INTRODUCTION TO FM & BASIC CONCEPT

Q. 1. Define Financial Management ?

Ans. Financial management is an integral part of overall management, which is concerned with the application of general managerial principles to the areas of financial decision-making. In other words, it is the operational activity of a business firm, which is responsible for obtaining and utilizing effectively the funds necessary for efficient operations.

Q. 2. Distinguish between Profit Maximisation and Wealth Maximisation.

Ans. Different between Profit Maximisation and Wealth Maximisation.

Profit Maximisation	Wealth Maximisation
1) It measure the performance of a business firm only on the basis of its profit.	1) It measures the performance of business firm on the basis of share holder wealth
2) It is based on the assumption of perfect competition in the product market.	2) It assumes an efficient Capital Market
3) If does not taken into A/c the risks involved in achieving this goal.	3) It takes into a/c the risks involved in any particular investment project.
4) This goal ignores the time value of money.	4) This goal considers the time value of money.
5) A firms may not pay regular dividends to its share holder and reinvest its retained earnings to achieve this goal.	5) A firm pay regular dividend to its share holder to achieve this goal.

Q**. 3. Explain in brief Discounting Technique and compounding Techniques.**

Ans. Discounting Techniques : The present Value of a sum of money to be received at a future date is determined by discounting the future value at the interest rate that the money could earn over the period. This process is known as discounting. The present value of money is more than the future value. So, the amount of goods or services which will be received in future against a certain sum of money, less amount of money is required in order to get the same amount of goods and services at present. So the presently amount of money is obtained if the future money is discounted. Since the present value of money is obtained by discounting the future cash flows, the concept of discounting is also known as Present value concept.

Compounding Techniques: The ''Time value of money'' describes the effects of compounding. An amount invested today has more value than the same amount invested at a later date because it can utilize the power of compounding. Compounding is the process by which interest is earned on interest. When a principal amount is invested, interest is earned on the principal during the first period or year. In the second period or year interest is earned on the original principal plus the interest earned in the first period and so on. Briefly, the technique by which the future money of equal value of the present money is determined by adding necessary interest to the present money is called compounding technique. The future value (F) of a lump sum today (P) for n periods at i rate of interest is given by the formula $F_n = P(1+i)_n = P(CVF_{n,i})$.

Q. 4. Give an Idea about the Wealth Maximisation objective of financial Management. [2006 , 2010]

Ans. <u>Wealth / Value Maximisation</u> : Wealth maximization means that the company is using its resources in a good manner. If the sale value is to stay high, the company has to reduce its cost and use the resources properly. If the company follows the goal of wealth maximization, it means that the company will promote only those policies that will lead to an efficient allocation of resources.

You must be aware that many companies sell their share in the stock market. People buy the share as an investment. It means that they expect these share to give them some returns. It is the duty of the finance manager to see that the share holder get goods return on their share. Hence the value of the share should increase in the share market. The share value is affected by many things. If a company's is able to make good. Sale and build a good name for it self in the industry, the company's share value goes up.

If the company makes a risky investment, people may lose confidence in the company and the share value will come down. So this means that the finance manager has the power to influence decision regarding finances of the company. The decision should be such that the share value does not decrease. Thus wealth or Value maximization is the most important goal of financial Management.

Q. 5. Explain the Function of Financial Management. [2009 , 2007]

Ans. Function of Financial Management:- ''Finance manager is a person who makes such financial decision which influence directly up on quantum of profit and supply of finance''. The job of finance manager is crucial. His function may be stated as follow.

a) Men, materials, money, machines, method, market etc, are the different aspect to manage. Finance manager has to manage money. Money is the most scarce resources 'Thus finance manager has to manage money skillfully.

b) Finance manager has to undertake tight financial control and sound financial management to ensure profitability of the business.

c) Finance manager has to institute an efficient inventory management by improving inventory turnover & accurately fixing the level of inventorial.

d) Finance manager advises on credit collection policies and initiates proper collection derive.

e) Finance manager is responsible for the realization of financial goal of the enterprise.

f) Finance manager takes investment decision on fixed and current assets and make or determines the allocation of funds on the basis of financial viability.

g) Finance manager makes proper utilization of assets for the prosperity of the business.

h) Finance manager makes financial forecasting and planning and exercises financial control for efficient financial management.

i) Financial manager determines the various financial policies of the business, such as depreciation policy, reserve policy, Dividend policy, Investment policy, Valuation of assets policy etc.

j) Finance manager is responsible for the preparation of annual account.

Q. 6. Explain the concept of time value of money with examples.

Ans. The term time value of money can be defined as ''The value derived from the use of money over time as a result of investment and reinvestment. This term may refer to either present value or future value calculation. The present value is the value today of an amount that would exist in the future worth stated investment rate called the discount rate.''

The time value of money is one of the basic concepts of finance. We know that if we deposited money in a bank account we will receive interest, because of this; we prefer to receive money today rather than the same amount in the future. Money we receive today is more valuable to us than money received in the future by the amount of interest we can earn with the money. This is referred to as the time value of money.

e.g. If you are offered the choice between having Rs.100 today and having Rs.100 at a further date, you will usually prefer to have Rs.100 now. If the choice is between paying Rs. 100 now or paying the same Rs. 100 at a future date. You will usually prefer to pay Rs. 100 later. But why is this? Rs. 100 has the same value one year from now also. Actually although the value is the same, you can do much more with the money if you have it now, over the time you can earn some interest on your money.

10 (a). What do you mean by 'Chief Financial Officer'? {2013 (G)} (2 marks)
(b). State briefly the role of 'Chief Financial Officer'? {2013 (H)} (5 marks)
(c). State two function of 'Chief Financial Officer'? {2014 (G)} (2 marks)
(d). Define the term 'Chief Financial Officer'? {2015 (G)} (2 marks)
(e). Explain the role of 'Chief Financial Officer' (CFO) in the modern business environment? [2015 (H)] (5 marks)

Ans. (a) A chief financial officer (CFO) is the senior executive responsible for managing the financial actions of a company. The CFO's duties include tracking cash flow and financial planning as well as analyzing the company's financial strengths and weaknesses and proposing corrective actions. The CFO is similar to a treasurer or controller because he is responsible for managing the finance and accounting divisions and for ensuring that the company's financial reports are accurate and completed in a timely manner. CFO is usually posted at the top of finance department of an organization, He acts like directors-in-charge of finance. He has to function in co-ordination with chief accountant and assistant manager. All decisions involving management of fund come under the purview of Finance Manager. This includes –

1. Fund Requirement Estimation :

a) The CFO has to carefully estimate the firm's requirements of fund.

b) The purpose of funds (investment in fixed assets or working capital) and timing of funds (i.e. when it is required) should be determined, using techniques like budgetary control and long range planning.

c) This call for forecasting all physical activities of the organization and translating them into monetary terms.

