

Suddhananda School of Management & Computer Science



MBPC1004 CORPORATE FINANCE

Notes



BY

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Module I

Foundations of Finance: Nature & Scope. Organization of Financial Functions. Emerging role of FMs in India and in Global context. Financial Goal. Agency problems. Time value of money, Compounding and discounting. Short term and long-term sources of fund.

FOUNDATIONS OF FINANCE

1. Introduction to Finance

Definition of Finance

Finance refers to the management of money, investments, credit, banking, and assets to ensure the efficient functioning of businesses, governments, and individuals. It involves decision-making about acquiring, allocating, and utilizing financial resources to maximize wealth.

Importance of Finance

- Helps businesses in investment planning.
- Ensures financial stability through proper fund allocation.
- Helps in decision-making regarding capital structure and funding.
- Affects the overall growth and sustainability of an organization.

Branches of Finance

Finance is broadly classified into three major branches:

1. **Personal Finance** – Budgeting, savings, investments, insurance, and retirement planning for individuals.
2. **Corporate Finance** – Capital budgeting, working capital management, and financial decision-making within organizations.
3. **Public Finance** – Government revenue, taxation, public expenditure, and national financial policies.

• **Example:** A company like Tata Motors needs finance to invest in new technology, pay salaries, expand business operations, and maintain liquidity. Proper financial management ensures it can balance short-term and long-term objectives effectively.

Nature and Scope of Finance

Finance plays a **critical role** in decision-making for individuals, businesses, and governments. It involves **fund allocation, risk assessment, and financial planning** to ensure economic stability and growth.

✦ Nature of Finance

Finance has a **distinct nature** that makes it essential in all economic activities. The key characteristics are:

1☐ Finance is Quantitative & Analytical

- Financial decisions rely on **numerical data, forecasts, and financial statements**.
- Various **quantitative techniques** like **cash flow analysis, ratio analysis, and forecasting models** help decision-making.
- It involves **data-driven decision-making** rather than intuition-based judgments.

• **Example:** Before investing in a new project, a company **analyses projected cash flows, return on investment (ROI), and break-even points** to determine feasibility.

2☐ Finance is Dynamic

- Financial markets **fluctuate** due to **economic trends, interest rates, inflation, and technological innovations**.
- Businesses must adapt to **market changes, economic policies, and technological disruptions**.

• **Example:** During **economic recessions**, companies may **reduce capital expenditures** to conserve cash, whereas in **booming economies**, they **expand operations aggressively**.

3☐ Finance is Strategic

- Finance is not just about managing money but also about **planning for long-term growth and sustainability**.
- Strategic financial decisions help **maximize shareholder wealth** and **ensure business expansion**.
- Financial managers **analyse risks, optimize capital structure, and plan for the future**.

• **Example:** Apple strategically **invests in research & development (R&D)** to create new products like iPhones and MacBooks, ensuring long-term business success.

✦ Scope of Finance

The **scope of finance** covers various aspects of managing money and making financial decisions in an organization. It primarily includes:

1 ☐ Investment Decisions (Capital Budgeting)

- **Determining where to invest funds** to achieve **maximum returns**.
- Companies choose between **investing in new machinery, expanding business operations, or acquiring other companies**.
- Investment decisions involve **evaluating profitability, risk, and long-term benefits**.

• **Example:** Tesla invests in **battery production and AI technology** to enhance its electric vehicle production.

✦ Key Concepts in Investment Decisions:

- ✓ **Capital Budgeting** – Selecting profitable long-term investments.
- ✓ **Risk & Return Analysis** – Weighing investment risks vs. potential returns.
- ✓ **Cost-Benefit Analysis** – Ensuring financial feasibility before investment.

2 ☐ Financing Decisions (Capital Structure Management)

- Concerned with **raising capital for business operations**.
- Businesses decide whether to finance through **equity (selling shares) or debt (taking loans/bonds)**.
- The goal is to find an **optimal capital structure** that **minimizes costs and maximizes profits**.

• **Example:** Reliance Industries raises funds by **issuing corporate bonds** instead of **taking bank loans** because bond financing is cheaper.

✦ Key Concepts in Financing Decisions:

- ✓ **Debt Financing** – Borrowing money through loans or bonds.
- ✓ **Equity Financing** – Raising capital by selling shares.
- ✓ **Cost of Capital** – Measuring the cost of financing through debt/equity.

3 ☐ Dividend Decisions

- Determines how **profits are distributed** among shareholders.
- Companies decide whether to **pay dividends (share profits with investors) or retain earnings (reinvest in business expansion)**.
- A **higher dividend pay-out** attracts investors, whereas **retained earnings** help fund future growth.

- **Example:** Infosys reinvests a **significant portion of its earnings into AI and automation projects** instead of paying high dividends to shareholders.

📌 **Key Concepts in Dividend Decisions:**

- ✓ **Dividend Pay-out Ratio** – Percentage of earnings paid as dividends.
 - ✓ **Retained Earnings** – Profits reinvested in the company.
 - ✓ **Shareholder Expectations** – Balancing between **dividends and long-term growth**.
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4 📌 **Risk Management**

- Identifying, analysing, and mitigating **financial risks** that could impact a company.
- Risks include **market risk, credit risk, liquidity risk, and operational risk**.
- Companies use **hedging strategies, diversification, and insurance** to manage risks.

- **Example:** A company exporting goods to the USA may **hedge against currency fluctuations** by using **forward contracts** to lock in an exchange rate.

📌 **Key Concepts in Risk Management:**

- ✓ **Hedging** – Using financial instruments to reduce risk exposure.
 - ✓ **Diversification** – Spreading investments to minimize potential losses.
 - ✓ **Liquidity Management** – Ensuring sufficient cash flow for business operations.
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3. **Organization of Financial Functions**

Structure of Financial Management in a Business

In a company, the financial function is structured as follows:

- ◆ **Chief Financial Officer (CFO)** – Oversees all financial activities and strategy.
- ◆ **Treasury Department** – Manages cash flow, working capital, and risk.
- ◆ **Accounting & Taxation** – Records transactions, prepares financial statements, and ensures tax compliance.
- ◆ **Financial Planning & Analysis (FP&A)** – Prepares budgets, financial models, and forecasts.

- **Example:** Reliance Industries' CFO must ensure enough liquidity for daily operations while planning long-term investments in new energy projects.

4. Emerging Role of Financial Managers in India and the Global Context

The role of financial managers has significantly evolved in both **India and the global market** due to **technological advancements, regulatory changes, globalization, and financial innovations**. Financial managers are no longer just responsible for bookkeeping and budgeting but are now expected to drive strategic decision-making, manage risks, and ensure long-term financial stability.

✦ Role of Financial Managers in India

Financial managers in India face unique challenges due to **regulatory frameworks, economic fluctuations, and the need for digital transformation**. Their responsibilities include:

1 ☐ Managing Compliance with Regulatory Laws

- Compliance with **GST (Goods & Services Tax), Income Tax, and corporate governance laws** is essential.
- Financial managers ensure accurate tax filings, prevent legal penalties, and maintain transparency.
- Compliance with **SEBI (Securities and Exchange Board of India)** regulations is crucial for publicly listed companies.

• **Example:** A company like Tata Steel must **accurately file GST returns and comply with SEBI disclosure norms** while reporting quarterly earnings.

2 ☐ Adopting FinTech & Digital Transformation

- India's **digital finance ecosystem** is growing rapidly with UPI, mobile banking, and block chain applications.
- Financial managers integrate **FinTech solutions** for **real-time analytics, digital payments, and automated invoicing**.
- Companies use **Artificial Intelligence (AI) & Machine Learning (ML)** for fraud detection, predictive analysis, and investment forecasting.

• **Example:** HDFC Bank uses **AI-powered credit risk assessment models** to evaluate loan applications efficiently.

3 ☐ Focus on Cost Reduction & Operational Efficiency

- Financial managers work on **budget optimization** to control expenses and improve profitability.
- They use **cost control techniques** like **Zero-Based Budgeting (ZBB)** and **Activity-Based Costing (ABC)** to ensure financial efficiency.
- They ensure **optimal working capital management** by managing inventory, receivables, and payables efficiently.

• **Example:** Reliance Retail reduces operational costs by using **data analytics to predict inventory demand** and optimize supply chain management.

4 ☐ Ensuring Foreign Investments & Risk Mitigation

- With **Foreign Direct Investments (FDI)** rising in India, financial managers ensure compliance with **FDI policies & RBI guidelines**.
- They also manage **foreign exchange risks** due to rupee fluctuations against the US dollar and other currencies.
- **Hedging strategies** like **currency futures and options** are used to minimize forex risks.

• **Example:** Infosys, which earns significant revenue from US-based clients, uses **hedging techniques** to protect its profits from rupee-dollar fluctuations.

✦ Role of Financial Managers in the Global Context

In a rapidly **globalizing economy**, financial managers **must adapt to international financial standards, global investment trends, and technological disruptions**.

1 ☐ Managing Foreign Exchange Risks & Global Investments

- Companies operating internationally face **foreign exchange volatility** affecting revenues and profits.
- Financial managers **analyse currency movements** and use **hedging techniques** like forward contracts and currency swaps.
- They oversee **international investments** in global markets, ensuring **optimum risk-return trade-offs**.

• **Example:** Apple manages **global supply chain risks** by hedging against **currency fluctuations in the Chinese Yuan and Euro** to stabilize costs.

2 ☐ Using Big Data, AI & Block chain for Financial Decision-Making

- **Big data analytics** helps in **investment forecasting, fraud detection, and credit risk assessment**.
- **AI-powered automation** in finance improves **decision-making efficiency** in **portfolio management and stock market predictions**.
- **Block chain technology** is revolutionizing **cross-border payments, transaction security, and supply chain financing**.

• **Example:** JP Morgan Chase uses **block chain-based smart contracts** to facilitate **fast and secure cross-border transactions**.

3 Adapting to International Financial Regulations

- Global businesses must comply with **IFRS (International Financial Reporting Standards)**, which standardize financial reporting.
- **Basel norms** ensure banks maintain **adequate capital reserves** to prevent financial crises.
- **Corporate Social Responsibility (CSR)** and **ESG (Environmental, Social, and Governance) standards** are becoming important for financial planning.

• **Example:** HSBC ensures compliance with **Basel III norms**, which require banks to maintain strong **capital adequacy ratios** to manage financial risks.

Financial Goals and Agency Problems

In finance, businesses set **clear financial goals** to ensure long-term growth, profitability, and shareholder satisfaction. However, **agency problems** may arise when managers prioritize personal benefits over the company's financial objectives.

✦ Financial Goals of a Business

The primary financial goal of any business is to **maximize value for its stakeholders** while maintaining a balance between profitability, liquidity, and growth. The four main financial goals include:

1 Wealth Maximization

- The ultimate objective of financial management is **increasing shareholder wealth** by **maximizing the company's stock value**.
- Focuses on **long-term growth**, ensuring that investments generate high returns.
- Takes into account **time value of money**, risk, and sustainability.

• **Example:** Companies like Amazon **focus on reinvesting profits** to enhance innovation, leading to long-term stock price appreciation.

2 ☐ Profit Maximization

- Businesses strive to **increase net profits** by **boosting revenue and controlling costs**.
- This goal is **short-term oriented**, sometimes leading to decisions that may not align with long-term sustainability.
- It does not always consider **risk, ethical concerns, or the impact on stakeholders**.

• **Example:** A company may **cut down employee benefits** to **reduce costs and increase profit margins**, but this could lead to low employee morale and long-term inefficiencies.

3 ☐ Liquidity Maintenance

- Companies must **maintain enough cash and liquid assets** to cover **day-to-day expenses, debts, and emergencies**.
- Lack of liquidity can lead to **financial distress** even if a company is profitable on paper.
- Businesses use **working capital management strategies** to balance liquidity and profitability.

• **Example:** A retail company like Walmart **keeps cash reserves** and maintains **short-term financing options** to handle unexpected economic downturns.

4 ☐ Sustainability & Growth

- Businesses must invest in **long-term projects and sustainable business practices** to stay competitive.
- Focuses on **expanding operations, entering new markets, and adopting new technologies**.
- Companies that **fail to invest in future growth** often struggle to survive in competitive markets.

• **Example:** Tesla invests heavily in **renewable energy and AI-driven automation** to maintain long-term growth in the electric vehicle industry.

✦ Agency Problems in Finance

What is an Agency Problem?

An **agency problem** occurs when the **interests of a company's management (agents) conflict with the interests of shareholders (principals)**. Managers may act in their own **interest** rather than working towards **maximizing shareholder value**.

Why Does the Agency Problem Occur?

- **Information Asymmetry** – Managers have **more information** than shareholders, making it difficult to monitor their actions.
 - **Misaligned Incentives** – Managers may prioritize **short-term personal gains** over long-term company success.
 - **Lack of Accountability** – Weak corporate governance can allow managers to **make poor decisions** without consequences.
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✦ Examples of Agency Problems

Example 1: Unnecessary Spending on Luxury Offices

- A manager may **approve a high-cost office renovation** instead of **investing in new technology** that would improve company efficiency.
- This benefits the manager's **work environment** but does not contribute to **business profitability**.

Example 2: Risky Investments for Short-Term Bonuses

- Managers may **invest in high-risk projects** to **boost short-term profits** and earn **performance-based bonuses**, even if those investments could **harm the company in the long run**.

Example 3: Stock Buybacks Instead of R&D

- A company might **buy back shares to artificially inflate stock prices**, instead of **investing in research & development** for long-term innovation.
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✦ How to Reduce Agency Problems?

Businesses implement **various strategies** to **align management's goals with shareholder interests** and **reduce agency problems**:

1 Performance-Based Compensation

- Offering **stock options, bonuses, or profit-sharing** to managers **based on company performance**.
 - Ensures that **managers benefit when shareholders benefit**.
- **Example:** Google provides **equity-based compensation** to executives, meaning their wealth grows as the company's stock price increases.
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2 Strong Corporate Governance

- Implementing **clear policies, checks, and balances** to **ensure managers act responsibly**.
- Appointing an **independent board of directors** to oversee management decisions.
- Regular **shareholder meetings** to discuss company performance.

• **Example:** Tata Sons has a **strong corporate governance framework** that ensures independent oversight of managerial decisions.

3 Transparency through Regular Audits

- Conducting **internal and external financial audits** to ensure financial integrity.
- Providing **detailed financial reports to shareholders** to maintain trust.
- Ensuring **full disclosure of executive salaries, business expenses, and investments**.

• **Example:** Public companies like Infosys are **required to publish quarterly financial statements** to maintain investor confidence.

Time Value of Money (TVM)

✦ Concept of Time Value of Money (TVM)

The **Time Value of Money (TVM)** is a fundamental financial concept stating that **money today is worth more than the same amount in the future** due to its potential earning capacity. This principle forms the basis of investment decisions, loan calculations, and financial planning.

• **Key Idea:**

- A rupee today can be **invested to earn interest**, making it **worth more in the future**.
 - **Delaying cash flows reduces their present value**, as future money must be **discounted back** to today's value.
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✦ Importance of TVM in Finance

- 1 **Investment Decisions:** Helps in evaluating whether an investment will provide returns higher than the cost of capital.
- 2 **Loan Repayments:** Determines loan payments, interest rates, and mortgage calculations.
- 3 **Retirement Planning:** Assists in calculating how much to save today for a comfortable future.
- 4 **Capital Budgeting:** Businesses use TVM to assess the profitability of long-term projects.

💡 Example:

Imagine you receive ₹1,000 today or ₹1,000 after one year.

- If invested today at **10% interest**, it will grow to **₹1,100** in a year.
 - Therefore, ₹1,000 today is **more valuable** than ₹1,000 received in the future.
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✦ Future Value (FV) & Present Value (PV)

TVM calculations revolve around two key concepts:

- **Future Value (FV):** Determines how much money today will be worth in the future.
 - **Present Value (PV):** Determines how much a future sum is worth today.
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✦ Future Value (FV) Calculation

Future Value (FV) measures how much an investment today will be worth after a specific period at a given interest rate.

