually does.
- The objective of wealth maximization is not necessarily socially desirable.
- There is some controversy as to whether the objective is to maximize the stockholder's wealth or the wealth of the firm, which includes other financial claimholder's such as debenture holders, preference shareholders.
- The objective of wealth maximization may also face difficulties when ownership and management are separated, as is the case in most of the corporate form of organizations. When managers act as the agents of the real owner, there is the possibility for a conflict of interest between shareholders and the managerial interests.

Financial Instruments: Equity Shares, Preference Shares, Right Issue:

Why there is a need for Finance: Every business needs funds both for short term and long term. They may need working capital, or, fixed capital. The finance may be obtained from the varied sources and through various instruments. The various sources of finance include shareholders, financial instruments, and financial institutions and so on. The funds can be collected through various instruments such as equity shares, convertible bonds, non- convertible debentures, fixed deposits, loan agreements, and so on. The finance is needed at various stages and for various purposes like promoting a business, smooth conduct of business activities.

Methods of Raising Finance:

1. Public Issue of Shares: The company can raise a substantial amount of fixed capital by issue of shares- equity and preference. In India, however, equity shares are more popular as compared to preference shares. The issue of shares requires a number of formalities to be completed such as approval of prospectus by S.E.B.I., appointment of underwriters, bankers, and registrars to the issue, filing of the prospectus with the registrar of companies, and so on.

2. Rights Issue of Shares: A Right issue is issue of shares to the existing shareholders of the company through a Letter of

Offer made in first instance to the existing shareholders on pro data basis. The shareholders have a choice to forfeit this right partially or fully. The company, then issue this additional capital to public. This is an inexpensive method as underwriting commission, brokerage are very small. Rights issue prevents dilution of control but it may conflict with the broader objective of wider diffusion of share capital.

3. Private Placement of Shares: This is a method of raising funds from a group of financial institutions and others who are ready to invest in the company.

4. Issue of Debentures: There are companies who collect long term funds by issuing debentures- convertible, or, non-convertible. Convertible debentures are very popular in the Indian market.

5. Long Term Loans: The company may also obtain long term loans from banks and financial institutions like I.D.B.I., I.C.I.C.I., and so on. The funding of term loans by financial institutions often acts as an inducement for the investors to sub- scribe for the shares of the company. This is, because, the financial institutions study the project report of the company before sanctioning loans. This creates confidence in the investors, and they too, lend money to the company in form of shares, debentures, fixed deposits, and so on.

6. Accumulated Earnings (Reserves): The Company often resorts to ploughing back of profits that, is, retaining a part of profits instead of distributing the entire amount to shareholders by way of dividend. Such accumulated earnings are very useful at the time of replacements, or, purchases of additional fixed assets.

We will discuss rights issue in detail:

Rights Issue: Rights issue is an invitation to the existing shareholders to subscribe for further shares to be issued by a company. A right simply means an option to buy certain securities at a certain privileged price within a certain specified period. The Company Act, 1956 lays down the manner in which further issue of shares, whether equity or preference, is to be made so as to ensure equitable distribution of shares without disturbing the established equilibrium of shareholding in the company. According to Section 81 of the Companies Act, whenever a public limited company proposes to increase its subscribed capital by the allotment of further shares, after the expiry of two years from the formation of the company or the expiry of one year from the first allotment of shares in the company, whichever is earlier, the following conditions or procedure must be followed:

- Such shares must be offered to holders of equity shares in proportion, as nearly as circumstances admit, to the capital paid-up on those shares.
- The offer must be made by giving a notice specifying the number of shares offered.
- The offer must be made to accept the shares within a period specified in the notice being not than 15 days.
- Unless the articles of association of the company provide otherwise, the notice must also state that the shareholder has the right to renounce all or any of the shares offered to him in favor of his nominees.

Shares so offered to existing shareholders are called Right Shares as the existing equity shareholders of the public company have a first right of allotment of further shares. The offer of such shares to the existing equity shareholder is known as Privileged Subscription or Right Issue. The prior right of the shareholders is also known as pre-emptive right. After expiry of the time specified in the notice or on receipt of earlier information from the shareholder declining to accept the shares offered, the Board of Directors may dispose them off in such a manner as they think most beneficial to the company.

Advantages of Rights Issue:

- It ensures that the control of the company is preserved in the hands of the existing shareholders.
- The expenses to be incurred, otherwise if shares are offered to the public, are avoided.
- There is more certainty of the shares being sold to the existing shareholders.
- It betters the image of the company and stimulates enthusiastic response from shareholders and the investment market.
- It ensures that the directors do not misuse the opportunity of issuing new shares to their relatives and friends at lower prices on the one hand and on the other get more controlling rights in the company.

Financial Instruments: The capital of a joint stock company can be divided into "Owned capital" and "Borrowed capital". Owned capital means the capital of the owners which comprises of shares, both preference and equity and borrowed capital comprises of debentures, fixed deposits and bonds.

Shares: A share can be defined as "A fraction part of the capital of the company which forms the basis of ownership and interest of a subscriber in the company". Precisely, a share is a small part of the total capital. When the owned capital is divided into a number of equal parts, then, each part is called as a share. A person who contributes for a share is called as a share- holder.

Types of shares: Shares can be broadly divided into equity shares and preference shares

1. **Equity Shares:**
2. **Preference Shares:**

Equity Shares: Shares which enjoy dividend and right to participate in the management of Joint Stock Company are called equity shares, or, ordinary shares. They are the owners and real risk bearers of the company. Equity shares can be defined as per as our Indian Companies Act (1956) as, "Shares which are not preference shares are equity shares, or, ordinary shares". Equity shareholders are the real owners of the company and, therefore, they are eligible to share the profits of the company. The share given to equity shareholders in profits is called "Dividend". At the time of winding of company, the capital is paid back last to them after all other claims have been paid in full.

Advantages of Equity Shares:

- The company has no immediate liability to pay it.
- No fixed dividend obligation.
- Increases creditworthiness of business, ceteris paribus.
- No charge created on assets of the business.
- Shareholders control the company.
- Limited liability of the investors.
- High dividends.
- No collateral security needed.
- Increases firm credibility.

Disadvantages of Equity Shares:

- Equity dividend not tax- deductible.
- High cost of equity issue.
- Gradual dilution of shareholder's control over business.
- Manipulation by a few shareholders.
- Dividend at the discretion of the Directors.
- Very risky investment.
- Residual claim on investments.

Preference Shares: Shares which enjoy preference as regards dividend payment and capital repayment are called "Preference Shares". They get dividend before equity holders. They get back their capital before equity holders in the event of winding up of the company. The owners 14 of these shares have a preference for dividend and a first claim for return of capital; when the company is closed down. But, their dividend rate is fixed. Preference share can be of following types:

- **Cumulative Preference Shares:** Such shareholders have a right to claim the dividend. If, dividend is not paid to them, then, such dividend gets accumulated, and, therefore, they are called as "Cumulative Preference shares".
- **Non- Cumulative Preference Shares:** They are exactly opposite to cumulative preference shares. Their right to get dividend lapses if, they are not paid dividend and it does not get accumulated. Thus, their right to claim dividend for the past years will lapse and will not be accumulated.
- **Participating Preference Shares:** Such shareholders have a right to participate in the excess profits of the company, in addition to their usual dividend. Thus, if, there are excess profits and huge dividends, are declared in the equity shares, the holders of these all shares get a second round of dividend along with equity shareholders; after a dividend at a certain rate has been paid to equity shareholders.
- **Non- Participating Preference Shares:** Such shareholders do not have any right to share excess profits. They get only fixed dividend.
- **Convertible Preference Shares:** Such shares can be converted into equity shares, at the option of the company.
- **Redeemable Preference Shares:** Such shares are to be redeemed, or, paid back in cash to the holders after a period of time.
- **Non- Redeemable Preference Shares:** Such shares are not paid in cash during the life of the company.