2. Capital Structure / Financing decisions :

a) The CFO has to determine the proper mix/combination of procuring funds. Funds can be procured from various sources for short term and long term purposes.

b) Decisions regarding capital structures (called financing decisions) should be taken to provide proper balance between long term and short term funds and also loan funds & own funds.

c) Long term funds are required to finance fixed assets & long term investments and provide for permanent needs of working capital. Short term funds are for working capital purposes.

3. Cash Management Decisions :

a) The CFO has to ensure that all section/branches/ factories/ departments and unit of the firm have adequate fund (cash), to facilities smooth flow of business operations.

b) He should also ensure that there is no excessive cash (idle funds) in any division at any points of time.

c) For this purpose, cash management and cash disbursement /transfer policies should be laid down.

4. Capital Budgeting / investment decisions :

a) Funds procured should be invested/utilized effectively. The finance Manager should prescribe the assets management policies, for fixed assets and current assets.

b) Long term funds should be invested in fixed assets /project after capital budgeting and in permanent working capital after estimating requirements carefully.

5. Financial Analysis / Performance Evaluation :

a) Financial analysis helps in assessing how effectively the funds have been utilized and in identifying method of improvement. So, the finance manager has to devalued financial performance of various units of the firm.

b) There are various tools of financial analysis like budgetary control, ratio analysis, cash flow and fund flow analysis, common size statement analysis, inter firm comparison, etc.

6. Dividend Decisions :

a) The finance managers should assist the top management in deciding the dividend payout and retention ratio i.e. what amount of dividend should be paid to shareholders and what amount should be retained in the business itself.

b) Dividend decisions depend upon factors like trend of earnings, requirement of funds for future growth, cash flow situation, trend of share prices and tax liability of firm / shareholders.

7. Financial Negotiations / Liaison with Lenders : The CFO is required to interact and carry out negotiations with financial institutions, bank, and public depositors. Negotiations especially with outside financiers require specialized skills.

8. Market Impact Analysis :

a) The CFO has to monitor the stock exchange and behavior of share prices. This involves analysis of major trends in the stock market and judging their impact on the share price of the firm.
b)
c) Value maximization objective is achieved through this analysis and action.

11. How do financial managers take financing and investment decisions? (5 marks) (2013 (H))

Ans. The financial and investment decisions are taken by a financial manager can be elaborate as follows :

1. Financial Decisions :

a) Financial analysis helps in assessing how effectively the funds have been utilized and in identifying method of improvement . So, the finance manager has to evaluate financial performance of various units of the firm.

b) There are various tools of financial analysis like budgetary control, ratio analysis, cash flow and fund flow analysis, common size statement analysis, inter firm comparison etc.

2. Investment Decisions

a) Funds procured should be invested/utilized effectively. The finance Manager should prescribe the assets management policies, for fixed assets and current assets.
b)
c) Long term funds should be invested in fixed assets /project after capital budgeting and in permanent working capital after estimating requirements carefully.

12. **What is meant by profit maximization of a firm ? (2 marks) [2014-G]**
Wealth maximization is depends on profit maximization – Discuss . (5 marks) [2014-H]
Why should a firm maximize its profits ? (2 marks) [2016-G]

Ans. Profit maximization is one of the basic objectives of financial management. Profit maximization implies that the financial managers have to make their decisions in a manner such that the wealth is maximized. Profit maximization can be the sole objective of a firm in the short run but this objectives cannot be carried in long run. The long run objectives has to be wealth maximization as it is the main objective of the firm: however, profit maximization can be a part of wealth maximization objective. Wealth maximization and profit maximization are two sides of a coin. Without focusing on the planning of profit maximizing, neither management of a concern can improve its market value that is the value of its wealth. Wealth can be maximize when the financial performance is closer to financial targets i.e. increasing its profitability, through budget and other devices of financial control. Hence, it can also be said that the wealth maximization objective can be attained only by profit maximization. Higher the profits higher the wealth, thus, wealth maximization is dependent on profit maximization.

Advantages of Profit maximization are :

a) The main goal here is profits maximization hence, large amount of profit.
b) Good for short run
c) Best strategy for determining the link between financial decisions and profits.
d) Huge profit is made in the short span of time.
e) Must for survival of business, otherwise capital will lost.
f) Essential for growth and development of business.
g) Impact on society through factor payments.
h) Profit-making firms are only able to pursue social obligations.
i) Profit enable greater wages and dividends for the entrepreneurs who set up the company.
j) Profit can be used to finance investments in expanding the company.
k) Profit provides a fall back for difficult times.

13. Discuss the main objectives of financial management. {2015-H (5 marks)}

Ans. The financial managements is generally concerned with procurement, allocation and control of financial resources of a concern. The objectives can be –

a) To ensure regular and adequate supply of funds to the concern.

b) To ensure adequate returns to the shareholders which will depend upon the earning capacity, market price of the share, expectations of the shareholders.

c) To ensure optimum funds utilization. Once the funds are procure, they should be utilized in maximum possible way at least cost.

d) To ensure safety on investment, i.e. funds should be invested in safe ventures so that adequate rate of return can be achieved.

e) To plan a sound capital structures. There should be sound and fair composition of capital so that a balance is maintained between debts and equity capital.

14. Should profit maximization goal be regarded as the primary goal of financial management ? [2015-H]

Specify the limitations of maximization of profit as the objective of a firm. (2016 – H)

Ans. Profit maximization is one of the basic objectives of financial management. Profit maximization implies that the financial managers have to make their decisions in a manner such that the wealth is maximized. Profit maximization can be the sole objective of a firm in the short run but this objectives cannot be carried in long run. The long run objectives has to be wealth maximization as it is the main objective of the firm: however, profit maximization can be a part of wealth maximization objective.

The limitations of maximization of profits are :

a) Ignores Risk of uncertainty and emphasizes only profit ability. Higher the profits, higher the risks involved.
b) It does not take into account the time pattern of returns.
c) It is too narrow an objective; it fails to take into account the social considerations.
d) Quality of the products fall in satisfying goals in the short period.
e) It ignores social and moral obligation of the business.
f) The term ‘profit’ is vague.

15. The activities of financial managers involve taking three important decisions. Briefly explain these decisions ? [2016 (G)]

Ans. 1. Capital Structure / Financing decisions :

a) The CFO has to determine the proper mix / combination of procuring funds. Funds can be procured from various sources for short term and long term purposes.