⚡ Formula for Future Value (FV):

$$FV = PV \times (1+r)^n \quad FV = PV \times (1+r)^n \quad FV = PV \times (1+r)^n$$

Where:

- **FV** = Future Value
 - **PV** = Present Value (Initial Investment)
 - **r** = Interest Rate (in decimal)
 - **n** = Number of years
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💡 Example:

If ₹10,000 is invested at an annual **interest rate of 8%** for **3 years**, its future value will be:

$$FV = 10,000 \times (1.08)^3$$
$$FV = 10,000 \times 1.2597$$
$$FV = ₹12,597$$

This means **₹10,000 today will grow to ₹12,597 in 3 years** at 8% annual interest.

✦ Present Value (PV) Calculation

Present Value (PV) measures how much a future amount is worth today. It is used to determine how much should be invested now to reach a target amount in the future.

⚙ Formula for Present Value (PV):

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

Where:

- **PV** = Present Value
- **FV** = Future Value
- **r** = Interest Rate
- **n** = Number of years

💡 Example:

If you need **₹20,000** after **5 years**, and the interest rate is **10% per year**, how much should you invest today?

$$PV = \frac{20,000}{(1.1)^5}$$
$$PV = \frac{20,000}{1.6105}$$
$$PV = ₹12,418$$

This means **₹12,418 invested today at 10% interest will grow to ₹20,000 in 5 years**.

✦ Applications of Time Value of Money

TVM is widely used in various financial fields, including:

- ⚙ **Banking & Loans:** Helps in setting loan interest rates and EMI calculations.
 - ⚙ **Investment Analysis:** Assists in evaluating stocks, bonds, and mutual funds.
 - ⚙ **Capital Budgeting:** Used to assess project feasibility using **Net Present Value (NPV)** and **Internal Rate of Return (IRR)**.
 - ⚙ **Retirement & Savings Planning:** Helps individuals calculate how much to save for the future.
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✦ Practical Example: Comparing Two Investment Options

Imagine you have ₹50,000 and two investment options:

1. **Fixed Deposit (FD):** 5 years at **8% annual interest** (compounded annually).
2. **Stock Market Investment:** Expected return of **12% per year** for 5 years.

Future Value of Fixed Deposit (FD):

$$FV = 50,000 \times (1.08)^5$$
$$FV = 50,000 \times 1.4693$$
$$FV = ₹73,465$$

Future Value of Stock Market Investment:

$$FV = 50,000 \times (1.12)^5$$
$$FV = 50,000 \times 1.7623$$
$$FV = ₹88,115$$

Decision: If risk is not a concern, the **stock market investment is better (₹88,115 vs. ₹73,465)**. However, FD offers **guaranteed returns with no risk**.

✦ Note:

The **Time Value of Money (TVM)** is a key principle in finance, affecting **investment planning, loans, savings, and business decision-making**. Understanding **future value (FV)** and **present value (PV)** helps individuals and businesses **make informed financial choices**.

By applying TVM concepts, one can:

- ✓ **Maximize returns on investments**
- ✓ **Plan for financial goals effectively**
- ✓ **Make smart borrowing and lending decisions**

✦ **Final Thought:** Always consider TVM when making financial decisions because **a rupee today is worth more than a rupee tomorrow!** 📈📉

Compounding and Discounting

✦ Introduction

Compounding and discounting are two fundamental concepts in finance that help in evaluating the **time value of money (TVM)**.

- ✦ **Compounding** is the process of growing an investment by reinvesting the earned interest.
- ✦ **Discounting** is the process of determining the present value of future cash flows.

Both are crucial for financial decision-making, including **investment planning, loan calculations, and capital budgeting**.

✦ 1 Compounding

Compounding refers to the process of earning **interest on both the initial principal and the accumulated interest** over time. It **magnifies the growth** of investments due to the reinvestment of earnings.

✦ **Formula for Compounded Future Value (FV):**

$$FV = PV \times (1+r)^n$$

Where:

- **FV** = Future Value
- **PV** = Present Value (Initial Investment)
- **r** = Interest Rate (in decimal)
- **n** = Number of years

• **Example:**

Suppose you invest **₹5,000** at an annual interest rate of **12%** for **4 years**.

$$FV = 5,000 \times (1.12)^4$$
$$FV = 5,000 \times 1.5748$$
$$FV = ₹7,892$$

This means **₹5,000 today will grow to ₹7,892 in 4 years at 12% interest**.

◆ Types of Compounding

1 **Annual Compounding:** Interest is added once per year.

2 **Semi-Annual Compounding:** Interest is added twice per year. 3

Quarterly Compounding: Interest is added every three months. 4

Monthly Compounding: Interest is added every month.

• **Example:** If ₹10,000 is invested at **10% annual interest**, the **future value will be different** depending on compounding frequency:

- **Annually:** ₹11,000
- **Semi-Annually:** ₹11,025
- **Quarterly:** ₹11,038

The more frequent the compounding, the **higher the future value**.

★ 2 Discounting

Discounting is the reverse process of compounding. It helps in determining the **present value of a future sum of money** by accounting for the time value of money.

◆ Formula for Present Value (PV):

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

Where:

- **PV** = Present Value
- **FV** = Future Value
- **r** = Discount Rate
- **n** = Number of years

• Example:

You need **₹20,000** after **5 years**, and the interest rate is **10% per year**. How much should you invest today?

$$PV = \frac{20,000}{(1.1)^5} \quad PV = \frac{20,000}{1.6105} \quad PV = ₹12,418$$

This means **₹12,418 invested today at 10% interest will grow to ₹20,000 in 5 years**.

◆ Applications of Discounting

- ✓ Loan Repayment Calculation
 - ✓ Valuation of Bonds and Stocks
 - ✓ Capital Budgeting (NPV Calculation)
 - ✓ Retirement Planning
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Sources of Funds: Short-Term and Long-Term

✦ Introduction

A business needs funds for **daily operations, growth, and expansion**. These funds can be raised from **short-term or long-term sources**, depending on the financial need.

✦ 1 Short-Term Sources (Less than 1 Year)

Short-term financing is used for **day-to-day operations**, including **paying suppliers, managing cash flow, and covering immediate expenses**.

◆ Types of Short-Term Sources

1 Trade Credit

- Suppliers allow businesses to **purchase goods and pay later** (e.g., 30 to 90 days credit period).
- No immediate cash outflow, helping businesses manage liquidity.

• **Example:** A retail store **buys inventory on credit from suppliers** and pays after selling the goods.

2 Bank Overdraft

- Businesses can **withdraw more money than available in their bank account**, up to an agreed limit.
- Interest is charged **only on the amount overdrawn**.

• **Example:** A manufacturing company **overdraws ₹5 lakh** to pay workers' wages while waiting for customer payments.

3 Commercial Paper (CP)

- Short-term **unsecured promissory notes** issued by large corporations to raise working capital.
- Maturity period: **15 days to 1 year**.

• **Example:** Reliance Industries issues **commercial paper worth ₹500 crore** to meet short-term funding needs.

2 Long-Term Sources (More than 1 Year)

Long-term financing is used for **business expansion, acquiring assets, and funding large projects**.

Types of Long-Term Sources

1 Equity Financing (Shares & Stock Market)

- Companies raise funds by **selling shares to investors**.
- Investors become shareholders and receive dividends.
- No repayment obligation, but ownership is diluted.

• **Example:** Zomato raised **₹9,375 crore** through its **IPO (Initial Public Offering)** in 2021.

2 Debt Financing (Loans & Bonds)

- Companies **borrow money from banks** or issue **corporate bonds** to raise funds.
- **Interest payments are mandatory**, but ownership is not diluted.

• **Example:** Tata Motors issues **corporate bonds** to fund the launch of new electric vehicles.

3 Retained Earnings (Internal Financing)

- Companies **reinvest their own profits** instead of taking external loans.
- **No interest payments or ownership dilution**, but reduces cash available for dividends.

• **Example:** Infosys uses **retained earnings** to fund research in **AI and automation**.

✦ Comparison of Short-Term vs. Long-Term Financing

Feature	Short-Term Sources	Long-Term Sources
Duration	Less than 1 year	More than 1 year
Purpose	Working capital, daily operations	Business expansion, asset acquisition
Examples	Trade credit, overdraft, commercial paper	Equity financing, debt financing, retained earnings
Risk	Lower risk	Higher risk
Cost	Usually cheaper	Can be expensive (interest, dividends)

✦ Note:

Every business requires a **mix of short-term and long-term financing** to operate efficiently.

- **Short-term funds** help in **managing daily cash flow** and **working capital needs**.
- **Long-term funds** support **growth, expansion, and major investments**.

✦ **Final Thought:** The right choice of funding depends on **business needs, cost of capital, and financial strategy**. 📌📌

Conclusion

Finance is the backbone of business decision-making. Understanding the **time value of money, financial goals, investment decisions, and sources of funds** is crucial for financial managers. With the **emerging role of financial professionals in India and globally**, modern finance requires expertise in **technology, risk management, and compliance**.

Module II

Investment Decisions. Capital Budgeting: Features, types and Techniques of capital budgeting decision. Cost of Capital. Financing Decision: Operating Leverage, Financial Leverage. Capital structure. Theory and Policy. Dividend Decision Dividend Theory, Dividend Policy.

Capital Budgeting

Capital Budgeting: Meaning & Importance

✦ Meaning of Capital Budgeting

Capital budgeting is the process of evaluating and selecting **long-term investments** that align with a company's strategic goals. It involves deciding whether to invest in **new projects, equipment, expansion, or asset replacement**.

- **Example:** A company may decide whether to **build a new factory** or **purchase advanced machinery** by evaluating the project's expected profitability.

✦ Importance of Capital Budgeting

- ✓ **Ensures Long-Term Growth:** Helps businesses expand operations efficiently.
- ✓ **Maximizes Shareholder Value:** Selects projects that increase profits.
- ✓ **Manages Risk:** Evaluates potential losses before investing.
- ✓ **Efficient Resource Allocation:** Ensures funds are used wisely.
- ✓ **Controls Large Expenditures:** Helps manage high-cost projects effectively.

Features of Capital Budgeting

Capital budgeting is a key financial decision-making process that helps businesses allocate resources to long-term investment projects. Since these projects involve **large capital expenditures**, it is essential to evaluate them carefully. Several important features of capital budgeting must be considered to ensure the best investment decisions.

The major features of capital budgeting include:

1 Long-Term Investment

- ✓ **Capital budgeting decisions involve significant financial investment in long-term assets.** These assets may include machinery, buildings, technology upgrades, or large infrastructure projects. Unlike short-term investments, capital investments **generate benefits over many years** rather than providing immediate returns.

- **Example:**

A manufacturing company investing ₹100 crore in a new factory will expect to use the factory for the next **10 to 20 years**. The company must ensure that this investment generates enough profit over time to justify the cost.

◆ **Importance:** Since capital budgeting decisions have long-term effects, **companies must carefully evaluate** the expected return before committing to an investment.

2 ☐ Irreversible Decision

✓ **Once a company makes a capital investment, it is difficult or costly to reverse.** Unlike short-term investments (such as stocks or bonds, which can be easily bought or sold), capital budgeting investments involve **fixed assets that cannot be easily liquidated.**

• **Example:**

If a company spends ₹500 crore on constructing a power plant but later realizes that demand for electricity is low, it **cannot easily sell the power plant** to recover the money. The decision is **irreversible**, making proper analysis crucial before investing.

◆ **Importance:** Because of this **irreversibility**, financial managers must perform a **detailed feasibility study** and evaluate **alternative projects** before finalizing investment decisions.

3 ☐ High Risk & Uncertainty

✓ **Capital budgeting involves a high level of uncertainty because investments are made for the future.** Businesses estimate revenues, costs, and profits **based on forecasts.** However, economic conditions, competition, and market demand may change unexpectedly, affecting future returns.

• **Example:**

A car company investing ₹1,000 crore in electric vehicles (EVs) assumes that demand will grow. However, if **government policies change** or a **better technology emerges**, the company might not earn the expected profit, increasing financial risk.

◆ **Importance:** Because of this uncertainty, businesses use risk management techniques such as **sensitivity analysis, scenario planning, and discounted cash flow analysis** to make better capital budgeting decisions.

4 ☐ Cash Flow Analysis

✓ **Capital budgeting decisions focus on cash inflows and outflows rather than accounting profits.** Since investments require a **large amount of capital upfront**, financial managers must ensure that expected future cash flows are enough to recover the initial investment and generate profit.

• **Example:**

If a company invests ₹50 crore in a new project, it must estimate the future **cash inflows (revenue)** and **cash outflows (expenses, maintenance, and taxes)**. If future cash flows are **positive**, the project is viable. Otherwise, the company may **reject** the investment.

◆ **Importance:** A **detailed cash flow analysis** helps companies determine whether an investment will be **profitable and sustainable** in the long run.

5 □ Profitability Measurement

✓ **Capital budgeting decisions require careful evaluation of expected profitability.** Since these investments require large amounts of money, companies must ensure that they generate enough return to justify the cost.

• **Example:**

A company evaluating two projects:

- **Project A:** Investment ₹20 crore, expected profit ₹5 crore per year.
- **Project B:** Investment ₹15 crore, expected profit ₹3 crore per year.

By using techniques like **Net Present Value (NPV)**, **Internal Rate of Return (IRR)**, and **Payback Period**, the company can decide which project will generate more profit in the long run.

◆ **Importance:** Profitability analysis helps financial managers select **high-return projects** that improve a company's financial performance.

✦ **Note:**

Capital budgeting is a crucial financial decision-making process that involves **analysing, selecting, and managing long-term investments**. The features of capital budgeting, including **long-term impact, irreversibility, risk, cash flow analysis, and profitability measurement**, ensure that businesses make **wise investment choices**.

✓ Because these decisions **affect future growth, profitability, and financial stability**, companies must carefully evaluate capital investments using financial techniques like **NPV, IRR, and risk analysis** before committing funds.

Types of Capital Budgeting Decisions

Capital budgeting decisions involve **choosing long-term investments** that will help a company grow, improve efficiency, or expand into new markets. These decisions determine **how a company allocates its financial resources** to projects that offer the best returns.

There are two broad categories of capital budgeting decisions:

- 1 **Investment Dependency-Based Decisions**
- 2 **Purpose-Based Decisions**

Each category contains different types of decisions that businesses must consider.

1 Investment Dependency-Based Decisions

Investment decisions can be classified based on how they affect each other. Some investments are independent, while others are linked.

(i) Independent Investment Decisions

✓ These are **standalone investments**, meaning the decision to invest in one project does not affect the decision to invest in another.

✓ If multiple independent projects are profitable, the company can invest in **all** of them without any conflicts.

• Example:

- A company plans to build a **new warehouse** in City A and **purchase new software** for accounting.
- These two investments are independent because they **serve different purposes** and do not impact each other.
- The company can **accept both investments** if they are profitable.

◆ Importance:

✓ Allows companies to invest in **multiple projects at the same time** if resources are available.

✓ Reduces investment risk by diversifying capital across various projects.

(ii) Mutually Exclusive Investment Decisions

✓ These decisions involve **choosing only one project from multiple competing options**.

✓ Selecting one project means **rejecting** the others because they **serve the same purpose**.

• **Example:**

- A company wants to **replace an old machine** and has two options:
 - **Machine A:** Costs ₹10 lakh, lifespan of 10 years, operating cost ₹2 lakh per year.
 - **Machine B:** Costs ₹15 lakh, lifespan of 12 years, operating cost ₹1.5 lakh per year.
- The company **cannot buy both machines**; it must compare their costs and benefits and choose the best one.