Merits of Preference Shares:

- Fixed dividend.
- First claim on company assets.
- Cost of capital is low.
- No dilution over control.
- No dividend obligation.

No redemption liability.

- Demerits of Preference Shares:
- Not a very high dividend rate.
- No voting rights.

- Dividends paid are not tax- deductible.
- Non payment of dividend affects firm.

Debts: Debentures, Types of Debentures:

Debentures: When borrowed capital is divided into equal parts, then, each part is called as a debenture. Debenture represents debt. For such debts, company pays interest at regular intervals. It represents borrowed capital and a debenture holder is the creditor of the company. Debenture holder provides loan to the company and he has nothing to do with the management of the company.

Kinds of Debentures: A company can issue different kinds of debentures.

(a) Registered and Bearer Debentures: This classification of debentures is made on the basis of transferability of debentures. Registered debentures are those in respect of which the names, addresses, and particulars of the holdings of debenture holders are entered in a register kept by the company. The transfer of ownership of such debentures is possible through a regular instrument of transfer which is duly signed by the transferee and the transferor. However, the transfers are freely allowed through the execution of a regular Transfer Deed. Only formal approval of the Board is necessary. Interest on such debentures is paid through interest warrants. Bearer debentures are transferable by mere delivery. They are freely negotiable instruments. The company keeps no records of the debenture- holders in the case of bearer debentures. Such debentures are similar to Share Warrants; the interest on them is paid by means of attached coupons which encashed by the holder are as and when cash falls due. On maturity, the principal sum of Bearer Debenture is paid back to the holder.

(b) Secured and Unsecured Debentures: This classification is made on the basis of security offered to debenture-holders. Secured debentures are those which are secured by some safe charge on the property of the company. The charge or, mortgage may be "Fixed", or, "Floating", and thus, there may be "Fixed Mortgage Debentures", or, "Floating Mortgage Debentures" depending upon the nature of charge under the category of Secured Debentures. Unsecured, or, Naked Debentures are those that, are secured by any charge on the assets of the company. The holders of such debentures are like ordinary creditors of the company. The general solvency of the company is the only security available to unsecured or, naked debentures.

(c) Redeemable and Irredeemable Debentures: This classification is made on the basis of terms of repayment. Redeemable Debentures are for fixed period and they provide for payment of the principal sum on specified date, or, on demand, or, notice. Irredeemable Debentures are not issued for a fixed period. The issuing company does not fix any date by which the principal would be paid back. The holders of such debentures cannot demand payment from the company so long as it is a going concern. Such debentures are perpetual in nature as they are payable after a long time, or, on winding up of the company.

(d) Convertible and Non- Convertible Debentures: This classification is made on the convertibility of the debentures. Convertible Debentures are those which are convertible into Equity Shares on maturity as per the terms of issue. Convertible Debentures are those which are convertible into equity shares on maturity as per the terms of issue. Convertible debentures are now popular in our India and many companies issue convertible debentures which are automatically converted into shares after a fixed period, or, date (usually, after three years). The rate of exchange of debentures into shares is also decided at the time of issue of debentures. Interest is paid on such debentures till conversion. Such debentures are popular with the investing class. Non- Convertible Debentures are not convertible into Equity Shares after some period, or, on maturity. Prior approval of the shareholders is necessary for the issue of convertible debentures. It also requires sanction of the central government. The conversion of debentures into shares particularly of profitable companies is always advantageous to debenture holders as well as to the company.

Demerits of Debentures-

- Interest obligatory.
- High liability.
- Charged against assets.
- Not meant for weak firms.

Merits of Debentures-

- Issuing is cheap.
- No dilution of control.
- Best for depression periods.

INDIAN FINANCIAL SYSTEM

Savings mobilization and promotion of investment are functions of the stock and capital markets, which are a part of the organized financial system in India. The objective of all economic activity is to promote the well being and standard of living of the people, which depends on the income and distribution of income in terms of real goods and services in the economy. The production of output, which is vital to the growth process in the economy, is a function of the many inputs used in the productive process. These inputs are material inputs (in the form of physical materials, viz., raw materials, plant, machinery, etc.), human inputs (in the form of labor and enterprise) and financial inputs (in the form of

capital, cash and credit). The easy availability of financial inputs promotes the growth process through proper coordination between human and material inputs.

The financial inputs emanate from the financial system, while real goods and services are part of the real system. The interaction between the real system (goods and services) and the financial
system (money and capital) is necessary for the productive process. Trading in money and monetary assets constitute the activity in the financial markets and are referred to as the financial system.

Financial System:

The term "liquidity" is used to refer to cash, money and nearness to cash. Money and monetary assets are traded in the financial system. Thus, provision of liquidity and trading in liquidity are the major functions of the financial system. While cash creation is the function of the RBI, banks do credit creation and financial institutions including the RBI, banks and term-leading institutions, deal in claims on money or monetary assets.

sectors are the major borrowers whose investment is always greater than savings. On the other hand, in India the household and foreign sectors are the net savers, with savings exceeding investment. The financial system provides the intermediation between investors and helps the process of specialization and sophistication in the financial infrastructure, leading to greater financial development that is prerequisite for faster economic development.

Functions of Financial Markets-

The primary function of the financial markets is to facilitate the transfer of funds from surplus sectors (lenders) to deficit sectors (borrowers). Normally, households have excess of funds or savings, which they lend to borrowers in the corporate and public sectors whose requirement offunds, exceed their savings. A financial market consists of investors or buyers, 'sellers, dealers and brokers and does not refer to a physical location. Formal trading rules and communication networks for originating and trading financial securities link the participants in the market. The primary market in which public issue of securities is made through a prospectus is a retail market and there is no physical location. The investors are reached by direct mailing. On the other hand, the secondary market or stock exchange where existing securities are traded is an auction market and may have a physical location such as the rotunda of the Bombay Stock Exchange or\the trading floor of Delhi, Ahmedabad and other exchanges where the exchange members meet to trade securities face-to-face. In the Over-The-Counter (OTCEI) market and National Stock Exchange, trading in securities is screen-based. The Bombay Stock Exchange (BOLT) now introduces on-line trading, and other exchanges are in the process of introducing the same that is screen-based.

Financial markets trade in money and their price is the rate of return the buyer expects the financial asset to yield. The value of financial assets changes with the investors' expectations on earning or interest rates. Investors seek the highest return for a given level of risk (by paying the lowest price) and users of funds attempt to borrow at the lowest rate possible. The aggressive interaction, of investors and users of funds in a properly functioning capital market ensures the flow of capital to the best user. Investors receive the highest return and the users obtain funds at the lowest cost.

The three important functions of financial markets are:

(a) Financial Markets Facilitate Price Discovery. Financial markets help in establishing the prices of financial assets. Well organized financial markets seem to be remarkably in the rate of return and other incentives, funds flow from less efficient in price discovery.
That is why financial economists productive to more productive activities. The efficient functioning say: "If you want to know what is the value of a financial asset simply look at its price in the financial market".

(b) Financial Markets Provide Liquidity to Financial Assets. Investors can readily sell their financial assets through the mechanism of financial markets. In the absence of financial markets, which provide such liquidity, the motivation of investors to hold financial assets will be considerably diminished. Thanks to negotiability and transferability of securities through the financial markets, it is possible for companies (and other entities) to raise long-term funds from investors with short-term and medium term horizons. While one investor is substituted by another when a security is transacted, the company is assured of long-term availability of funds.

(c) Financial Markets Considerably Reduce the Cost of Transacting. The two major costs associated with transacting are search costs and information costs. Search costs comprise explicit costs such as the expenses incurred on advertising when one wants to buy or sell an asset and implicit costs such as the effort and time one has to put in to locate a customer. Information costs refer to costs incurred in evaluating the investment merits of financial assets.

Classification of Financial Markets-

Financial markets can be classified in various types based on the different characteristics.