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16. Explain two basic functions of Financial Management.

Ans. Financial Management is a managerial activity that deals with planning and controlling of a firm's financial resources. Financial management deals with two basic aspects as follows :

1. Procurement of Funds :

a) Funds can be obtained from various sources like Equity, Preference Capital, Debenture, Term Loans, etc. Funds procured from various sources have different characteristics in terms of risk, cost and control.

b) While procuring fund from different sources, the objective is to minimize the cost of funds obtained. Hence, a proper balancing of risk and control factors becomes essential.

c) Thus, procurement of funds involves the following –

1. Identification of sources of finance
2. Determination of Financial Mix
3. Raising of Funds

4. Division of profits between dividends and retention of profits (internal fund generation)

2. Effective Utilization of Funds

a) Funds are procured at a cost. Hence, it is crucial to employ then properly and profitably.

b) The finance manager identifies the areas where funds remain idle and why they are not used properly.

c) The finance manager analysis the financial implications of each decision to invest in fixed assets, the need for adequate working capital, etc.

17. Define risk. Classify risks associated with financial management (6 marks) (2013 (G))

Ans. The chance that an investment's actual return will be different than expected. Risk includes the possibility of losing some or all of the original investment. Different version of risk are usually measured by calculating the standard deviation of the historical returns of average return of a specific investment. A high standard deviation indicates a high degree of risk.

A fundamental idea in finance is the relationship between risk and return. The greater the amount of risk that an investor is willing to take on, the greater the potential of return. The reason for this is that investor need to be risks associated with financial management as follows :

1. Operating Risk
2. Financial Risk
3.Combined Risk

18. . Name the principal components of financial environment. (2013 (G) 2 marks)

Discuss the basic components of the financial environment under which a firm has to operate
[2015(H)5 marks]

What are the basic components of the financial environment under which a firm has to operate
[2016(G)5 marks]

Ans. The financial environment is composed of three key components:

1. Financial Managers: Financial managers are responsible for deciding how to invest a company's funds to expand its business and how to obtained funds (financing). The action taken by financial managers to make financial decisions for their respective firms are referred to as financial managements (or managerial finance). Financial managers are expected to make financial decisions that will maximize the firm's value and therefore maximize the value of the firm's stock price.

2. Financial Markets: Financial markets represent forums that facilitate the flow of funds among investors, firms, and government units and agencies .Each financial market is served by financial institutions that act as intermediaries. The equity market facilitates the sale of equity by firm to investor or between investors. Some financial institution serve as intermediaries by executing transactions between willing buyers and sellers of stock at agreed-upon prices the debts markets enable firms to obtain debt financing from institutional and individual investor or to transfer ownership of debts securities between investor. Some financial institution serve as intermediaries by facilitating the exchange of funds in return for debt securities at an agreed-upon price. Thus it is quite common for one financial institution to act as the institutional investor while another financial institution serves as the intermediary by executing the transaction that transfer funds to a firms that needs financing.

3. Investors (Including creditors) : Like firms, investors attempt to make decisions that will enhance their stream of expected future cash flows. Investor's cash outflows result from purchase of stocks (and other investment vehicles), so they would like to purchase their investments at relatively low prices. Thus, of investors believe a firm's stock price may decline and later rise, they may wait until the price declines before buying the stock. Their cash inflows from owing stock result from dividends and from the proceeds from selling the stock. Thus they prefer to sell stock when share prices are high. To make decisions about when to buy and when to sell any investment, investors need information.

19. Explain the term 'risk-return trade off' (2013- G)

Briefly state the concept of risk and return [2016 – H]

Ans. Risk refers to fluctuation Risk is the uncertainties or fluctuation =s in expected gain or benefit Return is the gain or reward. Risk and return are linked, in a probabilistic way. Higher risk may give you more return and vice versa. As risk and return move in the same direction. Instability or variations in what we cherish to obtain. Variations in sales, profit, capacity utilization, liquidity, solvency, market value and like are referred to risk. Business risk and financial risk are prominent among different risk, Business risk refer to variation in profitability while financial risk refers to variation in debts servicing capacity. The business risk alternatively, refers to variations in expected returns.

The risk-return tradeoff is the principle that potential return rises with an increase in risk. Low levels of uncertainty (high-risk) are associated with low potential returns, whereas high levels of uncertainty money can render higher profits only if it is subject to the possibility of being lost because of the risk-return tradeoff, you must be aware of your personal risk tolerance when choosing investments for your portfolio. Taking on some risks the price of achieving returns; therefore, if you want to make money, you can't cut out all risk. The goal instead is to find an appropriate balance- one that generates some profit, but still allows you to sleep at night

20. **Discuss the financial in which a firm operates. (2014 – G [5 marks])**

Ans. A financial environments is a part of an economy with the major players being firms, investors and markets essentially, this sector can represent a large part of a well-developed economy as individuals who retain private property have the ability to grow their capital. Firms are any business that offer goods or services to consumers. Investors are individuals or businesses that place capital into businesses for financial returns. Markets represent the financial environment that makes this all possible.

Historically, firms were very small or even nonexistent in economies or financial markets. Though a few firms have always been in existence, the ability for a large number of firms was not possible until markets became more mature. Mature markets allow for more access to resources necessary to produce goods and services. As firms begin to grow, expand, and multiply, higher capital needs to persist in order for firms to succeed Capital sources include money from outside parties. Such as investors.

Many times investors are individuals who have more capital than is necessary to provide a sufficient living standard. Any excess capital can actually make individuals more money if they invested the funds into a firm that offers a financial return. This symbiotic relationship in the financial environment allows both parties to increase their capital. Many different factors play a role for individuals making investments. A few of these may include risk, current market conditions, and competition, among others.

The last player in the financial environment is the market. Markets represent any place where seller and buyers can meet together and exchange items. In most cases, the exchange is capital for goods and services. Markets may be local, regional or international, depending on the economy. Free markets tend to have fewer government regulations, allowing for an increases exchange of goods due to lower transaction s cost.

A financial environment can exist anywhere so long as the major players exist in the economy. Newer markets tend to have fewer resources and lower level of economic activity due to their lack of resources. The financial environment is also subject to the business cycles, which dictates the stages of growth and decline in the economy. For example, when a new financial markets or environment receives an influx of resources, it has the ability to grow and expand as the players see fit decline occurs when the market is saturated with goods and services due to lack of demand.