⇨ **Importance:**

- ✓ Helps businesses **select the most profitable investment** when resources are limited.
 - ✓ Ensures that **funds are allocated efficiently** for maximum returns.
-

(iii) Contingent Investment Decisions

- ✓ These decisions depend on **another investment being made first**.
- ✓ The company cannot proceed with one project unless another project is approved.

• **Example:**

- A company plans to **expand production capacity** by installing new machinery. However, to support this expansion, it must first:
 1. Build a **new factory** to house the machines.
 2. Hire **more employees** to operate the machinery.
- The decision to install new machines is **contingent** on completing the factory and hiring workers.

⇨ **Importance:**

- ✓ Ensures that **investments are planned logically**, preventing delays and inefficiencies.
 - ✓ Helps in **coordinating multiple investment projects** for smooth execution.
-

2 Purpose-Based Decisions

Capital budgeting decisions can also be classified based on their **strategic purpose** for the company.

(i) Expansion Decisions

- ✓ These decisions involve **investing in new facilities, product lines, or market expansions** to grow the business.
- ✓ Companies make expansion decisions when demand for their products **increases**, or they want to **capture new markets**.

• **Example:**

- A company producing **smartphones** decides to expand into the **laptop market** by launching a new product line.
- This requires **investments in new technology, marketing, and production facilities**.

◆ **Importance:**

- ✓ Helps in **scaling up business operations** and increasing revenue.
 - ✓ Enables companies to **gain a competitive advantage** in the industry.
-

(ii) Replacement Decisions

- ✓ These involve **replacing outdated or inefficient equipment** with **newer and better alternatives**.
- ✓ The goal is to **improve productivity, reduce maintenance costs, and enhance quality**.

• **Example:**

- A steel company replaces **coal-powered furnaces** with **electric furnaces** to improve efficiency and reduce pollution.
- This decision **lowers energy costs** and increases production speed.

◆ **Importance:**

- ✓ Helps businesses **stay competitive** by adopting modern technology.
 - ✓ Reduces operational costs and improves **efficiency** in the long run.
-

(iii) Diversification Decisions

- ✓ These decisions involve **expanding into new markets or industries** to reduce business risk.
- ✓ A company diversifies to **reduce dependence** on a single product or market.

• **Example:**

- A **clothing brand** enters the **cosmetics industry** by launching a new line of beauty products.
- This diversification **reduces risk** because the company is not solely dependent on clothing sales.

◆ **Importance:**

- ✓ **Protects businesses from market downturns** in a single industry.
 - ✓ Expands revenue sources and **increases financial stability**.
-

(iv) Merger & Acquisition Decisions

✓ These decisions involve **buying or merging with other companies** to strengthen market position.

✓ Companies use mergers and acquisitions (M&A) to **increase market share, eliminate competition, or gain new technologies**.

• **Example:**

- Tata Motors acquired **Jaguar Land Rover** to expand its presence in the luxury car market.
- This acquisition helped Tata **gain advanced automobile technology** and enter the premium segment.

✦ **Importance:**

✓ Helps businesses grow **quickly** by acquiring established companies.

✓ Increases competitive strength and **reduces market competition**.

✦ **Note:**

Capital budgeting decisions play a **vital role** in shaping a company's financial future.

✓ **Independent investment decisions** allow companies to invest in multiple profitable projects.

✓ **Mutually exclusive decisions** ensure that businesses choose the **best project** among alternatives.

✓ **Contingent decisions** help in managing **dependent investments** effectively.

✓ **Expansion, replacement, diversification, and merger decisions** contribute to a company's **growth, efficiency, and risk management**.

☞ Since capital investments involve **large amounts of money and long-term commitment**, businesses must use **proper evaluation techniques** such as **Net Present Value (NPV), Internal Rate of Return (IRR), and Payback Period** before making decisions.

Techniques of Capital Budgeting

Capital budgeting is the process of evaluating long-term investment projects to determine their profitability and feasibility. Companies use **capital budgeting techniques** to decide whether to undertake a project, such as **buying new machinery, expanding business operations, or launching new products**.

There are **two major categories** of capital budgeting techniques:

- 1 **Traditional Techniques** (Simple but less accurate)
- 2 **Modern Techniques** (More accurate and widely used)

Each technique has its own advantages and limitations, and companies choose methods based on their financial strategies.

A. Traditional Techniques

Traditional techniques are simple and focus mainly on **profitability and risk recovery**.

1 Payback Period (PBP)

- ✓ The payback period measures the **time required to recover the initial investment** from the cash inflows generated by the project.
- ✓ A **shorter payback period is preferred** because it reduces risk and improves liquidity.
- ✓ However, it **does not consider the time value of money (TVM)** or cash flows after the payback period.

- **Formula:**

$$\text{PBP} = \frac{\text{Initial Investment}}{\text{Annual Cash Inflow}}$$
$$\text{PBP} = \frac{10,00,000}{2,50,000} = 4 \text{ years}$$

- **Example:**

A company invests ₹10 lakh in a project that generates ₹2.5 lakh per year.

$$\text{PBP} = \frac{10,00,000}{2,50,000} = 4 \text{ years}$$
$$\text{PBP} = \frac{10,00,000}{2,50,000} = 4 \text{ years}$$

This means the investment will be recovered in **4 years**.

- **Decision Rule:**

- ✓ If PBP is **shorter than the company's target period**, accept the project.
- ✓ If PBP is **longer than the target period**, reject the project.

2 Accounting Rate of Return (ARR)

- ✓ The **Accounting Rate of Return (ARR)** measures the return on investment as a percentage of the initial investment.
- ✓ Unlike PBP, ARR considers **profits** rather than cash flows.
- ✓ However, **it does not consider the time value of money (TVM)**, making it less accurate.

- **Formula:**

$$\text{ARR} = \frac{\text{Average Annual Profit}}{\text{Initial Investment}} \times 100$$

- **Example:**

A company invests ₹5 lakh in a project, generating an average profit of ₹1 lakh per year.

$$\text{ARR} = \frac{1,00,000}{5,00,000} \times 100 = 20\%$$

- **Decision Rule:**

- ✓ If ARR is **higher than the required rate of return**, accept the project.
- ✓ If ARR is **lower**, reject the project.

B. Modern Techniques

Modern techniques are more advanced and **consider the time value of money (TVM)**. They help in better decision-making by comparing cash flows over the life of the project.

1 Net Present Value (NPV)

- ✓ NPV is the **difference between the present value of cash inflows and outflows**.
- ✓ A positive NPV means the project is profitable, while a negative NPV means the project will result in losses.
- ✓ NPV considers the **time value of money**, making it one of the most accurate methods.

- **Formula:**

$$\text{NPV} = \sum \frac{C_t}{(1+r)^t} - C_0$$

Where:

- C_t = Cash inflow in year t
- r = Discount rate (cost of capital)
- t = Year
- C_0 = Initial investment

• **Example:**

A company invests ₹50,000 in a project, and the expected cash inflows for 3 years are ₹20,000, ₹30,000, and ₹40,000. The discount rate is 10%.

$$NPV = \frac{20,000}{(1.1)^1} + \frac{30,000}{(1.1)^2} + \frac{40,000}{(1.1)^3} - 50,000$$
$$NPV = (1.1)120,000 + (1.1)230,000 + (1.1)340,000 - 50,000 = 18,181 + 24,793 + 30,050 - 50,000 = 18,181 + 24,793 + 30,050 - 50,000 = ₹23,024 = ₹23,024 = ₹23,024$$

Since **NPV is positive**, the project is accepted.

◆ **Decision Rule:**

- ✓ If **NPV > 0**, accept the project.
- ✓ If **NPV < 0**, reject the project.

2 Internal Rate of Return (IRR)

- ✓ IRR is the **discount rate at which NPV = 0**.
- ✓ If IRR is **higher than the company's cost of capital**, the project is accepted.

• **Formula:**

$$\sum_{t=0}^n \frac{C_t}{(1+IRR)^t} = C_0$$

• **Example:**

A company invests ₹1,00,000 in a project that generates ₹40,000 per year for 3 years. Using trial and error, the IRR is found to be **18%**.

◆ **Decision Rule:**

- ✓ If **IRR > Cost of Capital**, accept the project.
- ✓ If **IRR < Cost of Capital**, reject the project.

3 Profitability Index (PI)

✓ The **Profitability Index (PI)** measures the ratio of present value of cash inflows to initial investment.

✓ If PI is greater than 1, the project is considered profitable.

• **Formula:**

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

• **Example:**

A company invests ₹1,00,000 in a project, and the present value of expected cash inflows is ₹1,20,000.

$$PI = \frac{1,20,000}{1,00,000} = 1.2$$
$$PI = \frac{1,20,000}{1,00,000} = 1.2$$

Since **PI > 1**, the project is accepted.

◆ **Decision Rule:**

✓ If **PI > 1**, accept the project.

✓ If **PI < 1**, reject the project.

• Case Study: Tata Motors Capital Budgeting Decision

Tata Motors is evaluating two projects:

Project	NPV (₹ crore)	IRR (%)	Decision
A	₹5 crore	18%	✓ Accepted
B	₹4 crore	15%	✗ Rejected

✓ **Tata Motors selects Project A** because it has a **higher NPV and IRR**, making it more profitable.

✦ **Note:**

Capital budgeting techniques help businesses **make strategic investment decisions** by analysing potential projects.

- ✓ **Traditional Techniques** like **Payback Period** and **ARR** are simple but lack accuracy.
- ✓ **Modern Techniques** like **NPV, IRR, and PI** consider the **time value of money**, making them more reliable.
- ✓ Companies should **combine multiple techniques** to make the best financial decisions.

◆ **Final Thought:**

Choosing the right capital budgeting technique ensures that **investments generate maximum returns and support long-term business growth.**

Cost of Capital – Detailed Explanation

Introduction

The **cost of capital** is the **minimum rate of return** a company must earn to justify an investment. It represents the **opportunity cost** of using funds in a business instead of investing elsewhere.

Companies raise capital through two primary sources:

- 1 **Equity** – Funds from shareholders
- 2 **Debt** – Borrowed funds (loans, bonds)

The **cost of capital** is crucial for decision-making in capital budgeting, financial planning, and corporate valuation.

✦ Components of Cost of Capital

The cost of capital has three major components:

1 Cost of Equity (Ke)

- ✓ The cost of equity is the **return expected by shareholders** for investing in a company.
- ✓ Unlike debt, there is **no fixed interest**, but companies must generate enough returns to satisfy investors.
- ✓ Higher business risks lead to a **higher cost of equity**.

• **Formula (Using CAPM - Capital Asset Pricing Model):**

$$K_e = R_f + \beta(R_m - R_f)$$

Where:

- **Ke** = Cost of equity
- **Rf** = Risk-free rate (e.g., government bonds)
- **β (Beta)** = Stock's volatility compared to the market
- **Rm** = Market return

• **Example:**

If:

- Risk-free rate (Rf) = 6%
- Market return (Rm) = 12%
- Beta (β) = 1.2

$$K_e = 6\% + 1.2(12\% - 6\%) = 6\% + 7.2\% = 13.2\%$$
$$K_e = 6\% + 1.2(12\% - 6\%) = 6\% + 7.2\% = 13.2\%$$

Thus, the **cost of equity is 13.2%**.

◆ **Key Takeaways:**

- ✓ Higher beta (β) means higher risk and cost of equity.
- ✓ Investors expect **higher returns** from risky companies.

2 □ Cost of Debt (Kd)

- ✓ The cost of debt is the **interest rate** a company pays on borrowed funds (loans, bonds, debentures).
- ✓ Debt is **cheaper than equity** because **interest expenses are tax-deductible**.

• **Formula (After Tax):**

$$K_d = I \times (1 - T)$$

Where:

- **Kd** = After-tax cost of debt
- **I** = Interest rate on debt
- **T** = Tax rate

• **Example:**

A company borrows **₹10 crore at 10% interest**, and the tax rate is **30%**.

$$K_d = 10\% \times (1 - 0.30) = 10\% \times 0.70 = 7\%$$
$$K_d = 10\% \times (1 - 0.30) = 10\% \times 0.70 = 7\%$$

Thus, the **after-tax cost of debt is 7%**.

◆ **Key Takeaways:**

- ✓ **Tax benefits** reduce the effective cost of debt.
- ✓ **Too much debt** increases financial risk.

3 Weighted Average Cost of Capital (WACC)

✓ WACC is the **average cost of all capital sources**, weighted according to their proportion in total capital.

✓ It helps in evaluating investment projects.

• Formula:

$$WACC = (E \times K_e) + (D \times K_d \times (1 - T))$$
$$WACC = \left(\frac{E}{V} \times K_e \right) + \left(\frac{D}{V} \times K_d \times (1 - T) \right)$$

Where:

- E = Market value of equity
- D = Market value of debt
- V = Total capital (E + D)
- K_e = Cost of equity
- K_d = Cost of debt
- T = Tax rate

• Example:

A company has:

- ₹50 crore in equity (K_e = 15%)
- ₹30 crore in debt (K_d = 10%)
- Tax rate = 25%

$$WACC = (5080 \times 15\%) + (3080 \times 10\% \times (1 - 0.25))$$
$$WACC = \left(\frac{50}{80} \times 15\% \right) + \left(\frac{30}{80} \times 10\% \times (1 - 0.25) \right)$$
$$WACC = (0.625 \times 15\%) + (0.375 \times 7.5\%) = 9.375\% + 2.81\%$$
$$WACC = (0.625 \times 15\%) + (0.375 \times 7.5\%) = 9.375\% + 2.81\% = 12.19\%$$

Thus, the **WACC is 12.19%**, meaning the company must earn at least this return on new investments.

◆ Key Takeaways:

✓ **Higher debt** lowers WACC (due to tax benefits).

✓ **Too much equity** increases WACC (higher shareholder expectations).

✦ Importance of Cost of Capital

- ✦ **Capital Budgeting:** Used in **NPV and IRR calculations** for investment decisions.
 - ✦ **Valuation of Companies:** Determines fair value for **Mergers & Acquisitions (M&A)**.
 - ✦ **Dividend & Financing Decisions:** Helps in **dividend policy and capital structure optimization**.
 - ✦ **Risk Management:** Affects stock prices and **investor confidence**.
-

✦ Note:

- ✓ The **cost of capital** is essential for **financial planning and investment decisions**.
 - ✓ **Equity is expensive but gives financial stability**.
 - ✓ **Debt is cheaper due to tax benefits but increases risk**.
 - ✓ **WACC helps in selecting profitable projects**.
-

Financing Decision – Detailed Explanation

✦ Meaning of Financing Decisions

A **financing decision** is a critical financial management decision that determines the **best mix of debt and equity** to fund a business.

- ✓ The goal is to **maximize shareholder wealth** while **minimizing financial risks**.
- ✓ A company can raise capital through:
 - 1 **Debt** – Borrowed funds (loans, bonds, debentures)
 - 2 **Equity** – Shareholder funds (common stock, retained earnings)

Key Question: Should a company use **more debt or more equity?**

• Example:

Tata Motors wants to expand its electric vehicle production. It must decide whether to:

- ✓ **Issue shares (Equity)** – No repayment, but dilutes ownership.
 - ✓ **Take a loan (Debt)** – Lower cost but increases financial risk.
-

✦ Importance of Financing Decisions

- ✓ Affects the company's **profitability and risk**.
 - ✓ Determines the **cost of capital (WACC)**.
 - ✓ Impacts **dividend policies** and **capital structure**.
-

✦ Types of Leverage in Financing Decisions

Leverage refers to the use of **fixed costs or borrowed funds** to increase profits. It magnifies both **profits and losses**.

There are **two main types of leverage** in financing decisions:

1. Operating Leverage

- ✓ **Operating leverage** measures the effect of **fixed costs** on a company's profits.
- ✓ Companies with **high fixed costs** experience greater changes in profits due to revenue fluctuations.
- ✓ **Higher operating leverage** means **higher risk** during low sales periods.