(a) One way is to classify financial markets by the type of financial claim. The debt market is the financial market for fixed claims (debt instruments) and the equity market is the financial market for residual claims (equity instruments).

(b) A second way is to classify financial markets by the maturity of claims. The market for short-term financial claims is referred to as the money market and the market for Longterm financial cli.1ims is called the capital market traditionally the cut-off between shortterm and long-term financial claims has been one year-though this dividing line is arbitrary, it is widely accepted. Since short-term financial claims are almost invariably debt claims, the money market is the market for short-term debt instruments. The capital market is the market for long-term debt instruments and equity instruments.

(c) A third way to classify financial markets is based on whether the claims represent new issues or outstanding issues. The market where issuers sell new claims is referred to as the primary market and the market where investors trade outstanding securities is called the secondary market.

(d) A fourth way to classify financial markets is by the timing of delivery. A cash or spot market is one where the delivery occurs immediately and a forward or futures market is one where the delivery occurs at a pre-determined time in future.

(e) A fifth way to classify financial markets is by the nature of its organisational structure.
An exchange-traded market is characterised by a centralised organisation with standardised procedures. An over-the counter market is a decentralised market with customised procedures.

We will concentrate on classification as per seasoning of claims:
(a) Primary market
(b) Secondary market

Both primary market and secondary market are parts of Capital market. **The capital market** is a financial relationship created by a number of institutions and arrangements that allows suppliers and demanders of long term funds to make transactions. It is a market for long term funds. The backbone of the capital market is formed by various securities exchanges that provide a forum for equity (equity market) transactions.

(a) Primary Market / New Issue Market / Initial Public Offering Markets: The primary market deals with the issue of new securities , that is, securities which are not previously available, It provides additional funds to the issuing companies either for starting a new enterprise or for the expansion or diversification of the existing one and, therefore its contribution to company financing is direct. The primary market is not rooted in any particular
spot and have no geographical existence. It is recognized only by the services it renders to lenders and borrowers of capital funds at the time of a particular operation.

Functions of primary market-
The general function of primary market, namely, channelizing of investible funds in to industrial enterprises, can be spilt in to three services, which are as follows:

(a) Origination: The term origination refers to the work of investigation and analysis and processing of new proposals. These functions are performed by specialist agencies which act as sponsors of the issue. The preliminary investigation entails careful study of technical, economical, financial, and legal aspects of the issuing companies. This is to ensure that it warrants the backing of the issue houses in the sense of lending their name to the - company and, thus, give the issue the stamp of respectability, to satisfy themselves that the company is strongly based, has good market prospects, is well managed and ;is worthy of stock exchange quotation. In the process of origination the sponsoring institutions render, as a second function, some service of an advisory nature which goes to improve the quality of capital issues. These services include advice on such aspects of capital issues as: (i) determination of the class of securities to be issued and price of the issues in the light of market conditions" (ii) the timing and magnitude e of issues, (iii) methods of flotation, and (iv) technique of selling, and so on market.

(b) Underwriting: To ensure success of an issue, the second specialist service underwriting provided by the institutional setup of the NIM takes the form of a guarantee that the issues would be sold by eliminating the risk arising from uncertainty of public response.
That adequate institutional arrangement for the provision of underwriting' is of crucial significance both to the issuing companies as well as the investing public cannot be overstressed.

(c) Distribution: The, sale of securities to the ultimate investors is referred to as distribution; It is a specialist job

which can best be performed by brokers and dealers in securities, who maintain regular and direct contact with the ultimate investors.

(b) Secondary Market/ Stock exchange / Security Market: The secondary market deals in to old securities, which may be defined as securities which have been issued already and listed on a stock exchange. The stock exchanges, therefore, provide regular and continuous market for buying and selling of securities and to that extent, lend liquidity and marketability play an important part in the process. Their role regarding supply of capital is indirect. The secondary markets can in no circumstance supply additional funds since the company is not involved in the transaction. The stock exchanges have physical existence and located in particular geographical areas.

Functions of secondary markets: Stock exchanges discharge following three vital functions in the orderly growth of capital formation:

(a) Nexus between savings and investments: First and foremost, they are the nexus between the savings and the investment of the community. The savings of the community are mobilized and channelled by stock exchanges for investment in to those sectors and units which are favored by the community at large, on the basis of such criteria as good return, appreciation of capital, and so on. It is the preference of investors for individual units a well as industry groups, which is reflected in the share price, that decides the mode of investment. Stock exchanges render this service by arranging for the preliminary distribution of new issues of capital, offered through prospectus, as also offers for sale of existing securities, in an orderly and systematic manner. They themselves administrator the same, by ensuring that the various requisites of listing are duly complied with Members of stock exchanges also assist in the flotation of new issues by acting (i) as brokers, in which capacity they, *inter alia,* try to procure subscription from investors spread all over the country, and (ii) as underwriters.

(b) Market Place: They provide a market place for the purchase and sale of securities, thereby enabling their free transferability through several successive stages from the original subscriber to the never-ending stream of buyers, who may be buying them today to sell them at a later date for a variety of considerations like meeting their own needs of liquidity, shuffling their investment portfolios to gear up for the ever-changing market situations, and so on. Since the point of aggregate sale and purchase is centralised, with a multiplicity of buyers and sellers at any point of time, by and large, a seller has a ready purchaser and a purchaser has a ready seller at a price which can be said to be competitive. This guarantees sales ability to one who has already invested and surety of purchase to the other who desires to invest.

(c) Continuous Price Formation: The third major function, discharged by the stock exchanges is the process of continuous price formation. The collective judgment of many people operating simultaneously in the market, resulting in the emergence of a large number of buyers and sellers at any point of time, has the effect of bringing about changes in the levels of security prices in small graduations, thereby evening out wide swings in prices. The ever-changing demand and supply conditions result in a continuous revaluation of assets, with today's prices being yesterday's prices, altered, corrected, and adjusted, and tomorrows values being again today's values altered, corrected and adjusted. The process is an unending one. Stock exchanges thus act as a barometer of the state of health of the nations economy, by constantly measuring its progress or otherwise. An investor can always have his eyes turned towards the stock exchanges to know, at any point of time, the value of the investments and plan his personal needs accordingly.

Time Value of Money-

Most financial decisions, such as the purchase of assets or procurement of funds, affect the firm's cash flows in different time periods. For example, if fixed asset are purchased it will require immediate cash outlays sand will generate cash flows during many future periods. Similarly, if firm borrows funds from the bank it receives cash now and commits an obligation to pay interest and repay principal in future periods. Cash flows become logically comparable when they are appropriately adjusted for their differences in time and risk.

The recognition of the time value of money and risk is extremely vital in financial decision making. If the timing and risk of cash floes is not considered, the firm may make decision, which may allow too its objectives of maximize the owner's welfare. The welfare of the owners would be maximized when net worth or net value is created from making a financial decision. What is Net Present Value? It's a time value concept. Money has time value. A rupee today is more valuable then a rupee a year hence.

Reasons for individual's Time Preference for Money:

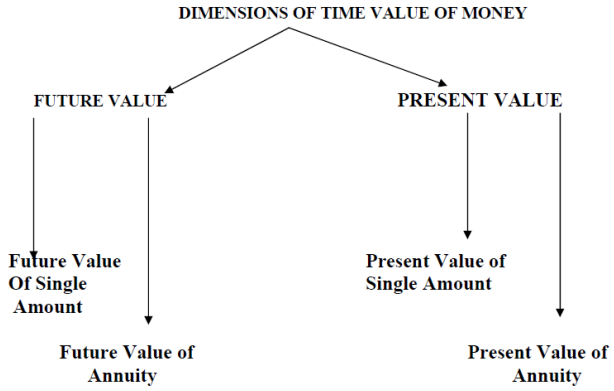
(a) Uncertainty: An individual is not certain about future cash receipts, he prefers receiving cash now.