21. **What is annuity? [2014 and 2016 – G] (2 marks)**

Ans. An annuity contractual financial product sold by financial institutions that is designed to accept and grow funds from an individual and then, upon annuitization, pay out a stream of payments to the individual at a later point in time. The period of time when an annuity is being funded and before payouts begin is referred to as the accumulation phase. Once payments commence, the contract is in the annuitization phase.

22. **Discuss the relationship between Risk and Return. []2014 – H 5 marks)**

Ans. To know relationship between risk and return may be main topic of any investor because investor is always interest (zest) to get high return at low risk. But if he succeeds to quantify the relationship and its direction, he can manage his investments with better way. Our aim to discuss the cobncepts is to explain what type of relationship between risk and return may happen.

Relationship between risk and return means to study the effect of both elements on each other. We measures the effect of increase risk or decrease risk on return of investment. The following is the main type of relationship of risk and return.

23. . **State the reasons of having time preference for money.**

Ans. Reasons of Time preference of money:

1. Risk: There is uncertainty about the receipt of money in future.

2. **Investments opportunities:** Most of the persons and the companies have a preference for present money because of availabilities of opportunities of investment for earning additional cash flows. For example, an individual is offered $ 1,000 one year later, he would prefer $ 1,000 now as he can invest it now and can earn interest on it.

3. **Preference for present consumption:** Most of the persons and the companies has a preference for present consumption then future consumption either because of urgency of need e.g. consumer durable or otherwise.

24. **Give a brief idea regarding financial environment of a business. [2013-H] (5 marks)**

Ans. In India, the financial environment of a business is influence by growth of managerial power. Three broad stages in the evolution of financial management are:

1. **Traditional phase:** In this phase, financial management was considered necessarily only for special, significant and occasional events, like, merger and acquisition, liquidation etc.

2. **Transitional Phase:** In this phase, Financial Management was considered to meet the day-to-day decision making requirements of top level management, like, fund analysis, financial planning, and control etc.

3. **Modern Phase:** In this phase, financial management is viewed as a supportive and facilitative functions for all level of managements.

Q. 25. What is the objective of Financial Management?

Ans. Financing investment and determining the dividend policy are the basic functions of the financial management. But decision-making is not possible without proper objective. So, the financial management has to take decisions regarding the above mentioned functions after considering the objectives of the business. There are two broadly classified objectives of the business – one is profit maximization objective and the other is wealth maximisation objective. These are discussed below :

A. **Profit maximization objective:** According to traditional approach, the basic objective of the financial management is to maximize profit, who believe this approach, they consider that profit is the yardstick of efficiency and here the overall efficiency of a firm is indicated through the earning of maximum profit. So, the managers manage the business taking into consideration the profit maximization objective in order to prove their efficiency. It can be mentioned in this regard that if a firm acts in a market economy, it producing such goods or services which maximize profit. On the other hand, if a firm acts in a Government-controlled economy, it must obey the Government control for producing goods and services. But the basic objective of the financial management is to maximize profit whether the business is conducted in a market economy or Government controlled economy. Because, the interest of both the firm and the shareholders are well protected by maximization of profit.

B. **Wealth maximization objectives:** Though every firm tries to earn maximum profit but the profit maximization approach is not lasting for a long time in business world, because, this approach has been criticized in different ways in subsequent time. As a result, in place of the profit maximization objective, wealth maximization objective is considered as the main objective of the financial management. Wealth maximization refers to the maximization of net present value of a project. The excess of present value of cash inflows from a project over the present value of cash outflows for that project is called Net Present Value. **Prof. Ezra Solomon** has suggested that the wealth maximization is the best criterion for the financial decision-making. Because its operational characteristics will satisfy the requirements of a suitable operational objective. He has also remarked that wealth maximization will maximize the attainment of other objectives. So, he concludes by saying that wealth maximization provides a useful objective as a basic guidance by which the evaluations of financial decision are made.

SOURCES OF FINANCE / CAPITAL

Q1. Write Short Note on Convertible Debenture

Ans. The debentures which can be converted wholly or partly either into equity or preference share at the option of the holders after expiry of a certain period according to the terms of issue, are called **Convertible Debentures.** The convertible debentures can be divided into two categories, such as fully convertible debentures and partly convertible debentures. The debentures which can be fully converted into shares are called **Fully Convertible Debentures.** On the other hand, the debentures which can be converted partly into equity shares, are called **Partly Convertible Debentures.** The part of the convertible debentures which are not converted into shares are paid back in cash to the debenture holders.

Conditions of conversion : The conditions of conversion are stipulated at the time of issuing the convertible debentures. The conditions are –

(i) The time span, over which the debentures can be converted
(ii) It remains specified that whether the debenture holders will get equity shares or preference shares by converting their debentures.
(iii) The rate of exchange between debentures and shares remains fixed.

Q. 2. Write the Merit and Demerits of convertible Debenture. [Hons.2007]

Ans. Advantage of Convertible Debentures : The advantages of convertible debentures can be discussed from two view-points, such as, from the view-point of the company and the investors. The advantages of the convertible debentures are discussed below from these two view-points :

Advantages from the view-point of the company : A company gets the following advantages, if it issues convertible debentures –

(i) **Low Rate of Interest :** A company can issue convertible debentures at a lower rate of interest than the non-convertible debenture. This is because the investors are prepared to accept the lower return now in consideration of the higher capital gain that they expect to make sale of shares obtained in future on conversion of the debentures.

(ii) **Low Cost of Capital :** The rate of interest of this type of debenture is low and such interest is an admissible expenses in case of ascertainment of tax. So, the cost of capital is lowered.

(iii) **Low Risk :** The rate of interest on convertible debentures is low. So, if a company issues this type of debentures, then its risk of bearing the fixed financial cost reduces.

(iv) **Flexibility :** If a company issues such debentures, its capital structure is flexible. Because, the debentures can be converted into equity share capital after a certain period of time according to the condition of issuing the debentures. As a result, the debt-capital is substituted by equity capital.

(v) **Attractable to Financial Institution :** The debt-capital can be converted into equity capital if investment is made in convertible debentures. So, investment in convertible debentures is very attractive to the financial institutions.

Advantages from the view-point of the investors : The investors get the following advantages if they invest their funds into convertible debentures :

(i) **Regular Income :** If the investors invest their funds into this type of debentures, they get interest regularly at a fixed rate. Even if the interest on such debentures remains outstanding, then such outstanding interest can also be realized after conversion into shares.

(ii) **Opportunity of Getting Ownership :** If the investors invest their funds into this type of debenture, they can convert their debentures into equity shares after a certain period of time. So, they get the opportunity of receiving the ownership of the company through such type of investment.