• Formula:

Degree of Operating Leverage (DOL) = $\frac{\% \text{ Change in EBIT}}{\% \text{ Change in Sales}}$
Degree of Operating Leverage (DOL) = $\frac{\% \text{ Change in EBIT}}{\% \text{ Change in Sales}}$

Where:

- **EBIT** = Earnings Before Interest & Taxes

• Example:

A factory has **high fixed costs (₹10 lakh per year)** but low variable costs.

- ✓ If sales increase by **10%**, profits might increase by **30%** due to operating leverage.
- ✓ If sales fall by **10%**, profits decline **sharply**, leading to losses.

✦ Key Takeaways:

- ✓ **High operating leverage = High fixed costs = High profit potential but higher risk.**
 - ✓ **Low operating leverage = Low fixed costs = Stable but lower profit potential.**
-

2 Financial Leverage

- ✓ **Financial leverage** refers to the **use of debt** to finance a company's operations.
- ✓ It **magnifies earnings per share (EPS)** but also increases **financial risk**.

- **Formula:**

Degree of Financial Leverage (DFL) = $\frac{\% \text{ Change in EPS}}{\% \text{ Change in EBIT}}$

Degree of Financial Leverage (DFL) = $\frac{\% \text{ Change in EBIT}}{\% \text{ Change in EPS}}$

- **Example:**

Company A and Company B both need **₹1 crore** for expansion:

- ✓ **Company A uses ₹1 crore from shareholders (Equity financing).**
- ✓ **Company B takes a ₹1 crore loan at 10% interest (Debt financing).**

If both companies earn ₹20 lakh profit:

- ✓ **Company A (Equity financing)** – No debt, so all profits go to shareholders.
- ✓ **Company B (Debt financing)** – Pays ₹10 lakh in interest, so only ₹10 lakh remains for shareholders.

However, if profits **increase to ₹40 lakh**, Company B benefits more because **debt interest remains fixed**, leading to **higher EPS growth**.

- **Key Takeaways:**

- ✓ **Higher financial leverage = Higher risk but also higher potential returns.**
- ✓ **Too much debt can lead to bankruptcy if profits fall.**

✦ Financing Decision – Debt vs. Equity

Feature	Debt Financing	Equity Financing
Ownership	No ownership dilution	Ownership dilution occurs
Cost	Interest must be paid	No fixed cost, but dividends may be paid
Risk	Higher risk due to fixed payments	Lower risk, no mandatory payments
Tax Benefit	Interest is tax-deductible	No tax benefits
Effect on EPS	Can increase EPS if profits are stable	More stable, but EPS may be lower

✦ Note:

- ✓ **Financing decisions** impact profitability, risk, and shareholder value.
- ✓ **Operating leverage** affects profits based on **fixed costs**.
- ✓ **Financial leverage** determines how debt impacts **earnings and risk**.
- ✓ A **balanced capital structure** is key to minimizing risk while maximizing growth.

• Final Thought:

Successful companies carefully manage their **debt-to-equity ratio** to maintain **financial stability** and **maximize returns**. ☺🏢

Capital Structure – Theory and Policy

✦ Meaning of Capital Structure

Capital structure refers to the **proportion of debt and equity** used by a firm to finance its operations and investments. It is a critical financial decision that affects the company's **profitability, risk, and cost of capital**.

- ✓ **Debt Financing:** Borrowed funds (Loans, Bonds, Debentures)
- ✓ **Equity Financing:** Shareholder funds (Common Stock, Retained Earnings)

The goal of capital structure management is to **find the optimal mix of debt and equity** that minimizes the **cost of capital (WACC)** and maximizes the **value of the firm**.

• Example:

- **Infosys** follows a **low-debt policy**, relying more on equity financing.
- **Tata Motors** maintains a **mix of debt and equity** to benefit from tax advantages and financial leverage.

✦ Importance of Capital Structure

- ✓ **Affects Risk and Return** – More debt means higher risk but also higher return potential.
 - ✓ **Determines Cost of Capital** – The right mix reduces financing costs.
 - ✓ **Influences Firm Value** – A well-structured capital mix enhances market valuation.
 - ✓ **Impacts Financial Stability** – High debt increases the risk of bankruptcy.
-

✦ Theories of Capital Structure

Several theories explain how capital structure impacts a firm's value and profitability. The key theories include:

1 ☐ Net Income (NI) Theory – Proposed by David Durand

✓ This theory suggests that **higher debt increases profits** because debt is a **cheaper source of finance** than equity.

✓ More debt means lower **Weighted Average Cost of Capital (WACC)**, which increases the firm's value.

• **Example:**

Company A and Company B both need ₹10 crore for expansion:

- **Company A uses 100% equity financing** – No debt, higher cost of capital.
- **Company B uses 50% debt and 50% equity** – Interest on debt is tax-deductible, reducing financing costs.

✓ According to **NI Theory**, Company B will have **higher profits** because debt financing is cheaper.

◆ **Conclusion:** More debt = More profit = Higher firm value ✓

2 ☐ Net Operating Income (NOI) Theory – By David Durand

✓ **Capital structure does not affect firm value.**

✓ The **cost of capital remains constant**, regardless of the debt-equity mix.

✓ The increase in **financial risk** from debt offsets any benefits from lower financing costs.

• **Example:**

- Two companies (X & Y) have the same earnings but different capital structures.
- **Company X (100% Equity Financing)** – No debt, all profits belong to shareholders.
- **Company Y (50% Debt, 50% Equity)** – Pays interest on debt, reducing net earnings.

✓ According to **NOI Theory**, both firms will have the **same total value**, because **risk-adjusted returns balance out**.

◆ **Conclusion:** Capital structure does not influence firm value ∅

3 ☐ Modigliani and Miller (M&M) Theory

✓ **Proposed by Franco Modigliani & Merton Miller (1958).**

✓ Assumes a **perfect market** where:

- No taxes
- No bankruptcy costs
- No transaction costs

M&M Theory without Taxes (Irrelevance Proposition)

✓ **Capital structure does not affect firm value** in a **perfect market**.

✓ Firms should focus on **investment decisions**, not financing choices.

• **Example:**

- If **Reliance Industries** increases debt, investors **adjust their expectations**, keeping stock prices unchanged.

⇨ **Conclusion:** Financing choices don't matter if markets are perfect.

M&M Theory with Taxes (Revised Model)

✓ **Debt is beneficial because interest is tax-deductible**, reducing the overall cost.

✓ Firms should **prefer debt financing** to take advantage of tax benefits.

• **Example:**

- **Tata Motors** uses debt financing to lower its taxable income, increasing profits.

⇨ **Conclusion:** More debt = More tax savings = Higher firm value ✓

✦ **Note:**

✓ **Capital structure decisions are crucial** for financial stability and growth.

✓ Theories like **NI, NOI, and M&M** provide different perspectives on debt vs. equity.

✓ The **optimal mix of debt and equity** depends on taxation, profitability, and risk tolerance.

• **Final Thought:** A **balanced capital structure** helps companies **minimize costs and maximize value**. ✓📈

✦ **Capital Structure Policy**

✦ **Meaning of Capital Structure Policy**

Capital structure policy refers to the company's strategy for deciding the right mix of **debt, equity, and other financial instruments** to finance its operations. The goal is to maximize the firm's value while minimizing its cost of capital and financial risk.

✦ Objectives of Capital Structure Policy

- ✓ **Minimize Cost of Capital:** Choosing a mix of debt and equity that lowers financing costs.
- ✓ **Maximize Firm Value:** A well-planned structure increases stock prices and investor confidence.
- ✓ **Ensure Financial Stability:** Avoid excessive debt to prevent financial distress.
- ✓ **Maintain Flexibility:** Allow room for future financing needs without restrictions.
- ✓ **Optimize Risk-Return Tradeoff:** Balance financial risk and return to benefit shareholders.

✦ Types of Capital Structure Policies

1 ☐ Conservative Capital Structure

- ✓ Focuses on **low debt and high equity** financing.
- ✓ Reduces **financial risk** but may lead to **higher cost of capital**.
- ✓ Suitable for **stable businesses with strong cash flows**.

• Example:

- **Infosys** follows a conservative capital structure with minimal debt, relying mostly on equity and retained earnings.

◆ **Pros:** Low risk, stable financial position.

◆ **Cons:** Higher cost of equity, lower financial leverage.

2 ☐ Aggressive Capital Structure

- ✓ Uses **high debt financing** to benefit from **tax savings** and leverage.
- ✓ Increases **financial risk** but can boost **return on equity (ROE)**.
- ✓ Suitable for companies in **growth industries** with **high profitability**.

• Example:

- **Tata Motors** and **Reliance Industries** use high debt financing to expand operations and benefit from interest tax shields.

◆ **Pros:** Lower cost of capital, higher earnings potential.

◆ **Cons:** Higher financial risk, risk of bankruptcy if earnings decline.

3 ☐ Moderate Capital Structure (Balanced Approach)

- ✓ Maintains a **balanced mix of debt and equity**.
- ✓ Reduces financial risk while enjoying some tax benefits of debt.
- ✓ Suitable for companies aiming for **stable growth**.

• **Example:**

- **Hindustan Unilever (HUL)** follows a moderate approach, maintaining a **mix of equity and debt** to keep financial risk low while optimizing returns.

◆ **Pros:** Optimal balance between risk and return, financial flexibility.

◆ **Cons:** May not fully utilize tax advantages of debt.

✦ Factors Influencing Capital Structure Policy

Factor	Impact on Capital Structure
Business Risk	High-risk firms prefer lower debt to avoid financial distress.
Tax Rate	Higher tax rates encourage more debt due to interest tax shields.
Profitability	Profitable firms use retained earnings (equity) instead of debt.
Growth Opportunities	High-growth firms need more equity to avoid excessive debt burden.
Market Conditions	Favorable stock markets encourage equity financing, while low interest rates favor debt.
Industry Type	Capital-intensive industries (e.g., steel, telecom) rely more on debt.
Cost of Debt vs. Equity	If debt is cheaper, firms prefer higher leverage.

✦ Real-World Examples of Capital Structure Policies

✓ **Infosys & TCS (Conservative Approach):** They use minimal debt and rely on strong cash flows for expansion.

✓ **Tata Motors & Reliance (Aggressive Approach):** They use significant debt to finance large-scale projects.

✓ **Hindustan Unilever (Moderate Approach):** Uses a balanced mix of debt and equity to maintain financial stability.

✦ Note:

- ✓ A **well-planned capital structure policy** is crucial for financial stability and growth.
- ✓ Companies must consider **risk, cost of capital, and industry trends** before deciding on their mix of **debt and equity**.
- ✓ The **right policy varies from business to business**, depending on **financial goals and market conditions**.

• **Final Thought:** A **balanced capital structure** helps companies **minimize financial risk, maximize profitability, and enhance shareholder value**. 📈✓

Dividend Decisions

✦ Meaning of Dividend Decision

A **dividend decision** refers to a company's choice on whether to **distribute its profits** to shareholders in the form of **dividends** or **reinvest the earnings** into the business for expansion and growth.

Key Considerations in Dividend Decisions:

- ✓ Should the company pay **higher or lower dividends**?
- ✓ Should the profits be **retained for reinvestment**?
- ✓ What impact will dividends have on **shareholder value and market price**?

A **good dividend policy** balances shareholder expectations with the company's financial needs.

✦ Types of Dividend Decisions

1 Regular Dividend Policy

- ✓ The company pays dividends at **fixed intervals (quarterly, annually, etc.)**.
- ✓ Preferred by investors who seek **stable income**.
- ✓ Used by well-established companies with **stable profits**.

• Example:

- **Hindustan Unilever (HUL)** follows a **regular dividend policy**, ensuring steady payouts to shareholders.

⚡ **Pros:** Builds investor trust, attracts long-term investors.

⚡ **Cons:** The company must pay even if profits decline.

2 ☐ Stable Dividend Policy

- ✓ Dividends **increase gradually** over time as profits grow.
- ✓ Ensures **predictability** for investors.
- ✓ Suitable for companies with **moderate and stable earnings growth**.

- **Example:**

- **Infosys** follows a stable dividend policy, **gradually increasing payouts** as profits rise.

- ◆ **Pros:** Increases investor confidence, reduces uncertainty.
- ◆ **Cons:** The company may need to borrow during low-profit years.

3 ☐ Residual Dividend Policy

- ✓ The company **pays dividends only after funding all profitable investments**.
- ✓ If no investment opportunities exist, **higher dividends** are paid.
- ✓ Suitable for companies in **high-growth industries**.

- **Example:**

- **Tesla** follows a **residual dividend policy**, preferring to **reinvest earnings** into innovation and expansion instead of paying dividends.

- ◆ **Pros:** Ensures efficient capital use, supports long-term growth.
- ◆ **Cons:** Unpredictable dividend payments, may disappoint income-seeking investors.

4 ☐ No-Dividend Policy

- ✓ The company **does not pay any dividends** and reinvests all profits.
- ✓ Common in companies focused on **rapid expansion**.
- ✓ Preferred by investors who seek **capital appreciation** rather than dividend income.

- **Example:**

- **Amazon & Tesla** do not pay dividends, using profits for innovation and growth.

- ◆ **Pros:** Boosts long-term value, fuels business expansion.
- ◆ **Cons:** May not attract investors seeking regular income.

✦ Factors Affecting Dividend Decisions

Factor	Impact on Dividend Policy
Profitability	Higher profits allow higher dividends, while losses may result in no dividends.
Growth Opportunities	Companies with high growth potential retain earnings instead of paying dividends.
Liquidity	Availability of cash affects dividend payouts.
Taxation Policy	High dividend taxes may discourage companies from paying dividends.
Shareholder Expectations	Investors who prefer steady income favor stable dividend policies.
Legal & Regulatory Constraints	Government rules may restrict excessive dividend payouts.
Debt Obligations	High debt burdens may force companies to reduce dividends.

Dividend Theories III

Dividend theories explain how dividend decisions affect a firm's **value, stock price, and shareholder wealth**. Some theories argue that **dividends influence stock prices**, while others claim they **do not impact firm value**.

✦ Types of Dividend Theories

1. □ Walter's Model (Relevance Theory)

Walter's Model suggests that a company's **dividend policy directly affects its value**. The decision to distribute or retain earnings depends on the firm's **return on investment (r)** and **cost of capital (Ke)**.

- ✓ If $r > K_e$ → The firm should **reinvest earnings** instead of paying dividends.
- ✓ If $r < K_e$ → The firm should **distribute dividends** as reinvestment does not add value.

• Example:

- A **tech startup** earns **20% return (r = 20%)**, while its capital cost is **12% (Ke = 12%)**.
- Since $r > K_e$, it should **retain earnings** for future growth instead of paying dividends.

◆ **Limitation:** Assumes all earnings are reinvested in the same firm, which may not always be true.

2 □ Gordon's Model (Bird-in-Hand Theory)

Gordon argues that **investors prefer regular dividends over capital gains** because of the risk associated with future earnings. A firm's **market value depends on its dividend policy**.

✓ Higher dividends → Increase stock price.

✓ Lower dividends → Decrease stock price.

• **Example:**

- **Hindustan Unilever (HUL)** follows a stable dividend policy, attracting investors and maintaining a high stock price.

◆ **Limitation:** Assumes **no external financing**, which is unrealistic.

3 □ Modigliani & Miller (M&M) Theory (Irrelevance Theory)

Modigliani & Miller argue that **dividend policy does not affect the value of a firm** in a **perfect market**. Investors can **sell shares instead of receiving dividends** to generate cash.

✓ A company's **profitability and investment decisions** determine its value, not dividends.

✓ Dividends are **irrelevant** because investors can create their own dividend by selling shares.