(b) Preference for Consumption: Most people have subjective preference for present consumption over future consumption of goods and services either because of the urgency of their present wants or because of the risk of not being in a position to enjoy future consumption that may be caused by illness or death. As money is the means by which individuals acquire most goods and services, they may prefer to money have now.

(c) Investment Opportunities: Most individuals prefer present cash to future cash because of the available

opportunities to which they can put present cash to earn additional cash.

For e.g., an individual who is offered Rs. 100 now or Rs 100 one year from now would prefer Rs100 now if he could earn interest of Rs 5 by putting in the saving account in the bank for one year. His total cash in one year from now will be Rs.105.



Valuation of Bonds and Shares-

Introduction: Valuation is the process that links risk and return to determine the worth of an asset. It can be applied to expected benefits from real/physical as well as financial to determine their worth at a given point of time. We will focus on valuation of two financial assets, namely, bonds/debentures and shares, the key inputs to valuation process are i) expected returns in terms of cash flows together with their timing and ii) risk in terms of the required return. The value of an asset depends on the return (cash flow) it is expected to provide over the holding / ownership period. The cash flow stream can be (1) annual, (2) intermittent and (3) even onetime.

In addition to total cash flow estimates, their timing/pattern (e.g. amount year-wise) is also required to identify the return expected from the bond/share. The required return is used in the valuation process to incorporate risk into the analysis. Risk denotes the chance that an expected cash flow would not be realized. The level of risk associated with a expected cash flow/return has a significant bearing on its value, that is, the greater the risk, the lower the value and *vice versa.* Higher risk can be incorporated into the valuation analysis by using a higher capitalization/ discount rate to determine the present value.

Valuation of securities will be discussed in following parts:

1. The basic valuation model
2. Valuation of Bond / Debenture
  a. Basic bond valuation
  b. Yield to maturity
  c. Semi-annual interest and bond value
3. Valuation of preference shares
4. Valuation of ordinary shares
  a. Zero growth model
  b. Constant growth model / Gordon model
  c. Variable growth model

Financial Analysis: Financial statements presents mass of complex data in absolute monetary terms and reveals little about liquidity, solvency and profitability of the business. In financial analysis, the data given in financial statements is classified into simple groups and a comparison of various groups is made with one another to pin point the strong and weak points of the business. For example, if all the items relating to current assets are placed in one group while the items related to current liabilities are placed in other group, the comparison between the two groups will provide useful information.

The principal techniques of financial analysis are:

1. Comparative Statement
2. Common Size Statement
3. Trend Analysis
4. Ratio Analysis
5. Fund Flow Statement
6. Cash Flow Statement

Comparative Financial Statements: When financial statements figures for two or more years are placed side-by-side to facilitate comparison, these are called 'Comparative Financial Statements.' Such statements not only show the absolute figures of various years but also provide for columns to indicate the increase or decrease in these figures from one year to another. 'In addition, these statements may also show the change from one year to another in percentage form. Because of the utmost usefulness of the comparative statements, the Companies Act, 1956 has provided that the Profit & Loss Account and Balance Sheet of a Company must show the figures of the previous year also with the figures of the current year.

Purpose or Importance of Comparative Statements-

1. To Make the Data Simpler and More Understandable: When data for a number of years are put side-by-side in a comparative 'form it becomes easier to understand them and the conclusions regarding the profitability and financial position of the concern can be drawn very easily.

2. To Indicate the Trend: This helps in indicating the trend of change by putting the figures of production, sales, expenses, profits etc. for number of year's side-by-side.

3. To Indicate the Strong Points and Weak Points of the Concern: It may also indicate the strong points and weak points of the firm. Management can then investigate and find out the reasons for the weak areas and can take corrective measures.

4. To Compare the Firm's Performance with the Average Performance of the Industry: Comparative financial statements help a business unit to compare its' performance with *the* average performance of the industry.

5. To Help in Forecasting: Comparative study of the changes in the key figures over a period helps the management in forecasting the profitability and financial soundness of the business.

Capital Budgeting:

Introduction: Capital Budgeting is the process of making investment decision in capital expenditure. It involves the planning and control of capital expenditure. It is the process of deciding whether or not to commit resources to particular long-term projects whose benefits are to be realized over a period of time.

Features of Capital Budgeting-

1. Exchange of funds for future benefits:
2. The future benefits are expected to be realized over a period of time.
3. The funds are invested vested in long-term activities.
4. They have a long term and significant effect on the profitability of the concern,
5. They involve huge funds.

Importance of Capital Budgeting-

1. Large Investment: Capital budgeting decision involves large investment of funds. But the funds available with the firm are always limited and the demand for funds far exceeds the resources. Hence it is very important for a firm to plan and control its capital expenditure.

2. Long Term Commitment of Funds: capital expenditures involves not only large amount of funds but also funds for long term or permanent basis. The long tern commitments of funds increases, the financial risk involved in the investment decision. Greater the risk involved, greater is need for careful planning of capital expenditure i.e. Capital Budgeting.

3. Irreversible Nature: The Capital expenditure decision is of irreversible nature. Once the decision for acquiring a permanent asset is taken, it becomes very difficult to dispose of these assets without incurring heavy losses.

4. Long term Effect on profitability: Capital budgeting decisions have a long term and significant effect on the profitability of a concern. Not only the present earnings of the firm are effected by the investments in capital asserts but also the future growth and profitability of the firm depends upon the investment decision taken today. An unwise decision may prove disastrous and fatal to the very existence of the concern.

5. Difficulties of investment Decisions: The long tern investment decision are difficult to be taken because decision extends to a series of years beyond the current accounting period, uncertainties of future, higher degree of risk.

6. National Importance: Investment decision though taken by individual concern is of national importance because it determines employment, economic activities and growth.

Evaluations Techniques of Projects-
The commonly used methods are following:

1. Traditional Method
a. Pay backs period method or pay out or pay off method
b. Rate of return Method or Accounting Method

2. Time adjusted Method or discounted method
a. Net present value method
b. Internal rate of return

Pay Back Period Method: It represents the period in which the total investments in permanent assts pay backs itself. This method is based on the principal that every capital expenditures pays itself back within a certain period out of the additional earnings generated from the capital assets thus it measures the period of time for the original cost of a project to be recovered from the additional earnings of the project itself.

In case of evaluation of a single project, it is adopted if it pays back itself within a period specified by the management and if the project does not pay back itself within the period specified by the management than it is rejected.

The payback period can be ascertained in the following manner: Calculate annual net earning (profit) before depreciation and after taxes; these are called the annual cash flows.

Where the annual cash inflows are equal, Divide the initial outlay (cost) of the project by annual cash flows, where the project generates constant annual cash inflows.

Where the annual cash inflows are unequal, the pat back period can be found by adding up the cash inflows until the total is equal to the initial cash outlay of project or original cost of the asset.

$$\text{Payback period} = \frac{\text{Cash outlay of the project or original cost of the asset}}{\text{Annual cash Inflows}}$$

Illustration 1. A project costs Rs1, 00,000 and yields annual cash inflow of Rs. 20,000 for 8 years. Calculate its pay back period.

Solution:

$$\text{Pay back period} = \frac{\text{Cash outlay of the project or original cost of the asset}}{\text{Annual cash Inflows}}$$

$$= \frac{1,00,000}{20,000} = 5 \text{ years}$$

Advantages of Pay Back Period-

1. It is simple to understand and easy to calculate.
2. It saves in cost; it requires lesser time and labor as compared to other methods of capital budgeting.
3. This method is particularly suited to firm, which has shortage of cash or whose liquidity position is not particularly good.

Disadvantages of Pay Back Period

1. It does not take into account the cash inflows earned after the pay back period and hence the true profitability of the project cannot be correctly assessed.

2. It ignores the time value of money and does not consider the magnitude and timing of cash inflows. it treats all cash flows as equal though they occur in different time periods.

3. It does not take into consideration the cost of capital, which is very important; factor in making sound investment decision.