(iii) **Possibility of capital gain :** There is a possibility of capital gain by sale of shares when the debentures will be converted into shares.

Disadvantages of Convertible Debentures : The disadvantages of convertible debentures are

(i) **Benefit of Tax Savings is not Available for Ever :** When the convertible debentures are converted into shares, no interest has to be paid on debentures. As a result, the benefit of tax savings can not be obtained. So, the tax liability of the company increases.

(ii) **Earning per Share Decreases :** When the convertible debentures are converted into equity shares, the number of equity shares increases. As a result, dividend has to be distributed among large number of shares. So, the earning per share decreases.

Q3. Write Short Note on Commercial Paper

Ans. In 1990, the Reserve Bank of India (RBI) introduced the commercial paper scheme in the India Money Market on the recommendation of the Vaghul Working Group. **Commercial Paper is a short-term unsecured promissory note which is issued by the non-banking firms for collecting working capital for a short period.**

Features : The commercial paper has the following characteristics :

(i) The commercial paper is a short-term unsecured promissory note.

(ii) It can be issued for a period ranging from 15 days to 1 year.

(iii) It is issued at a discount and redeemed at its face value.

(iv) It has a fixed maturity period. After expiry of such maturity period, the face value of the commercial paper is paid back to the investors

(v) The commercial paper can be issued in two ways, viz. as a direct paper and as a dealer paper. When a company issues commercial papers directly to the investors, they are called **Direct Paper.** On the other hand, when commercial papers are issued by security dealers on behalf of their corporate customers, they are called **Dealer Papers.**

(vi) The company which intends to issue commercial paper, it announces current rates of commercial papers of various maturities. The investors select those maturities which closely approximate their holding period.

Q4. Write Short Note on Public Deposit

Ans. The debt-capital which is procured by Manufacturing Concerns and non-banking financial institutions through accepting deposit as fixed deposit from the public, is called **Public Deposit.** In the past, it was a source of Long-term capital. But at present, public deposit can not be accepted for procuring long-term Capital. This source is considered now as a source of Working Capital. It is mentioned in section 58-A of the amended companies Act, 1974, that the Central Government will fix the maximum limit of public deposit which can be accepted by a company. A company can not accept public deposit more than 25% of its paid-up Share Capital and free reserves. The minimum maturity period of this public deposit is 6 months and maximum period is 3 yaers. However, the maturity period may be upto 5 years in the case of non-banking financial institutions. It is can be mentioned in this context that a company may accept public deposit upto 10% of paid-up share capital and free reserves for a minimum period of 3 months for meeting short-term requirements.

Q5 . Write a note on the popularity of trade credit as a source of short-term finance. [2008] What are the advantages of trade credit?

Ans. Trade credit represents the credit extended by the supplier of goods and services. It facilitates the purchase of supplies without immediate payment. This is commonly used by business organization as a source of short term financing. It is granted to those customers who have reasonable amount of financial standing and goodwill. On an average, trade credit accounts for about 40% of current liabilities.

Advantages: There are some advantages of trade credit, these are:

Firstly, if the financial condition of a customer is found sound and if he does not have any bad reputation in the market regarding inability of meeting the credit, he can easily get trade credit.

Secondly, no legal formality is required to fulfill to get the trade credit.

Thirdly, there is no need of any charges against the firm's assets for obtaining the trade credit.

Fourthly, if trade credit is very flexible i.e. it can be taken and redeemed in any time.

Fifthly, if trade credit is repaid within the stipulated time, cash discount is available.

Finally, it has no explicit cost.

Q6. **Write notes on Finance Lease and Operating Lease. [B.Com Hons. 2012, 2006 , 2008]**

FINANCE LEASE :

A finance lease is a way of providing finance – effectively a leasing company (the lessor or owner) buys the asset for the user (usually called the hirer or lessee) and rents it to them for an agreed period.

A finance lease is defined in Statement of Standard Accounting Practice 21 as a lease that transfers
"substantially all of the risks and rewards of ownership of the asset to the lessee".
Basically this means that the lessee is in a broadly similar position as if they had bought the asset.

The lessor charges a rent as their reward for hiring the asset to the lessee. The lessor retains ownership of the asset but the lessee gets exclusive use of the asset (providing it observes the terms of the lease).

The lessee will make rental payments that cover the original cost of the asset, during the initial, or primary, period of the lease. There is an obligation to pay all of these rentals, sometimes including a balloon payment at the end of the contract. Once these have all been paid, the lessor will have recovered its investment in the asset.

OPERATING LEASE

In contrast to a finance lease, an operating lease does not transfer substantially all of the risks and rewards of ownership to the lessee. It will generally run for less than the full economic life of the asset and the lessor would expect the asset to have a resale value at the end of the lease period – known as the residual value.

This residual value is forecast at the start of the lease and the lessor takes the risk that the asset will achieve this residual value or not when the contract comes to an end.

An operating lease is more typically found where the assets do have a residual value such as aircraft, vehicles and construction plant and machinery. The customer gets the use of the asset over the agreed contract period in return for rental payments. These payments do not cover the full cost of the asset as is the case in a finance lease.

Operating leases sometimes include other services built into the agreement, e.g. a vehicle maintenance agreement.

Ownership of the asset remains with the lessor and the asset will either be returned at the end of the lease, when the leasing company will either re-hire in another contract or sell it to release the residual value. Or the lessee can continue to rent the asset at a fair market rent which would be agreed at the time.

Q.7. **What is trade Credit ?** **[B.Com Gen. 2014]**

Ans. Trade Credit is probably the easiest and most important source of short-term finance available to businesses.
Trade credit means many things but the simplest definition is an arrangement to buy goods and/or services on account without making immediate cash or cheque payments.

Trade credit is a helpful tool for growing businesses, when favourable terms are agreed with a business's supplier. This arrangement effectively puts less pressure on cashflow that immediate payment would make. This type of finance is helpful in reducing and managing the capital requirements of a business.

Q.10. **What are the features of Finance Lease ?**

Ans. :

1. A finance lease is a device that gives the lessee a right to use an asset.
2. The lease rental charged by the lessor during the primary period of lease is sufficient to recover his/her investment.
3. The lease rental for the secondary period is much smaller. This is often known as peppercorn rental.
4. Lessee is responsible for the maintenance of asset.
5. No asset-based risk and rewards is taken by lessor.
6. Such type of lease is non-cancellable; the lessor's investment is assured.