• **Example:**

- **Amazon** does not pay dividends, but its stock price continues to rise due to strong reinvestment in growth.

◆ **Limitation:** Assumes **no taxes, transaction costs, or investor preferences**, which is unrealistic.

4 □ Residual Theory of Dividends

This theory states that dividends should be paid **only after funding all profitable investment opportunities**.

✓ If profitable projects exist → Retain earnings.

✓ If no profitable projects → Pay dividends.

• **Example:**

- **Tesla** reinvests all profits into R&D and expansion, paying **zero dividends** to shareholders.

⚡ **Limitation:** Results in **irregular dividend payments**, which may not appeal to income-seeking investors.

📌 **Note:**

✓ **Walter & Gordon's models** suggest that **dividends impact stock prices**.

✓ **M&M theory** claims **dividends do not affect firm value**.

✓ **Residual theory** focuses on **investment needs over dividends**.

• **Key Takeaway:** A company should balance **dividends and reinvestment** to maximize **shareholder wealth and long-term growth**. ✓📌

Dividend Policy 📌

📌 Meaning of Dividend Policy

A **dividend policy** refers to a company's approach to distributing profits to shareholders **in the form of dividends** or retaining earnings for future investment. The policy determines **how much and when** dividends will be paid.

A company's **dividend policy** affects **stock price, investor expectations, and financial stability**.

📌 Types of Dividend Policies

1 📌 Regular Dividend Policy

✓ The company **pays a fixed amount of dividend** every year.

✓ Suitable for **companies with stable earnings**.

✓ Provides **certainty to investors**.

• **Example:**

- **Tata Consultancy Services (TCS)** pays a regular dividend to its shareholders every year, ensuring investor trust.

⚡ **Limitation:** The company **must pay dividends even in bad years**, which can create financial strain.

2 ☐ Stable Dividend Policy

- ✓ The company **pays a fixed percentage of its earnings** as dividends.
- ✓ Ensures **consistency in dividend payments**, even if earnings fluctuate.
- ✓ Investors receive **higher dividends in profitable years and lower in weak years**.

• **Example:**

- **Infosys** follows a stable dividend policy, distributing a portion of its annual profits as dividends.

⚡ **Limitation:** If earnings fall significantly, **dividends may still decrease**, disappointing investors.

3 ☐ Irregular Dividend Policy

- ✓ The company **does not have a fixed dividend pay-out**.
- ✓ Dividends are declared **based on company profits and financial position**.
- ✓ Suitable for **companies with unpredictable earnings**.

• **Example:**

- **Steel companies** like **Tata Steel** may pay **higher dividends in boom years and lower or no dividends in recession periods**.

⚡ **Limitation:** Uncertainty in dividend payments may **reduce investor confidence**.

4 ☐ No Dividend Policy

- ✓ The Company **reinvests all its profits** for growth and expansion.
- ✓ Common for **start-ups and high-growth firms**.
- ✓ Attracts investors looking for **long-term capital gains** instead of regular income.

• **Example:**

- **Amazon and Tesla** do not pay dividends, preferring to reinvest earnings into **new projects and business expansion**.

⚡ **Limitation:** Investors who rely on **regular income** may **avoid investing** in such companies.

🚀 Factors Affecting Dividend Policy

- ✓ **Company Profits** – Higher profits allow for larger dividends.
 - ✓ **Business Growth** – Companies with high growth prefer reinvestment over dividends.
 - ✓ **Market Conditions** – Economic recessions may lead to lower or no dividends.
 - ✓ **Legal Restrictions** – Some laws restrict excessive dividend payments.
 - ✓ **Shareholder Expectations** – Investors may expect regular or growing dividends.
-

🚀 Note:

A company must choose a dividend policy that **balances shareholder interests and business growth**.

- ✓ **Regular dividends** ensure stability but may burden the company.
- ✓ **Stable dividends** provide predictability but depend on earnings.
- ✓ **Irregular dividends** give flexibility but reduce investor confidence.
- ✓ **No dividends** promote reinvestment but may not attract income-seeking investors.

• **Key Takeaway:** The right dividend policy depends on **profitability, growth strategy, and investor expectations**. ✓📈

Conclusion

- ✓ **Capital budgeting** ensures efficient project selection.
- ✓ **Cost of capital** affects financial planning.
- ✓ **Financing decisions** impact risk and profitability.
- ✓ **Capital structure** optimizes debt-equity mix.
- ✓ **Dividend decisions** balance shareholder returns and business growth.

🗨️ **These principles guide financial managers to maximize wealth and business success.**



Module III

Current Assets Management: Working Capital concepts, Policies, estimation, factors affecting working capital, Sources of financing Working Capital, **Management of Cash:** Cash budget, Management of collections and disbursement, Investment of Surplus cash; **Management of Receivables:** Terms of Credit, Credit Policy decision; **Management of Inventory:** Techniques of Inventory planning and control.

Current Assets Management

Current Assets Management

Current Assets Management refers to the process of efficiently managing a company's short-term assets to ensure **liquidity, profitability, and operational efficiency**. These assets include **cash, accounts receivable, inventory, and marketable securities**, which are expected to be converted into cash within **one year**.

✦ Importance of Current Assets Management

- ✓ Ensures **smooth business operations** by maintaining liquidity.
- ✓ Prevents **cash shortages** and financial distress.
- ✓ Optimizes the balance between **profitability and risk**.
- ✓ Reduces unnecessary **holding costs** for cash and inventory.
- ✓ Enhances **credit management** to avoid bad debts.

• Example:

A retail company must maintain enough cash to pay suppliers, manage inventory efficiently to meet customer demand, and collect receivables on time to maintain liquidity.

✦ Components of Current Assets Management

1 Cash Management

Managing cash to ensure **liquidity while maximizing investment returns**.

- ✓ **Cash Budgeting** → Forecasting cash inflows & outflows.
- ✓ **Cash Collection & Disbursement** → Accelerating collections & delaying payments.
- ✓ **Surplus Cash Investment** → Investing idle cash in short-term securities.

• Example:

A company **invests surplus cash** in fixed deposits or money market instruments to earn interest instead of keeping idle cash.

2 Receivables Management

Ensures **timely collection of credit sales** while minimizing bad debts.

- ✓ **Credit Policy** → Deciding credit terms & limits.
- ✓ **Credit Collection** → Offering early payment discounts.
- ✓ **Bad Debt Control** → Monitoring overdue accounts.

- **Example:**

An electronics company offers a **2% discount** for payments made within **10 days** to encourage early collections.

3 Inventory Management

Ensures **optimal stock levels** to avoid shortages or excess holding costs.


- ✓ **Economic Order Quantity (EOQ)** → Determines optimal purchase quantity.
- ✓ **Just-in-Time (JIT)** → Orders inventory only when needed.
- ✓ **ABC Analysis** → Categorizes inventory based on value & importance.

- **Example:**

Toyota follows the **JIT system**, where parts are delivered **just before production**, reducing storage costs.

Objectives of Current Assets Management

- ✓ **Ensure Liquidity** – Keep enough cash to meet obligations.
- ✓ **Minimize Idle Funds** – Invest surplus funds in profitable assets.
- ✓ **Reduce Costs** – Minimize holding & financing costs.
- ✓ **Improve Profitability** – Optimize asset utilization.
- ✓ **Enhance Creditworthiness** – Maintain a healthy balance between receivables and payables.

- **Key Takeaway:** A well-managed current assets strategy helps a business **stay financially stable, reduce risk, and improve overall profitability.** ✓

📌 Working Capital Concepts: In-Depth Explanation

1 📌 Meaning of Working Capital

Working capital refers to the funds required by a business to cover its **day-to-day operating expenses**. It ensures a company can pay for wages, raw materials, rent, utilities, and other short-term liabilities while maintaining smooth business operations.

A business with sufficient **working capital** can handle unexpected expenses, take advantage of growth opportunities, and avoid financial distress.

2 📌 Types of Working Capital

🔹 1. Gross Working Capital (GWC)

- ✓ Represents the **total current assets** of a company.
- ✓ Includes **cash, accounts receivable, inventory, and short-term investments**.
- ✓ Measures the company's ability to cover short-term financial needs.

• Example:

If a company has the following current assets:

- 🔹 Cash: ₹2,00,000
- 🔹 Accounts Receivable: ₹3,50,000
- 🔹 Inventory: ₹4,50,000
- 🔹 Short-term Investments: ₹1,00,000

Gross Working Capital = ₹2,00,000 + ₹3,50,000 + ₹4,50,000 + ₹1,00,000 = ₹11,00,000

🔹 2. Net Working Capital (NWC)

- ✓ **Net Working Capital = Current Assets – Current Liabilities**
- ✓ Measures the liquidity position and ability to meet short-term obligations.
- ✓ A **positive NWC** means the company can meet its short-term liabilities easily.
- ✓ A **negative NWC** means the company may face financial difficulties.

• Example:

A company has:

◆ **Current Assets** = ₹10,00,000

◆ **Current Liabilities** = ₹6,00,000

Net Working Capital = $10,00,000 - 6,00,000 = ₹4,00,000$
 $\text{Net Working Capital} = 10,00,000 - 6,00,000 = ₹4,00,000$

Since **NWC is positive**, the company has a strong financial position.

◆ 3. Permanent Working Capital (PWC)

✓ Also known as **fixed working capital**.

✓ The **minimum amount of working capital** required for daily operations, regardless of business fluctuations.

✓ Includes **basic cash, accounts receivable, and inventory levels** needed for survival.

✓ Even if sales increase or decrease, this amount remains constant.

• **Example:**

A retail store always needs **₹5 lakh** in inventory, cash, and accounts receivable to keep the business running, irrespective of seasonal changes.

◆ 4. Temporary Working Capital (TWC)

✓ Also called **fluctuating working capital**.

✓ The additional working capital needed **during peak seasons or sudden growth**.

✓ Varies based on sales, production cycles, and demand.

• **Example:**

A toy manufacturer needs extra working capital **before the festive season** to stock up on inventory for increased sales.

3 Components of Working Capital

Working capital consists of **current assets** and **current liabilities**.

◆ **Current Assets (Short-term resources)**

1 **Cash & Bank Balances** – For day-to-day expenses.

2 **Accounts Receivable (Debtors)** – Credit sales to customers.

3 **Inventory (Stock)** – Raw materials, work-in-progress, finished goods.

- 4 **Short-term Investments** – Treasury bills, money market funds.
- 5 **Prepaid Expenses** – Advance payments (e.g., rent, insurance).

◆ **Current Liabilities (Short-term obligations)**

- 1 **Accounts Payable (Creditors)** – Payments due to suppliers.
- 2 **Short-term Loans** – Bank overdrafts, working capital loans.
- 3 **Outstanding Expenses** – Salaries, utility bills yet to be paid.
- 4 **Taxes Payable** – Corporate taxes, GST, VAT.

✦ **Working Capital Policies: Detailed Explanation**

1 **Meaning of Working Capital Policy**

A company's **working capital policy** refers to how it **manages current assets and liabilities** to ensure smooth business operations. The policy determines how much cash, inventory, and receivables a company should maintain to balance **liquidity and profitability**.

A well-designed working capital policy ensures that the company has enough funds to meet short-term obligations while **avoiding excessive investments in idle assets**.

2 **Types of Working Capital Policies**

◆ **1. Conservative Working Capital Policy**

- ✓ **Maintains a high level of working capital** to ensure financial safety.
- ✓ Companies invest in **higher cash reserves, inventory, and receivables** to avoid liquidity issues.
- ✓ Low risk but **lower profitability** because excess funds are not invested in profit-generating activities.
- ✓ Suitable for industries where stability and uninterrupted supply are crucial.

• **Example:**

Pharmaceutical companies maintain **high inventory** to prevent shortages of medicines, even if demand fluctuates.

✓ **Advantages:**

- ✓ Ensures liquidity and reduces the risk of financial distress.
- ✓ Helps businesses handle unexpected economic downturns.
- ✓ Builds customer and supplier confidence due to a stable financial position.

✗ Disadvantages:

- ✗ Leads to idle funds, reducing profitability.
 - ✗ High inventory carrying costs.
 - ✗ Might result in excess working capital, leading to inefficiency.
-

◆ 2. Aggressive Working Capital Policy

- ✓ **Maintains a low level of working capital** to maximize profits.
- ✓ Focuses on **minimizing cash, inventory, and receivables** to free up funds for other investments.
- ✓ Relies more on **short-term borrowings** instead of maintaining large cash reserves.
- ✓ High risk, but can **increase returns** if managed effectively.
- ✓ Suitable for **fast-growing industries** that need to invest heavily in expansion.

• Example:

Retail chains like **Big Bazaar and DMart** operate on an **aggressive policy** by keeping **low inventory levels** and focusing on quick turnover to reduce storage costs.

✓ Advantages:

- ✓ Maximizes profitability by utilizing excess funds for expansion.
- ✓ Reduces the cost of maintaining idle assets.
- ✓ Improves operational efficiency and cost management.

✗ Disadvantages:

- ✗ Higher risk of liquidity shortages.
 - ✗ Dependence on short-term borrowing can lead to financial instability.
 - ✗ May struggle during unexpected demand surges or supply chain disruptions.
-

◆ 3. Moderate (Hedging) Working Capital Policy

- ✓ A **balanced approach** that matches **short-term assets with short-term liabilities** and **long-term assets with long-term liabilities**.
- ✓ Aims to **reduce risk while maintaining profitability**.
- ✓ Ensures that the company has enough liquidity **without excessive idle funds**.
- ✓ Suitable for companies with **moderate growth and stable business cycles**.

• Example:

Tata Motors follows a **moderate working capital policy** by matching production costs with sales revenue. It ensures liquidity without excessive investment in working capital.

✓ Advantages:

- ✓ Ensures financial stability while optimizing profits.
- ✓ Maintains a balance between risk and return.
- ✓ Provides flexibility in managing market fluctuations.

✗ Disadvantages:

- ✗ Requires careful planning and execution.
- ✗ Might not be as profitable as an aggressive policy.
- ✗ Needs continuous monitoring to maintain the right balance.

3 Choosing the Right Working Capital Policy

A company must **choose a working capital policy** based on its **industry, business cycle, and financial goals**.

Factor	Conservative Policy	Aggressive Policy	Moderate Policy
Liquidity	High	Low	Medium
Risk Level	Low	High	Moderate
Profitability	Low	High	Medium
Suitable for	Stable industries	High-growth companies	Balanced businesses

Examples of Industries Using Different Policies:

- ✓ **Conservative Policy** – Pharmaceutical, FMCG, Utilities.
- ✓ **Aggressive Policy** – Retail, E-commerce, Tech Startups.
- ✓ **Moderate Policy** – Automotive, Consumer Electronics.

✦ Note:

- ✓ **Working capital policies play a crucial role in financial management.**
- ✓ **A conservative approach ensures stability, while an aggressive approach maximizes profits.**
- ✓ **The moderate approach balances risk and profitability** and is widely used in stable industries.
- ✓ **Businesses should choose a policy** based on their risk tolerance, industry trends, and operational needs.

✦ Estimation of Working Capital: Detailed Explanation

◆ Meaning of Working Capital Estimation

Working capital estimation is the process of determining the amount of funds required to meet the **day-to-day operational expenses** of a business. It ensures that a company has **sufficient liquidity** to manage its **short-term obligations** while avoiding excess idle funds.

• Why is Working Capital Estimation Important?

- ✓ Ensures smooth business operations.
 - ✓ Prevents cash shortages or liquidity crises.
 - ✓ Reduces the risk of over-borrowing or underutilization of funds.
 - ✓ Helps in strategic financial planning.
-

1 □ Factors Affecting Working Capital Estimation

Several factors influence the estimation of working capital. Some key factors include:

✓ 1. Nature of Business

- **Manufacturing firms require high working capital** due to large investments in raw materials and production processes.
- **Service-based firms require low working capital** as they have minimal inventory and receive immediate payments.