4. It treats each asset individually in isolation with other asset, which is not feasible in real practice.

5. It does not measure the true profitability of the project, as the period considered under this method is limited to a short period only and not the full life of the asset.

Rate of Return Method: This method take into account the earnings expected from the investment over their whole life. It is known as accounting rate if Return method for the reasons that under this method, the accounting Concept of profit is used rather than cash inflows.
According to this method, various projects are ranked in order of the rate of earnings or rate of return. The project with the higher rate of return is selected as compared to the one with the lower rate of return. This method can be used to make decisions as to accepting or rejecting a proposal. The expected return is determined and the project with a higher rate of return than the minimum rate specified by the firm called cut-off rate, is accepted and the one which gives a lower expected rate of return than the minimum rate is rejected.

Time Adjusted or Discounted Cash Flows Methods-
The traditional methods of capital budgeting suffer from serious limitations that give the equal weights to present and future flow of income. These do not take into accounts the time value of money. Following are the discounted cash flow methods:

Net Present Value Method: This method is the modern method of evaluating the investment proposals. This method takes into consideration the time value of money and attempts to calculate the return in investments by introducing the factor of time element. It recognizes the fact that a rupee earned today is more valuable earned tomorrow. The net present value of all inflows and outflows of cash occurring during the entire life of the project is determined separately for each year by discounting these flows by the firm's cost of capital.

Following are the necessary steps for adopting the net present value method of evaluating investment proposals.

1. Determine appropriate rate of interest that should be selected as the minimum required rate of return called discount rate.
2. Compute the present value of total investment outlay.
3. Compute the present value of total investment proceeds.
4. Calculate the net present value of each project by subtracting the present value of cash inflows from the present value of cash outflows for each project.
5. If the net present value is positive or zero, the proposal may be accepted otherwise
rejected.

Advantages of Net Present Value-
1. It recognizes the time value of money and is suitable to be applied in situations with uniform cash outflows and cash flows at different period of time.
2. It takes into account the earnings over the entire life of the projects and the true profitability of the investment proposal can be evaluated.
3. It takes into consideration the on\objective of maximum profitability.

Disadvantages of Net Present Value
1. This method is more difficult to understand and operate.
2. It is not easy to determine an appropriate discount rate.
3. It may not give good results while comparing projects with unequal lives and investment of funds.

Capital Structure-

In order to run and manage the company, funds are needed. Right from the promotional stage up to end, finances play an important role in the company's life. If funds are inadequate,

the business suffers and if the funds are not properly managed. The entire organization suffers. It is therefore; necessary that correct estimate of the current and future needs of the capital to be made to have an optimum capital structure.

The capital structure is made up of debt and equity securities and refers to permanent financing of a firm. It is composed of long-term debt, preference share capital and shareholder's funds.
According to Gestenberg: "Capital structure of a company refers to the composition or make up of its capitalization and it includes all long-term capital resources viz: loans, reserves, shares and bonds".

Forms of capital structure-
(a) Equity shares only
(b) Equity and preference Shares
(c) Equity Shares and Debentures
(d) Equity, preference and Debentures.

Factors Determining the Capital Structure-

Financial Leverage: The use of long term fixed interest bearing debt and preference share capital along with equity share capital is called financial leverage. The use of longterm debt magnifies the earning per share if the firm yields a return higher than the cost of debt. The earning per share also increases with use of preference share capital but due to the fact that interest is allowed to be deducted while computing tax, the leverage impact of debt is more.

2. Growth and Stability of Sales: The capital structure of a firm is highly influenced by the growth and stability of its sales. If the sales are expected to remain fairly stable, it can raise a higher level of debt. Stability of sales ensures that the firm will not face any difficulty in meeting its fixed commitments of interest payment and repayments of debts.
If sales are highly fluctuating, it should not employ debt financing in its capitals structure.

3. Cost of Capital: Cost of capital refers to the minimum rate of return expected by its suppliers. The capital structure should also provide for the minimum cost of capital.
Usually, debt is cheaper source of finance compared to preference and equity. Preference capital is cheaper then equity because of lesser risk involved.

4. Cash flow Ability to Service the Debt: A firm which shall be able to generate larger and stable cash inflows can employ more debt in its capital structure as compared to the one which has unstable and lesser ability to generate cash inflows. Whenever a firm wants to raise additional funds, it should estimate, project its cash inflows to ensure the coverage of fixed charges.

5. Nature and Size of Firm: Nature and size of firm also influences the capital structure. A public utility concern has different capital structure as compared to manufacturing concern. Public utility concern may employ more of debt because of stability and regularity of their earnings. Small companies have to depend upon owned capital, as it is very difficult for them to raise ling term loans on reasonable terms.

6. Control: whenever additional funds are required, the management of the firm wants to raise the funds without any loss of control over the firm. In case funds are raised through the issue of equity shares, the control of existing shares are diluted. Preference shareholders and debenture holders de not have the voting right. From the point of view of control, debt financing is recommended.

7. Flexibility: Capital structure of the firm should be flexible. I.e. it should be capable of the being adjusted according top the needs of changing conditions. A firm should arrange its capital structure in such a way that it can substitute one form of financing by other.
Redeemable preference share capital and convertible debentures may be preferred on account of flexibility.

8. Requirement of Investors: It is necessary to meet the requirement of both institutional as well as private investors when debt financing is used. Investors who are over cautious prefer safety of investment, so debentures would satisfy such investors. Investors, who are less cautious in approach, will prefer preference share capital.

9. Capital Market Conditions: The choice of securities is also influenced by the market conditions. If share market is depressed the company should not issue equity share capital as investors would prefer safety. In case of boom period, it would be advisable to issue equity share capital.

10. Assets structure: If fixed assets constitute a major portion of the total assets of the company, it may be possible for the company to raise more of long term debts.

11. Period of Financial: If finance is required for the limited period, 7 years, debentures should be preferred. If funds are needed for permanent basis, equity share capital is more appropriate.

12. Purpose of financing: If funds are required for the productive purpose, debt financing is suitable as interest can be paid out of profits generated from the investment.

13. Costs of floatation: The cost of financing a debt is generally less than the cost of floating equity and hence it may persuade the management to raise debt financing.

14. Personal Consideration: Management, which is experienced and very enterprising, does not hesitate to use more of debts in their financing as compared to less experienced and conservative management.

15. Corporate Tax Rule: High rate of corporate taxes on profits compels the companies' to prefer debt financing, because interest is allowed to deduct while computing taxable profits.

Theories of Capital Structure-

Different kinds of theories have been propounded by different authors to explain the relationship between Capital structure and cost of capital and value of the firm. The important theories are:

1. Net income approach
2. Net Operating Income approach
3. The Traditional approach
4. Modigliani and Miller approach

Assumptions: In discussing the theories of capital structure, the following assumptions have been used:

1. There are only two sources of finance i.e. equity and debt
2. There would be no change in the investment decision.
3. That the firm has a policy of distributing the entire profits among the shareholders implying that there is no retained earnings.
4. The operating profits of the firm are given and nor expected to grow.
5. The business risk complexion of the firm is given and is not affected by the financing mix.
6. There is no corporate and personal tax.

E = Total market value of the Equity
D = Total market value of the Debt
V = Total market value of the firm i.e., D + E
I = Total Interest Payment
NOP = Net operating profit i.e. EBIT
NP = Net Profit or profit after Tax
Do = Dividend paid by the company at Time o
D1 = Expected Dividend at the end of the year 1
Po = Current market price of the Share
P1 = Expected Market Price of the share after 1 year.
Kd = After Tax Cost of Debt i.e. I/D
Ke = Cost of Equity i.e. D/Po
Ko = Overall Cost of Capital i.e. WACC

$$\frac{D}{D+E} + \frac{E}{D+E}$$

$$= \frac{NOP}{V} = \frac{EBIT}{V}$$

1. Net Income Approach: According to Durand, this theory states that there is a relationship
between Capital structure and the value of the Firm and therefore the firm Can affects its value by increasing or decreasing the Debt proportion in the overall financing mix. This approach is based on the following assumptions.