Q.11. **What is Bill of Exchange ?** **[B.Com Gen. 2014]**

Ans : A bill of exchange is a non-interest-bearing written order used primarily in international trade that binds one party to pay a fixed sum of money to another party at a predetermined future date. The bills of exchange is a document in writing, containing an unconditional order signed by the maker directing a certain person to pay on demand or at a fixed or determinable future time period, the certain sum of money only to or to the order of a certain person or to the bearer of the document. Bill of exchange is similar to cheques and promissory notes. They can be drawn by individuals or banks and are generally transferable by endorsements.

Q12.. **What is Bonus Share ?** **[B.Com Gen. 2014]**

Ans : **Bonus shares** are shares distributed by a company to its current shareholders as fully paid shares free of charge(The Companies' Act,2013 states that bonus issue must be fully paid)

a) To capitalize a part of the company's retained earnings
b) For conversion of its share premium account, or
c) Distribution of treasury shares.

An issue of bonus shares is referred to as a **bonus share issue** or **bonus issue**.

A bonus issue is usually based upon the number of shares that shareholders already own. While the issue of bonus shares increases the total number of shares issued and owned, it does not change the value of the company. Although the total number of issued shares increases, the ratio of number of shares held by each shareholder remains constant. In this sense, a bonus issue is similar to a stock split.

Q.13. **What is Sweat Equity Shares ?** **[B.Com Gen. 2015]**

Ans : "Sweat equity shares" means such equity shares, which are issued by a Company to its directors or employees at a discount or for consideration, other than cash, for providing their know-how or making available rights in the nature of intellectual property rights or value additions, by whatever name called.

<u>CONDITIONS TO BE FULFILLED</u>

1) Not less than one year has, at the date of such issue, elapsed since the date on which the company had commenced business;

2) The issue is authorised by a special resolution passed by the company;

3) The resolution specifies the number of shares, the current market price, consideration, if any, and the class or classes of directors or employees to whom such equity shares are to be issued;

4) The special resolution 20pecialized the issue of sweat equity shares shall be valid for making the allotment within a period of not more than twelve months from the date of passing of the special resolution.

5) The sweat equity shares issued to directors or employees shall be locked in/non transferable for a period of three years from the date of allotment and the fact that the share certificates are under lock-in and the period of expiry of lock in shall be stamped in bold or mentioned in any other prominent manner on the share certificate.

6) Where the equity shares of the company are listed on a 21pecialize stock exchange, the sweat equity shares are issued in accordance with the regulations made by the Securities and Exchange Board in this behalf and if they are not so listed, the sweat equity shares are issued in accordance with the Companies (Share Capital and Debentures) Rules, 2014.

Q.14. **What is Debenture ?** **[B.Com Gen. 2015]**

Ans. : A debenture is a type of debt instrument that is not secured by physical assets or collateral. Debentures are backed only by the general creditworthiness and reputation of the issuer. Both corporations and governments frequently issue this type of bond to secure capital.

There are two types of debentures as of 2017 : convertible and non-convertible. Convertible debentures are bonds that can convert into equity shares of the issuing corporation after a specific period of time. These types of bonds are the most attractive to investors because of the ability to convert, and they are most attractive to companies because of the low interest rate.

Non-convertible debentures are regular debentures that cannot be converted into equity of the issuing corporation. To compensate, investors are rewarded with a higher interest rate when compared to convertible debentures.

Q.15. **What are the Advantages and Disadvantages of taking long term public deposits ? [Hons.2008]**

Ans. **: Merits of Public Deposits:**

1. Simplicity: Public deposits are a very convenient source of business finance. No cumbersome legal formalities are involved. The company raising deposits has to simply give an advertisement and issue a receipt to each depositor.

2. Economy: Interest paid on public deposits is lower than that paid on debentures and bank loans. Moreover, no underwriting commission, brokerage, etc. has to be paid. Interest paid on public deposits is tax deductible which reduces tax liability. Therefore, public deposits are a cheaper source of finance.

3. No Charge on Assets: Public deposits are unsecured and, therefore, do not create any charge or mortgage on the company's assets. The company can raise loans in future against the security of its assets.

4. Flexibility: Public deposits can be raised during the season to buy raw materials in bulk and for other short-term needs. They can be returned when the need is over. Therefore, public deposits introduce flexibility in the company's financial structure.

5. Trading on Equity: Interest on public deposits is paid at a fixed rate. This enables a company to declare higher rates of dividend to equity shareholders during periods of good earnings.

6. No Dilution of Control: There is no dilution of shareholders' control because the depositors have no voting rights.

7. Wide Contacts: Public deposits enable a company to build up contacts with a wider public. These contacts prove helpful in the sale of shares and debentures in future.

<u>Demerits of Public Deposits:</u>

1. Uncertainty: Public deposits are an uncertain and unreliable source of finance. The depositors may not respond when economic conditions are uncertain. Moreover, they may withdraw their deposits whenever they feel shaky about the financial health of the company.

2. Limited Funds: A limited amount of funds can be raised through public deposits due to legal restrictions.

3. Temporary Finance: The maturity period of public deposits is short. The company cannot depend upon public deposits for meeting long-term financial needs.

4. Speculation: As public deposits can be raised easily and quickly, a company may be tempted to raise more funds than it can profitably use. It may keep idle money to meet future contingencies. The management of the company may indulge in over-trading and speculation which exercise harmful effects on the business.

5. Hindrance to Growth of Capital Market: Public deposits hamper the growth of a healthy capital market in the country. Widespread use of public deposits creates a shortage of industrial securities.

6. Unsuitable for New Concerns: New companies lacking in sound credit standing cannot depend upon public deposits. Investors do not like to deposit money with such companies

Q.16. **Discuss the various sources of Long Term Financing ?** **[B.Com Gen 2015]**

Ans. : The following points highlight the long-term sources of fund of a company

1. Equity Shares: It represents the ownership capital of a firm. A public limited company may raise funds from public or promoters as equity share capital by issuing ordinary equity shares.

Ordinary shareholders are those the owners of which receive their dividend and return of capital after the payment to preference shareholders. The liability of equity shareholders is limited up to the face value of the shares. Further, equity share capital provides a security to other investors of funds. Hence, it will be easier to raise further funds for companies having adequate equity share capital.

2. Preference Shares : Long-term funds from preference shares are raised by a public issue of shares. It does not require any security nor ownership of a firm is affected. It has some characteristics of equity capital and some of debt capital. It resembles equity as preference dividend, like equity dividend is not tax deductible payment. These are shares which carry the following two rights:

(i) The right to receive dividend at a fixed rate before any dividend is paid on other shares.