• Example:

- **Tata Steel** requires high working capital to buy raw materials, pay workers, and manage inventory.
 - **Infosys**, a service-based company, requires lower working capital as it primarily deals with employee salaries and office expenses.
-

✓ 2. Business Operating Cycle

- The **operating cycle** is the time taken to convert raw materials into finished goods, sell them, and collect payments from customers.
- A **longer cycle** increases working capital needs, while a **shorter cycle** reduces them.

◆ Formula for Operating Cycle:

Operating Cycle=Inventory Period+Accounts Receivable Period–Accounts Payable Period
$$\text{Operating Cycle} = \text{Inventory Period} + \text{Accounts Receivable Period} - \text{Accounts Payable Period}$$

• **Example:**

A car manufacturing company has:

- Inventory Period = **60 days**
- Receivables Collection Period = **30 days**
- Payables Payment Period = **20 days**

Operating Cycle=(60+30)–20=70 days
$$\text{Operating Cycle} = (60 + 30) - 20 = 70 \text{ days}$$

Since the company takes **70 days to recover cash**, it needs **sufficient working capital to cover this period**.

✓ 3. Sales Volume

- Higher sales require **more working capital** to fund increased production and inventory.
- Businesses with seasonal demand may need **temporary working capital** during peak seasons.

• **Example:**

- **Amazon** increases working capital during festive seasons to stock up inventory.
 - A **local bakery** with steady sales requires consistent working capital throughout the year.
-

✓ 4. Credit Policy

- If a company offers **credit sales**, it needs more working capital to cover delayed payments.
- A **strict credit policy** reduces working capital needs since payments are received immediately.

• **Example:**

- A **wholesale distributor offering 60-day credit** needs **more working capital**.
 - A **supermarket with only cash transactions** needs **less working capital**.
-

✓ 5. Industry Trends & Economic Conditions

- Economic downturns may increase the need for working capital due to lower sales and slower payments.
- Inflation may require businesses to maintain **higher working capital** to cover increased costs.

• Example:

- During **COVID-19**, many businesses needed additional working capital due to supply chain disruptions and delayed customer payments.

2 Methods of Estimating Working Capital

◆ 1. Percentage of Sales Method

- ✓ Assumes that **working capital is directly related to sales**.
- ✓ Working capital is estimated as a **fixed percentage of projected sales**.

• Example:

A company estimates **₹1 crore in sales** and working capital is typically **25% of sales**.

$$WC = 1,00,00,000 \times 25\% = ₹25,00,000 \quad \text{WC} = 1,00,00,000 \times 25\% = ₹25,00,000$$

- ✓ **Best for:** Stable businesses with predictable sales patterns.

◆ 2. Operating Cycle Method

- ✓ Uses the **time required to complete the operating cycle** to estimate working capital.
- ✓ Helps businesses determine the **amount of capital tied up in daily operations**.

• Example:

A business has:

- Raw Material Holding Period = **30 days**
- Work-in-Progress Period = **10 days**
- Finished Goods Storage Period = **20 days**
- Receivables Collection Period = **25 days**
- Payables Payment Period = **15 days**

$$\text{Operating Cycle} = (30 + 10 + 20 + 25) - 15 = 70 \text{ days} \quad \text{Operating Cycle} = (30 + 10 + 20 + 25) - 15 = 70 \text{ days}$$

✓ **Best for:** Manufacturing and retail businesses.

◆ 3. Cash Forecasting Method

- ✓ Estimates working capital based on **future cash inflows and outflows**.
- ✓ Helps businesses **adjust to seasonal demand and unexpected expenses**.

• **Example:**

A company predicts monthly **cash inflows of ₹5 lakh** and **cash outflows of ₹4.5 lakh**.

$$\begin{aligned} \text{Net Cash Flow} &= \text{Inflows} - \text{Outflows} = 5,00,000 - 4,50,000 = ₹50,000 \\ \text{Net Cash Flow} &= \text{Inflows} - \text{Outflows} = 5,00,000 - 4,50,000 = ₹50,000 \end{aligned}$$

✓ **Best for:** Businesses with fluctuating cash flows, such as tourism and retail.

◆ 4. Regression Analysis Method

- ✓ Uses **statistical techniques** to predict future working capital needs based on past trends.
- ✓ Suitable for large firms with **historical financial data**.

• **Example:**

A company analyses its past **5 years' sales and working capital trends** to forecast future needs.

✓ **Best for:** Large companies with complex financial structures.

3 □ Formula for Working Capital Estimation

$$\begin{aligned} \text{Working Capital} &= \text{Estimated Current Assets} - \text{Estimated Current Liabilities} \\ \text{Working Capital} &= \text{Estimated Current Assets} - \text{Estimated Current Liabilities} \end{aligned}$$

• **Example:**

A company expects the following for the next year:

- **Estimated Current Assets** = ₹12,00,000
- **Estimated Current Liabilities** = ₹7,00,000

$$\begin{aligned} \text{Working Capital} &= 12,00,000 - 7,00,000 = ₹5,00,000 \\ \text{Working Capital} &= 12,00,000 - 7,00,000 = ₹5,00,000 \end{aligned}$$

Since **working capital is positive**, the company has a strong liquidity position.




4 **Practical Example: Tata Motors Working Capital Estimation**

Case Study: Tata Motors

Tata Motors, a leading automobile company, requires a significant amount of working capital due to:

- ✓ High inventory costs (raw materials, spare parts).
- ✓ Credit sales to dealers.
- ✓ Long production cycles.

To estimate its working capital needs, Tata Motors:

- 1  **Analyses past sales trends** and predicts a **20% sales growth** for the next year.
- 2  Uses the **Operating Cycle Method** to determine cash flow requirements.
- 3  Adjusts for **seasonal demand fluctuations** (higher sales during festive seasons).

By using these estimation techniques, **Tata Motors ensures it has sufficient liquidity** while avoiding excess idle funds.

Note:

- ✓ **Accurate estimation of working capital** is essential for financial stability.
 - ✓ **Factors such as business nature, sales volume, and credit policy affect working capital needs.**
 - ✓ **Different estimation methods** are used based on business type and financial trends.
 - ✓ **Companies must regularly review working capital** to ensure smooth operations.
-

Factors Affecting Working Capital: A Detailed Explanation

Introduction

Working capital is the **amount of money required for daily business operations**. It helps companies manage short-term expenses like purchasing raw materials, paying salaries, and covering utility bills. However, the need for working capital is not the same for every company—it depends on several factors.

In this explanation, we will discuss the **main factors affecting working capital**, along with real-life examples.

1 Business Cycle & Economic Conditions

The **economic environment** affects a company's working capital needs. Businesses go through different **phases of the economic cycle**:

✓ Boom Period (Economic Growth)

- When the economy is growing, **demand for products increases**.
- Businesses need **more working capital** to buy raw materials, hire workers, and produce more goods.
- Companies also provide credit to customers, which increases the need for working capital.

• Example:

During **festival seasons**, smartphone companies like **Samsung and Apple** experience higher sales. They increase production and stock more inventory, leading to higher working capital needs.

✓ Recession Period (Economic Downturn)

- Demand for products decreases, and companies **cut down production** to avoid losses.
- Businesses face **delayed payments from customers**, affecting cash flow.
- Companies **reduce inventory and expenses**, lowering working capital needs.

• Example:

During the **COVID-19 pandemic**, airline companies like **IndiGo and SpiceJet** had fewer passengers, so they reduced staff and expenses, lowering their working capital needs.

2 Length of the Production Cycle

The **production cycle** is the time taken to convert raw materials into finished goods. The **longer the production cycle**, the **higher the working capital requirement** because money remains tied up in raw materials and work-in-progress inventory.

✓ Long Production Cycle (High Working Capital Needs)

- Industries with long manufacturing processes need **more working capital** to finance production until goods are sold.

• **Example:**

- **Shipbuilding companies** take **months or years** to manufacture a ship, so they need high working capital.

✓ **Short Production Cycle (Low Working Capital Needs)**

- Businesses with **fast production cycles** sell goods quickly, reducing the amount of capital locked in inventory.

• **Example:**

- **Fast-moving consumer goods (FMCG) companies** like **Nestlé and Unilever** manufacture and sell products quickly, requiring **less working capital**.

3 **Credit Policy & Receivables Management**

A company's **credit policy** affects how much money it has available in cash.

✓ **Loose Credit Policy (More Working Capital Needed)**

- If a company allows **long credit periods** to customers, it will receive payments **slowly**, increasing **accounts receivable**.
- This means the company needs **extra working capital** to continue operations while waiting for payments.

• **Example:**

- **Wholesale distributors** often sell products to retailers on **credit** (30-90 days). This increases their **working capital needs**.

✓ **Strict Credit Policy (Less Working Capital Needed)**

- Companies that **demand immediate payment** or short credit periods receive cash **faster**, reducing their need for working capital.

• **Example:**

- **Supermarkets like D-Mart and Reliance Retail** operate mostly on **cash payments**, so they have **lower working capital requirements**.
-

4 Availability & Cost of Raw Materials

The availability and cost of raw materials impact working capital needs.

✓ Unstable Raw Material Supply (High Working Capital Needed)

- If raw materials are **not easily available** or **prices fluctuate**, companies must **buy and store large quantities**, increasing working capital needs.

• Example:

- **Pharmaceutical companies** like **Sun Pharma** stockpile medicines and ingredients to avoid shortages, leading to higher working capital needs.

✓ Stable Raw Material Supply (Low Working Capital Needed)

- If raw materials are **easily available**, companies can **buy them as needed** instead of maintaining large inventories.

• Example:

- **Textile companies** that get a steady supply of cotton require **less working capital** than those dependent on seasonal raw materials.

5 Seasonality in Demand

Some businesses have **seasonal demand**, meaning they sell more products during certain times of the year. These businesses need **more working capital during peak seasons** and **less in off-seasons**.

✓ High Working Capital during Peak Seasons

- Companies produce and stock **large amounts of inventory** before the high-demand period.
- More funds are needed for **marketing, logistics, and temporary workforce expansion**.

• Example:

- **Ice cream companies** like **Amul and Mother Dairy** need **more working capital in summer** to meet increased demand.

✓ Lower Working Capital during Off-Seasons

- During off-seasons, businesses **reduce production**, leading to **lower working capital needs**.
 - **Example:**
 - **Fireworks manufacturers** require **high working capital before Diwali** but **low working capital in non-festive months**.
-

6 Business Growth & Expansion Plans

Companies that are expanding operations need **more working capital** to finance:

- ✓ New production facilities
- ✓ More raw materials and inventory
- ✓ Higher marketing expenses
- ✓ Additional workforce

- **Example:**
 - **Zomato and Swiggy** expanded across India, requiring **high working capital** to pay delivery partners, onboard restaurants, and advertise their services.
-

7 Inflation & Market Conditions

Inflation affects the cost of raw materials, wages, and other expenses, influencing working capital needs.

✓ High Inflation (More Working Capital Needed)

- Prices of raw materials and wages increase, so businesses need **more funds** to maintain operations.
- **Example:**
 - **Construction companies** like **L&T** require **higher working capital** when cement and steel prices rise due to inflation.

✓ Low Inflation (Less Working Capital Needed)

- If inflation is low, raw material and wage costs remain stable, reducing working capital needs.
-

✦ **Note:**

The amount of **working capital a company requires depends on multiple factors**, including:

- ✓ The **business cycle**, where companies need more WC during booms and less during recessions.
- ✓ The **length of the production cycle**, with longer cycles requiring higher WC.
- ✓ **Credit policies**, where loose credit increases WC needs.
- ✓ **Raw material availability**, where unstable supplies lead to higher WC.
- ✓ **Seasonal variations**, where businesses need more WC during peak demand periods.
- ✓ **Growth and expansion**, which require additional funds for new projects.
- ✓ **Inflation and market conditions**, which affect costs and liquidity.

⚡ **Practical Implications for Businesses**

- ✓ Companies should regularly **analyse these factors** to maintain a **healthy working capital balance**.
- ✓ Efficient **cash flow management** helps businesses avoid liquidity problems.
- ✓ Companies must strike a **balance between liquidity and profitability** by managing working capital effectively.

✦ Sources of Financing Working Capital: A Detailed Explanation

◆ Introduction

Every business requires **working capital** to manage its daily operations, such as purchasing raw materials, paying wages, covering electricity bills, and handling short-term liabilities. However, businesses often **do not have enough cash** readily available and need to **arrange funds from external sources** to finance their working capital needs.

A company can **choose different sources of finance** depending on factors like **cost, risk, repayment terms, and business requirements**. These sources are broadly classified into **short-term and long-term sources** of working capital financing.

1 □ Short-Term Sources of Working Capital Finance

Short-term financing refers to funds borrowed for a **short duration**, usually **less than one year**. These funds are mainly used to cover **temporary or seasonal working capital needs**.

✓ 1. Trade Credit (Supplier Credit)

- **Definition:** Trade credit is the credit extended by suppliers, allowing businesses to purchase goods now and pay later.
- **Advantage:** It is an **interest-free** source of finance and helps businesses maintain cash flow.
- **Limitation:** Suppliers may offer shorter credit periods or charge higher prices.

• Example:

A garment manufacturer buys fabric on a **60-day credit period** from a textile supplier. The manufacturer sells finished clothes and uses the revenue to pay the supplier after 60 days.

✓ 2. Bank Overdraft

- **Definition:** A bank overdraft allows a company to withdraw more money from its bank account than it has, up to a pre-approved limit.
- **Advantage:** Flexible and quick access to funds when needed.
- **Limitation:** Banks charge **high interest rates**, and the overdraft amount must be repaid on time.

• **Example:**

A retail shop owner has ₹1 lakh in their account but needs ₹1.5 lakh to purchase inventory. The bank allows an overdraft of ₹50,000, which the owner repays after selling the goods.

✓ 3. Short-Term Bank Loans

- **Definition:** Businesses can take **short-term loans** from banks to finance their working capital needs. These loans have a fixed repayment period, usually **3 months to 1 year**.
- **Advantage:** Provides **large funds quickly** at competitive interest rates.
- **Limitation:** Requires **collateral** or strong credit history for approval.

• **Example:**

A construction company takes a **6-month bank loan** to purchase raw materials for a new project. After completing the project, they repay the loan.

✓ 4. Commercial Paper (CP)

- **Definition:** Commercial paper is an **unsecured short-term debt instrument** issued by large companies to raise funds from investors.
- **Advantage:** It offers **low-interest rates** compared to bank loans.
- **Limitation:** Only financially strong companies can issue CP, and it is not available to small businesses.

• **Example:**

Reliance Industries issues **commercial paper worth ₹500 crore** to raise short-term working capital from investors.

✓ 5. Factoring (Accounts Receivable Financing)

- **Definition:** In factoring, a business **sells its outstanding invoices (receivables) to a financial institution (factor)** at a discount to get immediate cash.
- **Advantage:** Converts credit sales into **instant cash** to meet working capital needs.
- **Limitation:** Factoring companies charge **high fees** (discount rates).

• **Example:**

A furniture company sells goods to a customer on a **3-month credit**. Instead of waiting, they sell the invoice to a factor at a **5% discount** and get **95% cash immediately**.

✓ 6. Letter of Credit (LC)

- **Definition:** A **letter of credit** is a guarantee from a bank that a seller will receive payment for goods exported, even if the buyer fails to pay.
- **Advantage:** Useful for **international trade** and large transactions.
- **Limitation:** Banks charge a **fee for issuing LCs**.

• **Example:**

An Indian tea exporter uses an **LC from a bank** to ensure they receive payment from a US buyer after shipping goods.

2 Long-Term Sources of Working Capital Finance

Long-term working capital financing is used when a company needs **permanent working capital** to support **steady business growth**. These funds are usually borrowed for **more than one year**.