1. The total Capital requirement of the firm is given and remains constant.
2. The cost of debt is less than cost of Equity.
3. Both Kd and Ke remain constant and increase in financial leverage i.e. use of more and debt financing in the capital structure does not affect the risk perception of the investors.

The line of argument in favor of Net Income approach is that as the proportion of Debt financing in capital structure increases, the proportion of an expensive source of fund increases. This results in the decrease in overall cost of capital leading to an increase in the value of the firm.
The reason for assuming Kd less than Ke are that interest rates are usually lower than the dividend rates due to the element of risk and the benefit of tax as the interest is a deductible expense. The total market value of the firm on the basis of Net Income approach can be ascertained as below:

Cost of Capital:

The cost of capital of a firm is the minimum rate of return expected by its investors. It is the weighted average cost of various sources of finance used by the firm. The capital used by the firm may be in the form of debt, preference capital, retained earnings and equity shares. The concept of cost of capital is very important in the financial management. Cost of capital for a firm may be defined as the cost of obtaining funds i.e., the average rate of return that the investors in a firm would expect for supplying funds to the firm.

Significance of Cost of Capital-

1. As Acceptance Criteria in Capital Budgeting: The concept of cost of capital has assumed growing importance largely because of the needs to devise a rational mechanism for making the investment decision of the firm. Considering the fosyof capital can make capital budgeting decisions. According to the present value method of capital budgeting, if the present value of expected returns from investment is greater than or equal to the cost of investment, the project may be accepted, otherwise it may be rejected.

2. As a Determinant of Capital Mix in Capital Structure Decisions: Financing the firm asset is the very crucial problem in every business and as a general rule there should be a proper mix of debt and equity capital in financing the firm's assets. While designing the optimal capital structure, the management g\has to keep in mind the on\objective of maximizing the value of the firm and min9imising the cost of capital.

3. As a Basis for Evaluating the Financial Performance: The concept of cost of capital can be used to evaluate the financial performance of the top management. The actual profitability of the project is compared the projected overall cost of capital and the actual cost of capital of funds rise to finance the project if the actual profitability of the project is mort than the projected.

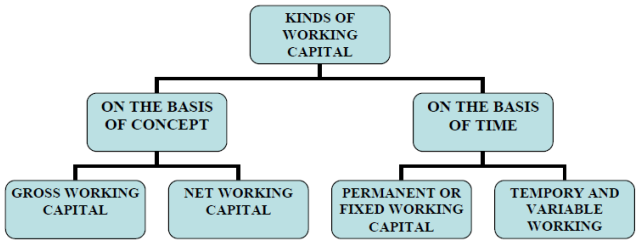
4. As the Basis for taking other Financial decisions: The cost of capital is also used in making other financial decisions such as dividend policy, capitalization of profits, making the right issue and working capital.

Computation of Cost of Capital-
Computation of overall cost of capital of a firm involves:
Computation of cost of Specific source of finance
1. Cost of Debt
2. Cost of Preference Capital
3. Cost of Equity Capital
4. Cost of Retained earnings
5. Weighted average cost of capital

Working capital-

Meaning of Working Capital: Capital required for the business can be of two types:
1. Fixed Capital
2. Working Capital
Fixed capital is required to create the production facilities through purchase of fixed assets like Land, Machinery, and Building etc. Investment in these assets represents that part of firm's capital, which is blocked on permanent or fixed basis and is called fixed capital. Funds are also needed for short-term purpose for the purchase of Raw material, Payment of Wages etc. these funds are known as Working Capital. In simple words, working capital refers to that part of firm's capital, which is required for financing short-term assets.

Definitions of Working Capital: According to Shubin: "Working Capital is the amount of funds necessary to cover the cost of operating the enterprises." According to Genestenberg: "Working Capital means current assets of a comp-any that are changed in the ordinary course of business from one form to another as for e.g. Cash to inventories, inventories to receivables and receivables to cash".



(A) On the basis of concept
(i) Gross working capital concept: According to this concept, working capital means total of all current assets of business..
Gross working capital = Total current assets.
(ii) **Net working capital concept:** According to this concept, working capital means excess of current assets over current liabilities.
Net Working capital = Current Assets – current Liabilities.

As per the general practice net working capital is referred to simply as working capital.

(B) On the basis of time-

(i) Fixed or permanent working capital: There is always a minimum level of current assets which is continuously required by the enterprise to carry out normal business operation.

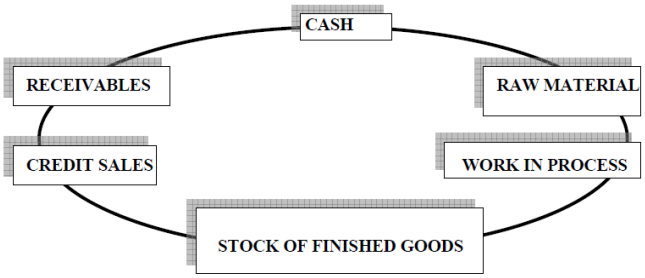
For ex. Every firm has to maintain a minimum level of stock and cash balance. This minimum level of current assets is called fixed working capital as this amount is permanently blocked in current assets.

(ii) Temporary or variable working capital. It is that amount of working capital which is required to meet the seasonal demand and some special needs. Any amount over and above the permanent level of working capital is called as Temporary or variable working capital.

Every business needs some amount of working capital. The need for working capital arises due to the time gap between the production and realization of cash from sales. Thus working capital is needed for the following purposes:
1. For the purchase of raw material, components and spares parts.
2. To pay wages and salaries
3. To incur day-to-day expenses.
4. To meet the selling costs s packing, advertising.
5. To provide the credit facilities to the customers.
6. To maintain the inventories of Raw material, work in progress, finished stock.

There is an operating cycle involved in the sales and realization of cash. The cycle starts with the purchase of raw material and ends with the realization of cash from sales of finished foods. It involves purchase of raw material and stores, it conversion in to stock of finished goods through work-in- progress, conversion of finished stock in to sales, debtors and receivables and ultimately in cash and this cycle continues again from cash to purchase of raw material and so on.

The gross operating cycle of the firm **= RMCP +WIPCP + FGCP+RCP**
Where, RMCP = Raw material conversion period
WIPCP = Work in progress conversion period
FGCP = Finished goods conversion period
RCP = Receivables conversion period
However, a firm may acquire some resources of credit and thus defer payments for certain period.
In this case-
Net operating cycle period = Gross operating cycle period - Payable deferral period.



Factors Determining Working Capital Requirements-

The working capital requirement of a concern depends upon a large number of factors, which are as follow:

1. Nature or Character of Business: Public utility undertakings like Electricity, Water supply and Railways need very limited working capital because they offer cash sales only and supply services not products. On the other hand, Trading and Financial firms require less investment in fixed assets but have to investment large amount in current assets like inventories, receivables etc.

2. Size of Business: Greater the size of business unit, generally larger will be the requirement of working capital. In some case even a smaller concern need more working capital due to high overhead charges, inefficient use of resources etc.

3. Production Policy: The production could be kept either steady by accumulating inventories during slack periods with a view to meet high demand during the peak season or the production could be curtailed during the slack season and increased during peak season. If the policy is to keep the production steady by accumulating inventories it will require higher working capital.

4. Seasonal Variations: In certain industries, raw material; is not available throughout year.
They have to buy raw material in bulk during the season to ensure an uninterrupted flow and process them during the entire year. A huge amount is blocked in the form of material inventories during such season, which give rise to more working capital.

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

6. Rate of Stock Turnover: There is high degree of inverse co relationship between the quantum of working capital and the velocity or speed with which the sales are affected. A firm with having a high rate of stock turnover will need lower amount of working capital as compared to the firm having a low rate of turnover.