(ii) The right to return of capital in the case of winding-up of company, before the capital of the equity shareholders is returned.

3. Debentures: A debenture is a document of acknowledgement of a debt with a common seal of the company. It contains the terms and conditions of loan, payment of interest, redemption of the loan and the security offered (if any) by the company.

4**. Loans from Financial Institutions:** In India 23pecialized financial institutions provide long-term financial assistance to private and public firms. Generally firms obtain long-term debt by raising term loans. Term loans, also referred to as term finance, represent a source of debt finance which is repayable in less than 10 years.

5. **Retained Earning :** When a company retains a part of undistributed profits in the form of free reserves and the same is utilised for further expansion and diversification programmes, is known as ploughing back of profit or retained earnings. These funds belong to the equity shareholders. It increases the net worth of the business.
Although it is essentially a means of long-term financing for expansion and development of a firm, and its availability depends upon a number of factors such as the rate of taxation, the dividend policy of the firm, Government policy on payment of dividends by the corporate sector, extent of profit earned and upon the firm's appropriation policy etc

CAPITAL STRUCTURE

1. What is a 'Capital Structure' ?

Ans. The capital structure is how a firm finances its overall operations and growth by using different sources of funds. Debt comes in the form of bond issues or long-term notes payable, while equity is classified as common stock, preferred stock or retained earnings. Short-term debt such as working capital requirements is also considered to be part of the capital structure.

Capital structure is the mix of the long-term sources of funds used by a firm. It 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 shareholders' funds.

Various authors have defined capital structure in different ways.

According to **Gerestenberg**, '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'.

Keown et al. defined capital structure as, 'balancing the array of funds sources in a proper manner, i.e. in relative magnitude or in proportions'.

In the words of **P. Chandra**, 'capital structure is essentially concerned with how the firm decides to divide its cash flows into two broad components, a fixed component that is earmarked to meet the obligations toward debt capital and a residual component that belongs to equity shareholders'.

Hence capital structure implies the composition of funds raised from various sources broadly classified as debt and equity. It may be defined as the proportion of debt and equity in the total capital that will remain invested in a business over a long period of time. Capital structure is concerned with the quantitative aspect. A decision about the proportion among these types of securities refers to the capital structure decision of an enterprise.

2. What is an 'Optimal Capital Structure' ?

Ans. An optimal capital structure is the best debt-to-equity ratio for a firm that maximizes its value. The optimal capital structure for a company is one that offers a balance between the ideal debt-to-equity range and minimizes the firm's cost of capital.

Optimal capital structure is a financial measurement that firms use to determine the best mix of debt and equity financing to use for operations and expansions. This structure seeks to lower the cost of capital so that a firm is less dependent on creditors and more able to finance its core operations through equity.

In general, the optimal capital structure is a mix of debt and equity that seeks to lower the cost of capital and maximize the value of the firm. To calculate the optimal capital structure of a firm, analysts calculate the weighted average cost of capital (WACC) to determine the level of risk that makes the expected return on capital greater than the cost of capital.

8. What are the factors determine / considered the capital structures planning of a firm?

Ans: Besides these factors there are other factors as well and these have discusses below :

1. Size of the firm: Firms which are of small size have to rely considerably upon the owners' funds for financing. If the size of the company is growing bigger the requirements of capital will also increase. Under this circumstances only equity capital will not come be sufficient, rather more funds are to be injected from outside sources in the forms of debt capital. So size is one of the determining factors in designing capital structures of any firm.

2. Nature of the firm : The nature of the firm affects the capital structure of the firm. If any firm has got stability in its earnings or enjoys monopoly regarding its products may opt for external source of finance because it will have adequate profits to meet the recurring cost of interest.

3. Cost of capital : It is a very significant aspect in determining capital structure of a firm. It is undeniably true that cost of equity is higher than cost of debt. Again it should also be remembered that if the firm invests debt capital more in comparisons to equity capital, the firm will be exposed to more risk.

4. Trading on equity : Wealth maximization of the firm by increasing the market value of the shares is one of the basic objectives of financial management. If after tax earnings increase, the wealth of the firm increases. If it is a high levered firm (i.e., percentage of debt capital is high than equity capital) the cost of financing will be less due to tax advantage, and that will ultimately enhance the earning of the equity shareholders. If the firm is able to magnify its earnings it will enhance the claim of the equity shareholders i.e. earnings per share will increase. Therefore, the capital structures is to be designed in such a way so that earnings available for the equity shareholders will increase.

5. Marketability : Marketability here means the ability of the company of the company to sell or market particulars type of security in a particular period of time which in turn depends upon the readiness of the investors to buy that security. Marketability may not influence the initial capital structure very much but it is an important consideration in deciding the appropriate timing of security issues. At one time, the market favours debenture issues and at another time, it may readily accept ordinary share issues. If the shares market is depressed, the company should not issue ordinary shares but issue debts and wait to issue ordinary share till the shares market revives. During boom period in the share market, it may not be possible for the company to issue debentures successfully. Therefore, it should keep its debt capacity unutilized and issue ordinary shares to raise finances.

6. Control : The capital structure of the firm is influenced by the extent to which the owner of the firm desires to maintain control over the affairs of the firm. The debenture holders and preference shareholders do not have any say in the management of a company. So in order to retain control the company may increase t5he debt capital in the capital structure of the company.

7. Flexibility: Flexibility means the firm's ability to adapt its capital structure to the needs of the changing conditions. The capital structures of a firm is flexible if it. Has no difficulty in changing its capitalization or sources of funds. The financial plan of the company should be flexible enough to change the composition of the capital structures. It should keep itself in a position to substitute one form of financing for another to economize on the use of funds.

8. Government Policy: Determining capital structure the government policies and market regulations are important determinants. If the government adopts a change in the lending policy that will have an impact on the capital which affects the capital structure decisions.

9. Legal requirements: The owners of the company have also to keep in mind the legal requirements while deciding about the capital structure of the company. Raising of equity capital is more complicated than raising debt capital.

10. Growth rate: It is undeniably true that growing company does require more fund for its expansion plans. Under this circumstances the company will have to depend on external source of finance than equity share capital.