✓ 1. Equity Financing (Issuing Shares)

- **Definition:** Companies raise long-term working capital by **issuing new shares to investors**.
- **Advantage:** No repayment obligation, reducing financial burden.
- **Limitation:** Dilutes **ownership and control** of existing shareholders.

• **Example:**

Zomato raised **₹9,375 crore** through an **Initial Public Offering (IPO)** to fund its working capital and expansion plans.

✓ 2. Retained Earnings (Internal Financing)

- **Definition:** Instead of distributing **profits as dividends**, a company reinvests them to finance working capital.
- **Advantage:** No debt, no interest cost.
- **Limitation:** Limited availability; not suitable for new or loss-making companies.

• **Example:**

Infosys uses its **retained profits** to fund working capital needs instead of taking loans.

✓ 3. Long-Term Bank Loans

- **Definition:** Banks provide long-term loans for **working capital requirements**, repayable over **several years**.
- **Advantage:** Large funds available with **fixed repayment schedules**.
- **Limitation:** Requires **collateral** and regular **interest payments**.

• **Example:**

A steel company takes a **5-year loan** of ₹50 crore to finance its working capital and production expansion.

✓ 4. Debentures (Corporate Bonds)

- **Definition:** Companies issue **debentures (corporate bonds)** to investors and pay **interest** over a long period.
- **Advantage:** Fixed interest rates, long repayment period.
- **Limitation:** Interest payments are **mandatory**, even in financial downturns.

• **Example:**

Tata Motors issued **debentures worth ₹1,000 crore** to finance its working capital needs.

✓ 5. Venture Capital & Private Equity

- **Definition:** Startups and fast-growing businesses raise working capital from **venture capitalists and private equity investors** in exchange for ownership shares.
- **Advantage:** Helps businesses expand without taking loans.
- **Limitation:** Investors demand **high returns** and decision-making power.

• **Example:**

Ola Cabs raised **\$500 million from SoftBank** for working capital and expansion.

✦ Note:

Working capital financing is essential for **business survival and growth**. Companies choose different sources based on their **financial needs, business size, and risk capacity**.

⚡ **Short-term financing options like trade credit, overdrafts, short-term loans, and factoring help companies manage temporary cash shortages.**

◆ **Long-term financing options like equity financing, retained earnings, debentures, and bank loans provide permanent working capital for stable operations.**

Businesses must carefully analyse **costs, risks, and repayment terms** before choosing a financing source. **A well-planned working capital strategy ensures smooth business operations and long-term financial stability.**

✦ **Management of Cash: A Detailed Explanation**

◆ **Introduction**

Cash is the **lifblood of a business** and plays a crucial role in maintaining the **liquidity, profitability, and financial stability** of an organization. Proper **cash management** ensures that a company has **sufficient cash** to meet its short-term expenses while avoiding excess idle cash that could have been invested for higher returns.

Effective cash management helps in:

- ✓ **Ensuring liquidity** to meet daily operational needs.
 - ✓ **Optimizing cash flow** by balancing inflows and outflows.
 - ✓ **Minimizing borrowing costs** by reducing dependence on external funds.
 - ✓ **Maximizing returns** by investing surplus cash wisely.
-

◆ **Objectives of Cash Management**

- 1 **Maintaining Liquidity:** Ensure that the company has enough cash to meet obligations like salary payments, rent, and utility bills.
 - 2 **Minimizing Idle Cash:** Avoid excessive cash holdings, as idle cash does not generate returns.
 - 3 **Managing Cash Shortages:** Prevent situations where the company runs out of cash to pay suppliers or creditors.
 - 4 **Optimizing Investment of Surplus Cash:** Utilize extra cash in short-term investments to earn interest or returns.
 - 5 **Reducing Borrowing Costs:** Maintain an efficient cash flow to minimize the need for short-term loans or overdrafts.
-

◆ Components of Cash Management

Cash management consists of **four key components**:

✓ 1. Cash Budgeting

A **cash budget** is a **forecast of cash inflows and outflows** over a specific period. It helps businesses plan their cash needs and avoid shortages.

• **Example:**

A company expects cash inflows of **₹10 lakh** from sales and outflows of **₹7 lakh** for salaries, rent, and raw materials. The cash budget shows a **net cash surplus of ₹3 lakh**, which can be invested in short-term securities.

✓ 2. Managing Collections (Receivables Management)

Efficient **receivables management** ensures that customers pay on time, reducing delays in cash inflows. Businesses can:

- ✓ Offer **cash discounts** for early payments.
- ✓ Implement **strict credit policies** to avoid bad debts.
- ✓ Use **factoring** to get immediate cash from outstanding invoices.

• **Example:**

A company offers a **2% discount** on invoices if customers pay within **10 days instead of 30 days**, improving cash inflows.

✓ 3. Managing Disbursements (Payables Management)

Companies must optimize their **payment schedules** to retain cash longer without damaging relationships with suppliers. Strategies include:

- ✓ Negotiating **longer credit periods** with suppliers.
- ✓ Timing payments **just before the due date** to maximize cash availability.
- ✓ Using **electronic payments** to avoid processing delays.

• **Example:**

A retailer buys goods with a **60-day credit period** and ensures payments are made **on the 59th day**, keeping cash available for a longer time.

✓ 4. Investing Surplus Cash

Excess cash should be invested in **low-risk, high-liquidity instruments** like:

- ✓ Treasury bills (T-Bills)
- ✓ Fixed deposits (FDs)
- ✓ Money market funds
- ✓ Short-term mutual funds

• Example:

A company expects **₹5 lakh** of surplus cash for **3 months**. Instead of keeping it idle, it invests in **T-Bills** earning a **5% annual return**, generating extra income.

✦ Cash Budget: A Detailed Explanation

◆ Introduction

A **cash budget** is a financial tool that helps businesses plan and control their **cash inflows and outflows** over a specific period. It ensures that a company has enough cash to meet its obligations while avoiding idle cash that could have been invested for better returns.

A well-prepared cash budget helps businesses:

- ✓ **Avoid liquidity crises** by ensuring cash availability.
- ✓ **Prevent excess cash accumulation**, which could be invested for higher returns.
- ✓ **Plan for short-term financing needs**, reducing the risk of cash shortages.
- ✓ **Ensure smooth business operations** without unexpected cash flow issues.

◆ Objectives of a Cash Budget

- 1 **Ensure Liquidity** → Ensures the company has sufficient cash to cover expenses like salaries, rent, and raw materials.
 - 2 **Avoid Idle Cash** → Prevents excess cash from sitting unused instead of earning returns.
 - 3 **Identify Cash Shortages** → Helps plan for loans or credit facilities in advance.
 - 4 **Optimize Cash Management** → Balances cash inflows and outflows effectively.
 - 5 **Facilitate Investment Decisions** → Helps decide when and how much surplus cash to invest in short-term assets.
-

◆ Components of a Cash Budget

✓ 1. Cash Inflows (Receipts)

Cash inflows refer to the money a company receives from various sources, such as:

- ✓ Cash sales
- ✓ Collection from debtors (Accounts Receivable)
- ✓ Loans received
- ✓ Interest and dividend income
- ✓ Sale of assets

• **Example:**

A retail store estimates ₹8 lakh in cash sales and ₹2 lakh from customer credit payments. The total **cash inflow = ₹10 lakh.**

✓ 2. Cash Outflows (Payments)

Cash outflows refer to the money spent by the company, including:

- ✓ Payment to suppliers (Accounts Payable)
- ✓ Salaries and wages
- ✓ Rent and utilities
- ✓ Loan repayments and interest payments
- ✓ Purchases of fixed assets

• **Example:**

A company has monthly expenses of ₹3 lakh for raw materials, ₹2 lakh for salaries, and ₹1 lakh for rent and utilities. The total **cash outflow = ₹6 lakh.**

✓ 3. Opening and Closing Cash Balance

✓ **Opening Cash Balance:** The cash available at the beginning of the budget period.

✓ **Closing Cash Balance:** The expected cash balance at the end of the period, calculated as:

Closing Cash Balance = Opening Cash Balance + Total Cash Inflows – Total Cash Outflows

$$\text{Closing Cash Balance} = \text{Opening Cash Balance} + \text{Total Cash Inflows} - \text{Total Cash Outflows}$$

• **Example:**

- Opening Cash Balance = ₹5 lakh
- Total Cash Inflows = ₹10 lakh
- Total Cash Outflows = ₹6 lakh

Closing Cash Balance = $5,00,000 + 10,00,000 - 6,00,000 = ₹9,00,000$ \text{ { Closing Cash Balance } = 5,00,000 + 10,00,000 - 6,00,000 = ₹9,00,000

The company will have **₹9 lakh in cash** at the end of the period.

◆ Importance of Cash Budget

- ✓ Prevents cash shortages and ensures timely payments.
 - ✓ Optimizes working capital and reduces the need for short-term borrowing.
 - ✓ Improves investment decisions by identifying surplus cash.
 - ✓ Helps in risk management by forecasting future cash positions.
-

◆ Challenges in Preparing a Cash Budget

- ✓ Uncertain cash inflows due to delayed customer payments.
 - ✓ Unexpected expenses like sudden repairs or legal fees.
 - ✓ Changes in economic conditions affecting sales and expenses.
 - ✓ Fluctuations in credit terms from suppliers or banks.
-

◆ Note:

A **cash budget is an essential financial tool** for businesses to manage liquidity, avoid cash shortages, and optimize surplus cash. By estimating **cash inflows and outflows**, companies can ensure smooth operations, reduce financial risk, and enhance profitability.

Key Takeaways:

- ✓ Prepare a **realistic cash budget** considering all possible inflows and outflows.
 - ✓ **Regularly update** the budget to adapt to changing financial conditions.
 - ✓ Use **excess cash** for short-term investments instead of keeping idle cash.
 - ✓ Ensure **strict receivables management** to avoid cash shortages.
-

✦ Management of Collections and Disbursements: A Detailed Explanation

◆ Introduction

Effective **management of collections and disbursements** is crucial for maintaining liquidity and optimizing working capital. Businesses must ensure that cash inflows (collections) are received quickly while delaying cash outflows (disbursements) strategically to maintain a healthy cash flow.

- ✓ **Collections:** Managing receivables efficiently to reduce delays in customer payments.
- ✓ **Disbursements:** Managing payables effectively to optimize cash outflows without harming supplier relationships.

Companies like **Amazon and Flipkart** use advanced collection and disbursement strategies to maintain a strong cash flow position.

◆ Objectives of Collections and Disbursements Management

- ✓ **Ensure Liquidity:** Ensure sufficient cash is available to meet business needs.
 - ✓ **Minimize Cash Holding Costs:** Avoid holding excess idle cash that could be invested elsewhere.
 - ✓ **Optimize Working Capital:** Balance between quick collections and delayed disbursements.
 - ✓ **Reduce Default Risk:** Minimize the risk of bad debts by improving collection efficiency.
 - ✓ **Enhance Profitability:** Efficient cash flow management leads to better profitability.
-

◆ Management of Collections (Speeding Up Inflows)

The goal of **collections management** is to ensure that receivables (payments due from customers) are collected as quickly as possible. Businesses can use various strategies to accelerate collections.

✓ 1. Offering Cash Discounts for Early Payments

- ✓ Encourages customers to pay earlier by offering discounts.
- ✓ Example: "2/10, net 30" → 2% discount if paid within 10 days, full payment due in 30 days.

- **Example:**

A supplier offers a 2% discount for payments made within 10 days instead of the standard 30 days. This speeds up collections and improves cash flow.

✓ 2. Implementing Efficient Invoicing Systems

- ✓ Sending invoices immediately after product delivery or service completion.
- ✓ Using **electronic invoicing (e-invoicing)** to speed up the process.
- ✓ Automating reminders for pending payments.

- **Example:**

SaaS companies like **Microsoft and Adobe** use automated invoicing and payment reminders to ensure timely collections.

✓ 3. Using Electronic Payment Methods

- ✓ Accepting **credit card payments, UPI, digital wallets, and bank transfers** speeds up collections.
- ✓ Reduces dependency on cash and cheque payments, which take longer to process.

- **Example:**

E-commerce companies like **Amazon and Flipkart** prefer **prepaid payments** to reduce collection delays.

✓ 4. Credit Policy Optimization

- ✓ Conducting **creditworthiness checks** before offering credit to customers.
- ✓ Setting **strict credit limits** for high-risk customers.
- ✓ Using **factoring or invoice discounting** to get early cash.

- **Example:**

Manufacturing firms **sell invoices to banks (factoring)** to get early payments instead of waiting for customers to pay.

◆ Management of Disbursements (Delaying Outflows)

While businesses want to **collect cash quickly**, they should also **delay payments to suppliers** as long as possible without damaging relationships.

✓ 1. Negotiating Longer Payment Terms

✓ Extending payment terms (e.g., from **30 days to 60 days**) allows companies to use cash for longer periods.

✓ Helps improve cash flow without taking additional loans.

• **Example:**

Retail chains like **Walmart and Big Bazaar** negotiate **longer credit periods** with suppliers while selling products on **cash or short credit terms** to customers.

✓ 2. Using Just-in-Time (JIT) Inventory Management

✓ Ordering raw materials **only when needed** reduces immediate cash outflows.

✓ Prevents tying up too much cash in inventory.

• **Example:**

Toyota follows the **JIT system**, where parts are ordered just before production to avoid excess working capital requirements.

✓ 3. Scheduling Payments Efficiently

✓ Prioritizing payments based on due dates.

✓ Making **bulk payments** at the end of a credit period instead of paying multiple small amounts.

• **Example:**

A company schedules **supplier payments every 30 days** instead of making daily payments, ensuring better cash flow management.

✓ 4. Using Electronic Payment Systems

✓ Using **automated bank transfers, NEFT, RTGS, and digital wallets** to avoid late payment penalties.

✓ Helps control **exact timing of disbursements**, ensuring cash availability.

• **Example:**

Corporations use online banking portals to schedule supplier payments just before the due date, keeping cash in hand for as long as possible.

◆ **Balancing Collections and Disbursements**

A well-managed business balances both **fast collections** and **delayed disbursements** to optimize cash flow.

Strategy	Effect on Cash Flow	Example
Early Collections	Increases cash inflows	Amazon collecting payments before dispatching goods
Delayed Payments	Reduces cash outflows	Walmart negotiating 60-day credit terms with suppliers
Credit Policy	Reduces default risk	Banks checking customer credit scores before lending
Electronic Payments	Faster transactions	Companies using UPI, NEFT for supplier payments

◆ **Importance of Efficient Cash Flow Management**

- ✓ **Avoids liquidity problems** that could lead to operational issues.
 - ✓ **Reduces the need for short-term loans**, saving interest costs.
 - ✓ **Enhances profitability** by making the best use of available cash.
 - ✓ **Builds better supplier relationships** by ensuring timely payments.
-

◆ **Note:**

Managing collections and disbursements effectively is crucial for any business. Companies must **accelerate collections from customers** while **delaying payments to suppliers** strategically. A well-planned **cash flow strategy** ensures financial stability, reduces reliance on external borrowing, and improves overall profitability.

Key Takeaways:

- ✓ **Encourage early payments** by offering discounts and using digital payment methods.
- ✓ **Negotiate longer credit terms** with suppliers to optimize cash outflows.
- ✓ **Use electronic invoicing and reminders** to speed up collections.
- ✓ **Ensure efficient scheduling of payments** to maintain cash reserves.

✦ Investment of Surplus Cash: A Detailed Explanation

◆ Introduction

Companies often generate **surplus cash** due to efficient operations, high profitability, or controlled expenses. However, keeping this excess cash idle **reduces financial efficiency** and leads to opportunity costs. To ensure optimal cash utilization, businesses must **invest surplus funds** wisely in short-term or long-term opportunities.