7. Credit Policy: A concern that purchases its requirement on credits and sells its products /services on cash require lesser amount of working capital. On the other hand, concern buying its requirement for cash and allow credit to its customers, will need larger amount of working capital as very huge amount of funds are bound to be tied up in debtors or bills receivables.

8. Business Cycle: Business Cycle refers to alternate expansion and contraction in general business activity. In period of boom i.e. when the business is prosperous, there is need for larger amount of working capital due to increase in sales, rise in prices, and expansion of business. On the contrary in the times of depression i.e., when there is down swing of cycle, the business contracts, sales decline, difficulties are faced in collection from debtors and firms may have a large amount of working capital lying idle.

9. Rate of Growth of Business: For the fast-growing concern, larger amount of working capital is required.

Importance or Advantages of Adequate Working Capital-

Working capital is the lifeblood and nerve center of a business. No business can run successfully without and adequate amount of working capital. The main advantage of maintaining adequate amount of working capital is as follow:

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

2. Goodwill: sufficient amount of working capital enables business concern to make the prompt payment and helps in creating and marinating goodwill.

3. Easy Loans: a concern having adequate amount of working capital, high solvency and credit standing can arranges loans from banks.

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

5. Exploitation of favorable market condition: Adequate amount of working capital enables a concern to exploit favorable market conditions such as purchasing its requirement in bulk when the prices are lower and by holding its inventories for higher prices.

6. Ability to face the crises: Adequate amount of working capital enables a concern to face the business crises in emergencies such as depression because during such periods, generally there is much pressure on working capital.

7. Quick and regular return on investments: Adequate amount of working capital enables a concern pay quick and regular dividends to its investors as there may not be much pressure to plough back profits.

8. Regular supply of raw material: Adequate amount of working capital ensures regular supply of raw material and continuous production.

Financing of Working Capital-

A) Financing of permanent/fixed/or Long term working capital
B) Financing of Temporary, variable or short term working capital

(A) Financing of permanent/fixed/or Long term working capital: Permanent working capital should be financed in such a manner that the enterprise may have its uninterrupted use for a sufficient long period. There are five important sources of long term or permanent capital.
1. Shares
2. Debentures / bonds
3. Public deposits
4. Plugging back of profits
5. Loans from financial institutions

These long term sources of finance have already been discussed in detail in the first unit of the book.

B) **Financing of Temporary, variable or short term working capital:** The main sources of short term working capital are as follows.

1) Indigenous Bankers: Private money lenders used to be the only source of finance prior to the establishment of commercial banks. They used to charge very high rates of interest.

2) Trade credit: Trade credit refers to the credit extended by suppliers of goods in the normal course of business. The credit worthiness of a firm and the confidence of its suppliers are the main basis of securing trade credit. The main advantages of trade credit are:
• It is easy and convenient method of finance.
• It is flexible as the credit increases with the growth of firm
• It is informal and spontaneous source of finance.

(3) Installment credit: In this asset are purchased and possession of goods is taken immediately but payment is made in installment over a predetermined period. Generally, interest is charged on the unpaid price or it may be adjusted in the price.

(4) Advances: Some business houses get advances from their customers and agents against orders. Usually the manufacturing concerns having long production cycle prefer to take advances from their customers.

(5) Factoring or Accounts Receivable Credit: A commercial bank may provide finance by discounting bills or invoices of its customers. Thus, a firm gets immediate payment for sale made on credit. A factor is a financial institution which offers services related to management and financing of debts arising out of credit sales.

(6) Accrued expenses: Accrued expenses are the expenses which have been incurred but not yet due and hence not yet paid also. For ex. Wages, salaries, rent, interest, taxes etc.

(7) Deferred Incomes: Deferred incomes are incomes received in advance before supplying goods or services. However, firms having great demand for its products and services, and those having good reputation in the market can demand deferred incomes.

(8) Commercial Paper: Commercial paper represents unsecured promissory notes issued by firms to raise short-term funds. But only large companies enjoying high credit rating and sound financial health can issue commercial paper to raise short-term funds. The Reserve Bank of India has laid down a number of conditions to determine eligibility of a company for the issue of commercial paper. Only a company which is listed on the. Stock exchange has a net worth of at least Rs. 10 corers and a maximum permissible bank finance of Rs. 25 crores can issue commercial paper not exceeding 30 per cent of its working capital limit. The maturity period of commercial paper mostly ranges from 91 to 182 days. It is sold at a discount from its face value and redeemed at face value on its maturity.

Working Capital Analysis-

Working capital is very essential to maintain the smooth running of a business. No business can run successfully without an adequate amount of working capital. The concept of working capital has its own importance in a going concern. A going concern, usually, has a positive balance of working capital, *i.e.,* the excess of current assets over current liabilities, but sometimes the uses of working capital may be more than the sources resulting into a negative value of working capital. This negative balance is generally offset soon by gains in the following periods. A study of changes in the uses and sources of working capital is necessary to evaluate the efficiency with which the working capital is employed in a business. This involves the need of working capital analysis. The analysis of working capital can be conducted through a number of devices, such as:

1. Ratio Analysis
2. Funds Flow Analysis
3. Budgeting

Ratio Analysis: A ratio is a simple arithmetical expression of the relationship of one number to another. The technique of ratio analysis can be employed for measuring short-term 'liquidity or working capital position of a firm. The following ratios may be calculated for this purpose:

i. Current Ratio
ii. Acid Test Ratio
iii. Absolute Liquid Ratio
iv. Receivables Turnover Ratio
v. Payables Turnover Ratio
vi. Working Capital Turnover ratio
vii. Ratio of Current Liabilities to Tangible Net Worth.

Funds Flow Analysis: Funds flow analysis is a technical device designated to study the sources from which additional funds were derived and the use to which these sources were put. It is an effective management tool to study changes in the financial position (working capital) of a business enterprise between beginning and ending financial statements dates. The funds flow analysis consists of: *(i)* preparing schedule of changes in working capital, and *(ii)* statement of sources and application of funds.

Working Capital Budget: A budget is a financial and/or quantitative expression of business plans and policies to be pursued in the future period of time. Working capital budget, as a part of total budgeting process of a business, is prepared estimating future long-term and short-term working capital needs and the sources to finance them, and then comparing the budgeted figures with the actual performance for calculating variances, if any, so that corrective actions may be taken in the future. The objective of a working capital budget is to ensure availability of funds as and when needed, and to ensure effective utilization of these resources. The successful implementation of working capital budget involves the preparing of separate budgets for various elements of working capital, such as, cash, inventories and receivables, etc.

Estimation of Working Capital Requirements-

Factors requiring consideration while estimating working capital	
1.	Total costs incurred on material, wages and overheads.
2.	The length of the time for which materials are to remain in stores before they are issued for production.
3.	The length of the production cycle or work in progress.

4.	The length of the sales cycle during which finished goods are to be kept waiting for sales.
5.	The average period of credit allowed to customers.
6.	The amount of cash required to pay day to day expenses of the business.
7.	The average amount of cash required to make the payments.
8.	The average credit period expected to be allowed by suppliers.
9.	Time lag in the payment of wages and other expenses.

Receivables Management-

Receivables constitute a significant portion of the current assets of a firm. But, for investments in
the receivables, a firm has to incur certain costs. There is also a risk of bad debts also. It is therefore, very necessary to have a proper control and management of receivables.

Meaning of Receivables: Receivables represents amount owed to the firm as a result of sale of goods or services in the ordinary course of business these are the claims of firm against its customers and form a part of the current assets. Receivables are also known as accounts Receivables; trade Receivables, customer Receivables, etc. the Receivables are carried for the customers. The period of credit and extent of Receivables depend upon the credit policy followed by the firm. The purpose of maintaining or investing in Receivables is to meet competition, and to increase the sale and profits of the business.

Costs of maintaining Receivables-

1. Cost of Financing Receivables. When a firm maintains receivables, some of the firm's resources remain blocked in them because there is a time lag between the credit sale to customer and receipt of cash from them as payment. Whether this additional finances is met from its own resources or from outside, it involves a cost to the firm in terms of interest (if financed from outside) or opportunity costs (if internal resources are used).