9. Short Notes on 'Trading on Equity''.

Ans. Trading on Equity is an effort of increasing the earning per equity share by using debt-capital and preference share capital in the capital structure. In other words, when fixed financial cost bearing debt-capital and preference share capital are used on reasonable basis along with equity share capital in the capital structure for the purpose of increasing the earning per equity share, it is called **Trading on Equity.** However, there is no such an word that the benefit of trading on equity will always be obtained even if debt-capital and preference share capital are used in the capital structure. It is possible to get this benefit only at that time when the following two conditions are fulfilled –

1st Condition – Rate of Return on Investment should be greater than the rate of interest on debt-capital: If the rate of return on investment is greater than the rate of interest on debt-capital, only then the benefit of trading on equity is obtained. For example, suppose, there are three firms – A, B and C. The earning before interest and tax (EBIT) of each firm is Rs.15,000 and their capital structures are as follows –

2nd condition – Rate of return on Shareholders' fund should be greater than the Rate of dividend on Preference Share : If the rate of return on shareholders' fund is greater than the rate of dividend on preference share capital, only then the benefit of trading on equity is obtained.

10. what is net operating income approach (noi approach) in capital structure theory ?

Ans. Net Operating Income Approach suggests that change in debt of the firm/company or the change in leverage fails to affect the total value of the firm/company. As per this approach, the WACC and the total value of a company are independent of the capital structure decision or financial leverage of a company.

As per this approach, the market value is dependent on the operating income and the associated business risk of the firm. Both these factors cannot be impacted by the financial leverage. Financial leverage can only impact the share of income earned by debt holders and equity holders but cannot impact the operating incomes of the firm. Therefore, change in debt to equity ratio cannot make any change in the value of the firm.

It further says that with the increase in the debt component of a company, the company is faced with higher risk. To compensate that, the equity shareholders expect more returns. Thus, with an increase in financial leverage, the cost of equity increases.

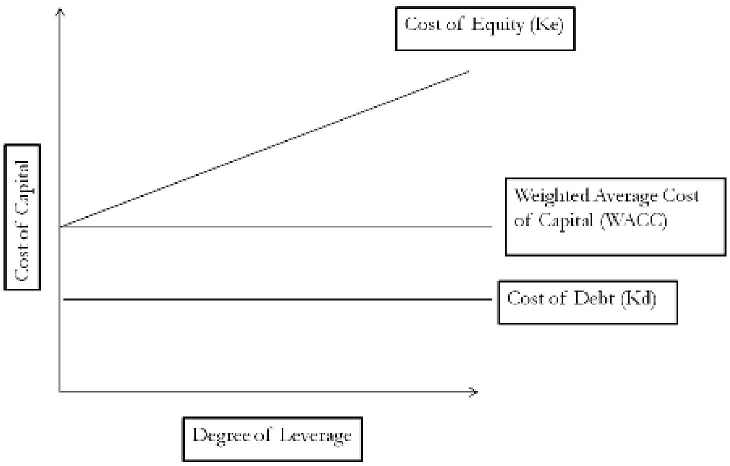
ASSUMPTIONS / FEATURES OF NET OPERATING INCOME APPROACH:

1) The overall capitalization rate remains constant irrespective of the degree of leverage. At a given level of EBIT, value of the firm would be "EBIT/Overall capitalization rate"

2) Value of equity is the difference between total firm value less value of debt i.e. Value of Equity = Total Value of the Firm – Value of Debt

3) WACC (Weightage Average Cost of Capital) remains constant; and with the increase in debt, the cost of equity increases. An increase in debt in the capital structure results in increased risk for shareholders. As a compensation of investing in the highly leveraged company, the shareholders expect higher return resulting in higher cost of equity capital

DIAGRAMMATIC REPRESENTATION OF NOI APPROACH TO CAPITAL STRUCTURE:



COST OF CAPITAL

Q. 7 How will you determine the Cost of Equity Share Capital in Growth Company.

Ans. In this approach the cost of equity share capital is determined on the basis of the expected dividend rate plus the expected rate of growth in dividend. The rate of growth in dividend is determined on the basis of the amount of dividends paid by the company for last few years and assumed to be uniform under this approach. The method of computation of cost of equity capital (K_e) can be shown as follows :

$$K_e = \frac{DPS_1}{NP} + g \;\; [in\ case\ of\ \cos t\ of\ new\ equity\ issue]$$

Or,

$$= \frac{DPS_1}{MP} + g \;\; [in\ case\ of\ \cos t\ of\ existing\ equity\ issue]$$

Here $DPS_1 = DPS_0 (1 + g)$

Where,

DPS_1 = Expected dividend per share at the end of current year.
NP = Net proceeds per share.
MP = Market price per share.
g = Expected growth in rate of dividend.
DPS_0 = Previous year's dividend per share.

Q. 8. Mention its significance Cost of Capital
Ans. Significance of Cost of Capital
The concept of cost of capital is very important in the financial management. It is important in the following managerial decisions :

(i) **Capital budgeting decisions :** the cost of capital plays a crucial role in the capital budgeting decision. The cost of capital is used as the discount rate in Net Present Value (NPV) calculations and as a target rate of return for comparing with a project's Internal Rate of Return (IRR). In present value method of capital budgeting, if the present value of all future streams of cash earnings from investments is greater then or equal to the cost of investment, the project may be accepted. Otherwise, the project may be rejected. Under IRR method, IRR is compared with the cost of capital. Thus the concept of cost of capital provides the criterion of accepting or rejecting the proposals in capital budgeting in the most judicious and rational manner.

(ii) Capital structure or capital mix decisions : The cost of capital is a significant factor in designing the capital structure of a company. The company's objective is to maximize the shareholder's wealth and, therefore, a finance manager should raise capital from different sources ensuring maximum return to the shareholders by minimizing risk and cost factors. For example, obtaining loan as a sources of capital involves lower cost due to income tax benefits, but it involves heavy risk inviting a cash crunch situation due to regular drainage of profit through payment of interest. It is, therefore, necessary that cost of capital from various sources should be measured and considered carefully while planning the capital structure of the company.

(iii)Evaluation of financial performance of top management : The concept cost of capital can be used effectively to evaluate the financial performance of top management. The process involves a comparison of actual profitability of the project undertaken with the projected overall cost of capital and an appraisal of the actual cost of capital incurred in raising the required funds to finance the project. If actual profitability of the project undertaken is more than the projected overall cost of capital and actual cost of capital, the financial performance of the top management may be considered satisfactory.

(iv) Inventory management policy : In respect of taking a decision regarding an inventory management policy, the cost of capital can be used as a guide rate to evaluate the financing cost of carrying inventory.

(v) Receivables management policy : In a similar manner, cost of capital may be used to calculate the cost of carrying the firm's investments in receivables and to evaluate the alternative policies and practices in respect of receivables.

(vi) Dividend policy : The concept of cost of capital helps a firm to frame its dividend policy most logically. Apart from this, it is also useful in respect of capitalization of profits through issue of bonus shares, right shares etc.