- ✓ **Short-Term Investments** → Low-risk, liquid investments to earn quick returns.
- ✓ **Reinvestment in Business** → Using cash for expansion, R&D, or asset acquisition.

• Example:

Companies like **TCS and Infosys** invest surplus cash in **fixed deposits and money market instruments** to earn interest income while maintaining liquidity.

◆ Importance of Investing Surplus Cash

- ✓ **Maximizing Returns:** Idle cash does not generate income, but investing it can yield returns.
 - ✓ **Ensuring Liquidity:** Investments should allow easy withdrawal if cash is needed.
 - ✓ **Minimizing Risk:** Choosing safe investment options to protect capital.
 - ✓ **Supporting Business Growth:** Reinvesting surplus cash can lead to long-term business expansion.
-

◆ Methods of Investing Surplus Cash

1. Short-Term Investments

These investments offer **low risk, high liquidity, and stable returns**. They are ideal for companies that need quick access to funds.

✓ Fixed Deposits (FDs)

- ✓ Bank deposits with fixed interest rates for a specified period.
- ✓ Low risk and stable returns.

- **Example:**

TCS parks surplus cash in FDs to **earn stable interest while ensuring liquidity**.

✓ Treasury Bills (T-Bills)

✓ Issued by the government with **high security and short maturity periods (91 days, 182 days, or 364 days)**.

✓ Zero risk of default.

- **Example:**

Banks and corporate houses invest in T-Bills as a **safe short-term investment**.

✓ Commercial Papers (CPs)

✓ **Unsecured short-term debt instruments** issued by corporations to raise funds.

✓ Higher returns than FDs and T-Bills but with slightly higher risk.

- **Example:**

Large corporations like Reliance and Tata Sons issue CPs to meet **short-term funding needs**.

✓ Money Market Mutual Funds (MMMFs)

✓ Funds that invest in highly liquid, short-term instruments like **T-Bills, CPs, and call money**.

✓ Provide diversification and professional management.

- **Example:**

Companies with **large cash reserves** invest in MMMFs for **better liquidity and returns**.

✓ Repurchase Agreements (Repo Market)

✓ Companies **lend surplus cash to banks or financial institutions** for a short duration in exchange for securities.

✓ Very secure and provides a guaranteed return.

- **Example:**

Banks and **large corporations like HDFC and SBI participate in repo markets** to earn short-term interest.

2 **Reinvestment in Business**

Companies can use surplus cash for **growth and expansion** instead of short-term investments.

✓ **Business Expansion**

- ✓ Opening **new branches, manufacturing plants, or retail outlets.**
- ✓ Expanding product lines or entering new markets.

- **Example:**

Amazon reinvests surplus cash in expanding warehouses and logistics networks.

✓ **Research & Development (R&D)**

- ✓ Investing in **technology, innovation, and new product development.**
- ✓ Helps in gaining a competitive advantage.

- **Example:**

Pharmaceutical companies like Pfizer and Biocon reinvest in R&D for new drug formulations.

✓ **Acquiring Assets**

- ✓ Purchasing **machinery, real estate, or software** to improve operational efficiency.
- ✓ Enhances long-term profitability.

- **Example:**

Tesla uses surplus cash to acquire advanced battery technology for electric vehicles.

✓ **Mergers & Acquisitions (M&A)**

- ✓ Buying **competitor firms or startups** to gain market share.
 - ✓ Helps in business diversification.
-

• **Example:**

Facebook (now Meta) acquired WhatsApp and Instagram using surplus cash reserves.

◆ **Balancing Risk and Return**

A company must **balance its investments** to ensure both **safety and profitability**.

Investment Type	Risk Level	Liquidity	Return Potential	Example
Fixed Deposits (FDs)	Low	High	Moderate	TCS FDs
Treasury Bills (T-Bills)	Very Low	High	Low	Government Bonds
Commercial Papers (CPs)	Medium	Medium	High	Reliance CPs
Money Market Funds	Low	High	Moderate	Mutual Funds
Business Expansion	Medium	Low	High	Amazon Warehouses
R&D Investment	High	Low	Very High	Tesla Battery Tech
Mergers & Acquisitions	High	Low	Very High	Facebook-Instagram

◆ **Note**

Investing surplus cash wisely is essential for businesses to maximize profits while ensuring financial stability. **Short-term investments** provide liquidity and security, while **reinvestment in business** supports growth and innovation.

✓ **Companies like TCS, Amazon, and Tesla strategically invest their surplus cash** in a mix of short-term securities and business expansion for long-term success.

✦ Management of Receivables: A Detailed Explanation

◆ Introduction

Receivables management is an essential part of working capital management. It involves **monitoring and controlling the credit extended to customers** to ensure timely collections and minimize bad debts. A company must balance **increasing sales by offering credit** and **avoiding financial losses due to unpaid invoices**.

- ✓ If the company is **too strict** in granting credit, it may lose potential customers.
- ✓ If the company is **too lenient**, it may face cash flow problems due to delayed payments.

• Example:

A company selling machinery may offer a **30-day credit period** to attract buyers but also provide a **5% discount for payments within 7 days** to encourage early payments.

◆ Objectives of Receivables Management

- 1 **Increase Sales & Profits** – Offering credit helps attract more customers.
- 2 **Ensure Timely Collections** – Reducing the risk of delayed payments and bad debts. 3
- 3 **Maintain Liquidity** – Ensuring enough cash flow for day-to-day operations.
- 4 **Reduce Credit Risk** – Identifying reliable customers to avoid financial losses.

• Example:

Retail companies like **Amazon and Flipkart** offer **EMI options** to increase sales, but they carefully select customers with good credit history.

✦ 1 Terms of Credit

A company decides its credit terms based on **industry standards, competition, and financial position**.

✓ Credit Period

- ✓ The number of days a customer gets to make the payment.
 - ✓ Usually **30, 45, or 60 days**, depending on the industry.
 - ✓ Longer credit periods **increase sales but delay cash flow**.
-

- **Example:**

A textile company may offer a **60-day credit period** to wholesalers to encourage bulk purchases.

- ✓ **Cash Discounts**

- ✓ Incentives for customers to **pay early**.

- ✓ Commonly written as "**2/10, Net 30**", meaning a **2% discount if paid within 10 days, otherwise full payment due in 30 days**.

- **Example:**

A furniture manufacturer offers a **3% discount if the invoice is cleared within 15 days** instead of 45 days.

- ✓ **Credit Limits**

- ✓ The **maximum credit amount** a company offers to a customer.

- ✓ Based on the **customer's past payment history and financial health**.

- **Example:**

Banks **set credit limits for credit card holders** based on their income and repayment history.

✦ 2 **Credit Policy Decision**

A company chooses between a **liberal or strict credit policy** based on its business strategy and risk appetite.

- ✓ **Liberal Credit Policy**

- ✓ Offers **longer credit periods, lower credit requirements, and easy approvals**.

- ✓ Increases sales but also **raises the risk of bad debts**.

- ✓ Suitable for businesses that **want to attract more customers**.

- **Example:**

Electronics stores like **Croma and Reliance Digital** offer **installments and EMI options** to increase sales, even though there is a risk of payment defaults.

✓ **Strict Credit Policy**

- ✓ Offers **shorter credit periods, strict payment terms, and detailed credit checks.**
- ✓ Reduces the risk of bad debts but may **limit sales growth.**
- ✓ Suitable for companies that **prioritize cash flow stability over aggressive sales expansion.**

- **Example:**

Luxury brands like **Rolex and Louis Vuitton** follow a **strict policy** and usually sell on **cash or limited credit.**

✦ 3 **Factors Affecting Credit Policy**

Companies must consider several factors while deciding their credit policy:

- ✓ **Industry Norms:** Some industries require longer credit periods (e.g., construction), while others operate on cash sales (e.g., retail).
- ✓ **Customer Financial Position:** Credit checks help avoid risky customers.
- ✓ **Company's Cash Flow:** A business with weak cash flow cannot afford to offer long credit periods.
- ✓ **Competition:** If competitors offer longer credit periods, the company may need to do the same to remain competitive.
- ✓ **Economic Conditions:** In a recession, companies may tighten credit policies to avoid defaults.

- **Example:**

During the **COVID-19 pandemic**, many businesses **shortened credit periods** due to financial uncertainty.

✦ 4 **Techniques for Efficient Receivables Management**

✓ **Credit Analysis**

- ✓ Evaluating the **customer's financial position and payment history** before granting credit.
- ✓ Use of **credit ratings and financial statements** to assess risk.

- **Example:**

Banks check **CIBIL scores** before approving personal loans.

✓ Collection Policy

- ✓ Strategies to ensure **timely payments** from customers.
- ✓ Sending **reminders, charging penalties, and legal action for defaulters.**

- **Example:**

Telecom companies **suspend services** if bills are unpaid for a long time.

✓ Factoring & Invoice Discounting

- ✓ Selling receivables to a **third-party financial institution** (factoring company) to get immediate cash.
- ✓ Reduces collection risk and improves liquidity.

- **Example:**

DHL and FedEx sell their unpaid invoices to banks to get cash immediately instead of waiting for customer payments.

➤ 5 Balancing Credit Risk & Profitability

A company must **find the right balance** between increasing sales and managing credit risk.

Credit Policy	Advantages	Disadvantages	Example
Liberal Credit Policy	Higher sales, customer satisfaction	Higher risk of bad debts, delayed payments	Amazon offers EMI & pay-later options
Strict Credit Policy	Low bad debts, stable cash flow	Fewer customers, lower sales	Rolex sells on cash & short credit only

◆ **Note:**

Managing receivables effectively is **crucial for maintaining a healthy cash flow** and minimizing financial risk. Companies must decide their **credit policies, payment terms, and collection strategies** based on their business needs and market conditions.

- ✓ **Liberal policies** help in sales growth but increase risks.
- ✓ **Strict policies** ensure liquidity but may limit customer base.
- ✓ The right balance ensures **business growth with financial stability.**

✦ Management of Inventory: A Detailed Explanation

◆ Introduction

Inventory management is a critical part of a company's **working capital management**. It involves **planning, controlling, and monitoring** the company's stock levels to ensure smooth operations while minimizing costs. Effective inventory management helps businesses avoid **shortages** that can disrupt production and **excess stock** that leads to high storage costs.

• Example:

A manufacturing company needs **raw materials, work-in-progress, and finished goods inventory** to continue production without delays. Poor inventory management can lead to **production halts, increased costs, and lost sales**.

✦ Objectives of Inventory Management

- 1 **Ensuring Uninterrupted Production** – Sufficient raw materials prevent delays in production.
- 2 **Minimizing Storage Costs** – Avoids excess inventory that increases warehousing expenses.
- 3 **Avoiding Stockouts** – Ensures that customer demand is met without delays.
- 4 **Reducing Wastage & Obsolescence** – Proper inventory rotation prevents outdated or spoiled stock.
- 5 **Optimizing Cash Flow** – Less capital is tied up in inventory, improving liquidity.

• Example:

A **retail store like Big Bazaar** needs to stock the right amount of fast-moving goods (e.g., food, toiletries) while minimizing slow-moving stock.

✦ Techniques of Inventory Planning and Control

To maintain optimal inventory levels, businesses use various inventory control techniques.

1 Economic Order Quantity (EOQ)

✓ EOQ determines the **ideal order quantity** that minimizes total inventory costs, including **ordering costs** (cost of placing an order) and **holding costs** (storage expenses).

✓ It helps in **placing orders at the right time and in the right quantity** to reduce unnecessary costs.

★ Formula:

$$EOQ = \sqrt{\frac{2DS}{H}}$$

Where:

- **D** = Demand (units per year)
- **S** = Ordering Cost per Order
- **H** = Holding Cost per Unit

• Example:

A company selling **10,000 mobile phones per year** has:

- **Ordering cost per order = ₹500**
- **Holding cost per unit = ₹50**

$$EOQ = \sqrt{\frac{2 \times 10,000 \times 500}{50}} = 447 \text{ units}$$

This means the company should order **447 phones at a time** to minimize total costs.

2 ☐ Just-in-Time (JIT) Inventory

- ✓ JIT is a strategy where inventory is **ordered only when needed**, reducing storage costs.
- ✓ Helps minimize waste and keeps **inventory investment low**.
- ✓ Requires **strong supplier coordination** to ensure materials arrive on time.

• Example:

Toyota uses JIT by receiving car parts **only when needed** for production, reducing storage costs.

- ✓ **Advantages:** Lower inventory costs, reduced waste, improved efficiency.
 - ✗ **Disadvantages:** High dependence on suppliers, risk of production stoppage if supplies delay.
-

3 ☐ ABC Analysis

- ✓ A technique for **categorizing inventory based on its value and importance**.
 - ✓ Helps companies focus on managing **high-value items more closely** while reducing efforts on low-value items.
-

Category	Description	Control Required	Example
A Items	High value, low quantity	Very high control	Gold in a jewelry store
B Items	Medium value, medium quantity	Moderate control	Laptop batteries in an electronics store
C Items	Low value, high quantity	Minimal control	Stationery in an office

• **Example:**

A **jewelry store** closely monitors **diamonds (A category)** but keeps **bulk silver (C category)** with minimal control.

4 **FIFO & LIFO Methods**

✓ FIFO (First-In-First-Out) → **Oldest stock is used first**

✓ LIFO (Last-In-First-Out) → **Newest stock is used first**

✓ **FIFO is used when inventory needs to be fresh.**

• **Example:**

Food industries (like supermarkets) follow FIFO to ensure older stock is sold first, avoiding expired products.

✓ **LIFO is used when prices are rising.**

• **Example:**

If a **construction company** follows LIFO, it will use the most recently purchased (higher cost) materials first, **reducing taxable profits**.

✦ **Factors Affecting Inventory Management**

1 **Demand Fluctuations** – Seasonal demand affects stock levels.

• **Example:** Ice cream companies stock **more inventory in summer** than in winter.

2 **Supplier Reliability** – Unreliable suppliers force companies to hold more stock.

• **Example:** A car manufacturer **keeps extra tires** if its supplier has frequent delivery issues.

3 **Storage Costs** – Higher warehouse rent increases costs.

• **Example:** Warehouses in **Mumbai are expensive**, so businesses keep minimal stock.

4 **Production Lead Time** – Longer production times require higher stock.

• **Example:** A **furniture manufacturer** holds extra wood if production takes **4-6 weeks**.

✦ **Balancing Inventory Costs & Availability**

A company must **find the right balance** between:

Inventory Strategy	Advantages	Disadvantages	Best for
High Inventory	No shortages, meets demand easily	High storage costs, risk of obsolescence	Seasonal businesses, industries with unpredictable demand
Low Inventory (JIT)	Lower costs, less wastage	Risk of stockouts, supplier dependency	Fast-moving industries like retail, automobile

◆ **Note:**

Effective inventory management **ensures a company operates smoothly** without excessive costs. Different industries use **EOQ, JIT, ABC analysis, and FIFO/LIFO** to optimize inventory levels.

- ✓ **A balance between cost control and availability** is key to success.
- ✓ **Technology like ERP systems** helps automate inventory tracking.
- ✓ **Companies must adjust strategies** based on demand, supplier reliability, and financial constraints.

• **Example:**

Companies like **Amazon** use **advanced inventory systems** to maintain **low storage costs** while ensuring quick delivery.

✦ **Conclusion**

Effective **current assets management** ensures that a business has the **right amount of cash, receivables, and inventory** to operate efficiently.

- ✓ **Cash management** prevents shortages and idle cash.
- ✓ **Receivables management** speeds up collections and reduces bad debts.
- ✓ **Inventory management** balances supply and demand, reducing holding costs.
- ✓ **Working capital policies** determine a firm's financial stability.

• **Key Takeaway:** A well-managed working capital strategy **enhances profitability, reduces financial risk, and ensures business sustainability.** ✓📊

Thank you