2. Administrative costs. When a company maintains receivables, it has to incur additional administrative expenses in the form of salaries to clerks who maintain records of debtors, expenses on investigating the creditworthiness of debtors etc.

3. Collection costs. These are costs, which the firm has to incur for collection of the amount at the appropriate time from he customers.

4. Defaulting cost: When customers make default in payment not only is the collection effort to be increased but the firm may also have to incur losses from bad debts.

Inventory Management-

Every enterprise needs inventory for smooth running of its activities. It serves as a link between production and distribution processes. There is generally a time lag between the recognition of needed and its fulfillment. The greater the time, higher the requirement of inventory. Thus it is very essential to have proper control and management of inventories.

Meaning of Inventory-
The inventory means stock of goods, or a list of goods in manufacturing concern, it may include raw material, work in progress and stores etc. it includes the following things:

1. Raw materials are those basic inputs that are converted into finished product through the manufacturing process. Thus, raw materials inventories are those units, which have been purchased and stored for future production.

2. Work-in-process inventories are semi-manufactured products. They represent products that need more work before they become finished products for sale.

3. Finished goods inventories are those completely manufactured products, which are ready for sale. Stocks of raw materials and work-in-process facilitate production, while stock of finished goods is required for smooth marketing operations.

Purpose of Holding Inventories-
There are three main purposes for holding the inventories:

1. The Transaction Motive: This facilitates the continuous production and timely execution of sales orders.

2. The Precautionary Motive: This necessitates the holding of inventories for meeting the unpredictable changes in demand and supply of material.

3. The Speculative Motive: This includes keeping inventories for taking the advantage of price fluctuations, saving in reordering costs and quantity discounts.

Objectives of Inventory Management-

The main objectives of inventory management are operational and financial. The operational objectives mean that the materials and spares should be available in sufficient quantity so that work is not disrupted for want of inventory. The financial objective mean that investment in inventories should not remain idle and minimum working capital should be locked in it. The followi8ng are the objectives of inventory management:

- To ensure the continuous supply of raw material, spare and finished goods so that the production should not suffer at any time.
- To avoid both over stocking and under stocking of inventory.
- To maintain the investment in inventories at the optimum level as required the operational and sales activities.
- To keep material cost under control so that they contribute in reducing the cost of production and overall costs.
- To eliminate duplication in ordering stocks. This is possible with the help of centralized purchase.
- To minimize the losses through pilferages, wastages and damages.
- To design the proper organization for inventory management.
- To ensure the perpetual inventory control so that the material shown in the stock ledgers should be actually lying in the stores.
- To facilitate the furnishing of data for short term and long-term planning and control of inventory.

Cash Management-

Introduction: Cash is the most liquid asset that a business owns. Cash in the business enterprises may be compare s to the blood in the human body, which gives life and strength to the human body and the cash imparts life and strength, profits and solvency to the business organization.

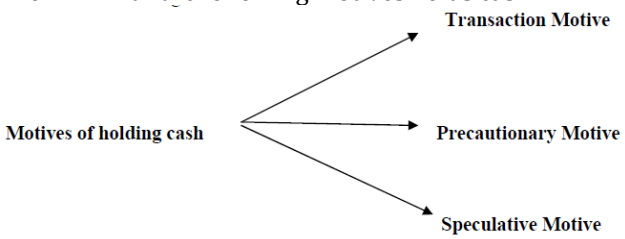
What do you understand by Management of Cash? The modern-day business comprises of numerous units spread over vast geographical areas. It is the duty of the finance manager to provide adequate cash to each of the units. For the survival of the business it is absolutely necessary that there should be adequate cash. It is the duty of the finance manager to maintain liquidity at all parts of the organization while managing cash. On the other hand, he has also to ensure there are no funds blocked in idle cash. Idle cash resources entail a great deal of cost in term of interest charges and in terms of opportunities costs. Hence the questions of cost of idle cash must also be kept in mind by the finance manager. A cash management scheme therefore, is a delicate balance between the twin objectives of liquidity and costs.

1. **Transaction needs:** Cash facilitates the meeting of the day to day expenses and other payments on the debts. Normally, inflows of cash from operation should be sufficient for this purpose. But sometimes this inflow may be temporarily blocked. In such cases, it is only the reserve cash balance that can enable the firm to make its payments in time
2. **Speculative needs:** Cash may be held in order to take advantage of profitable opportunities that may present themselves and which may be lost for want of ready cash settlement.

3. **Precautionary needs:** Cash may be held to act as for providing safety against unexpected events. Safety as is typified by the saying that a man.

Motives for Holding Cash-

The firm with the following motives holds cash:



1. Transaction Motive: Transaction Motive requires a firm to hold cash to conduct its business in the ordinary course. The firm needs cash to make payments for purchases, wages, operating expenses and other payments. The need to hold cash arises because cash receipts and cash payments are not perfectly synchronized. So firm should maintain cash balance to make the required payment. If more cash is need for payments than receipts, it may be raised through bank overdraft. On the other hand if there are more cash receipts than payments, it may be spent on marketable securities.

2. Precautionary Motive: cash is also maintained by the firm to meet the unforeseen expenses at a future date. Their are uncontrollable factors like government policies, competition, natural calamities, labor unrest which have heavy impact on the business operations. In such situations, the firm may require cash to meet additional obligations. hence the firm should hold cash reserves to meet such contingencies. Such cash may be invested in the short term marketable securities which may provide the cash s and when necessary.

3. **Speculative Motive**: To take the advantage of unexpected opportunities, a firm holds cash for investment in profit making opportunities. Such a motive is purely speculative in nature. For e.g. holding cash to rake advantage of an opportunity to purchase raw material at the reduced price on the payment of immediate cash or delay that purchase of

material in anticipation of declining prices. It may like to keep some cash balance to make profits by buying securities at the time when their prices fall on account of tight money conditions.

Cash Management: Cash management deals with the following:
1. Cash Planning
2. Managing Cash flows
3. Determining optimum cash balance

Following are some facets of cash management:

Cash planning: cash planning is a technique to plan and control the use of cash. A projected cash flow statement may be prepared, based on the present business operations and anticipated future activities.

Cash Budget / Cash Forecasts: cash budget is a summary statement of the firm's expected cash flows and cash balances over the projected period. This information helps the finance manager to determine the future cash needs of the firm, plan for the financing of these needs and exercise control over the cash and to reach liquidity of the firm. It is a forecast of expected cash intake and outlays.

The short-term forecast can be made with the help of cash flow projections. The finance, manager will make the estimate of likely receipts in the near future and the expected disbursement in that period. The long-term cash forecast are also essential for proper cash planning. Long-term forecast indicates company's future financial needs for working capital, capital projects etc. Both short term and long-term forecasts may be made with the help of the following methods:

1. **Receipts and disbursement methods**
2. **Adjusted net income methods**

Receipts and Disbursement Methods: In this method the receipts made payments of cash are estimated. The cash receipt may be from cash sales, collection from debtors, and sale of fixed assets. Payment may be made for cash purchases, to creditors for goods, purchases of fixed assets etc. the receipts and disbursement are to be equaled over a short as well as long periods.
Any shortfall in receipts will have to be met from banks or other sources. Similarly surpluses cash may be invested in the risk free marketable securities.

Adjusted Net Income Method: This method also known as Sources and Uses approach. This method helps in projecting the company's need for cash at some future date and to see whether the company will be able to generate sufficient cash. If not, then it will have to decide about borrowing.

In preparing the adjusted net income forecast, items such as net income. Depreciation, tax, dividends can be easily determined from the company's annual operating budget. Difficulty is faced in estimating the working capital changes because they are influenced by factors such as fluctuation in raw material costs, changing demand for the company's products, for projecting working capital ratios relating to receivables and inventories may be used.

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