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CA Prashant Sardar

FMM & SSM

Chart  
Book

CA CS Amit Tated



# PREFACE

*To all readers,*

*We are proud to present this book along with Team Expert & Vsmart. We have spent time writing this with a student perspective in mind. Each chapter has broken down core concepts and expanded on them with diagrams and tables, as and when possible. It is our goal to help each and every holder of this book to be able to fight against the odds and win. Victory presents itself with the backing of knowledge, practice and expertise.*

*This book provides a valuable window on the subjects and covers the necessary components chapter by chapter. The challenges in these subjects are both difficult and interesting.*

*People are working on them with enthusiasm, tenacity, and dedication to develop new methods of analysis and provide new solutions to keep up with the ever-changing threats. In this new age of global inter connectivity and interdependence, it is necessary to stay relevant, for both professionals and students.*

*This book is a good step in that direction and would not have been possible without our team, our colleagues, our students and everyone that has supported us in our journey as a CA professional. For any feedback or questions based on the material covered within the book, please feel free to contact us via email.*

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## About the CA Prashant Sarada :

- ✍️ **FIRST** in Nanded district and 10<sup>th</sup> in LATUR Board in XII commerce
- ✍️ **AIR 11** at CA Foundation level
- ✍️ **“The Best Paper Award”** for Economics at CA Foundation level
- ✍️ Recipient of 'Dhirubhai Ambani Scholarship “for 3 years
- ✍️ **15+** years of teaching experience

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## About the CA CS Amit Tated :

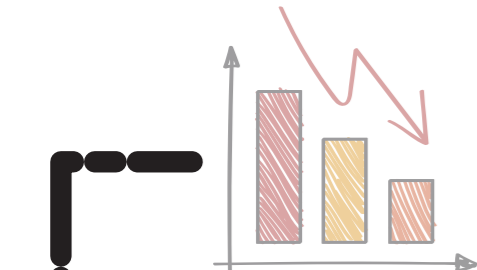
- ✍️ Cleared CA, CS, CISA, DISA, CISM, BCCP Exams
- ✍️ Believes in conceptual teaching & giving in depth knowledge of the subject to students.
- ✍️ A renowned teacher of theory subjects like Audit, Law, EIS, SM, IT, ISCA in INDIA for last 13 years with 200+ face-to-face batches teaching more than 65,000 students at various places in India & 35,000+ students in virtual centers across India.
- ✍️ Many of his students are Rankers & Highest Mark Scorers. (Including AIR 1 Multiple times)
- ✍️ Worked with PWC Audit Dept. for 1 year.
- ✍️ Held Strategic Position in IT Governance of HDFC Bank for 2 years.
- ✍️ Founder of A. T. Academy

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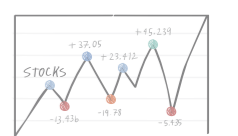
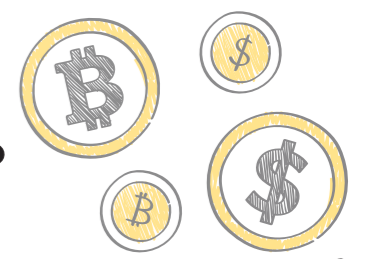
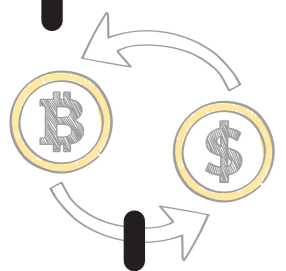
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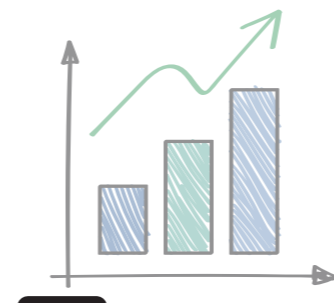
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Savings



Financial Plan



DEBT





# F M

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# CHAPTER 1- BASICS OF FINANCIAL MANAGEMENT



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## TWO MAIN ASPECTS OF FINANCIAL MANAGEMENT

### Procurement of Funds

Various sources are available like equity shares, preference shares, Debentures, Term loan, etc.

Overall cost of funds should be minimum and risk and control should be balanced.

#### Consideration for procurement of funds

#### Risk

Equity risk is lowest.

Debt risk is highest.

#### Cost

Equity cost is highest.

Debt cost is lowest.

#### Control

Equity control is diluted.

Debt control is not diluted.

### Effective Utilization of Funds

Utilizations are of two types :  
a) for day to day activities i.e., working capital  
b) for long term purpose i.e., fixed assets.

Utilizations of funds to be effective should give maximum returns and funds should not remain idle.

Funds should be invested properly & profitably in the business.

### SCOPE OF FINANCIAL MANAGEMENT

Maximization of share value

Financial decision or Finance Function

Financing decisions

Investment decisions

Dividend decisions

Return

Trade off (Balance)

Risk

### OBJECTIVES OF FINANCIAL MANAGEMENT

Long term objective

Wealth Maximization

$$V = V_e + V_d$$
$$V = f(F, D, I)$$

Short term objective

Profit Maximization

Maximizing profits of firm

Where,  
V=Value of firm,  
V<sub>e</sub>=Value of equity,  
V<sub>d</sub>=Value of Debt,  
f=function of,  
F=Financing decision,  
D=Dividend Decision &  
I=Investment Decision



## Profit Maximisation

It does not consider the effect of future cash flows, dividend decisions, EPS etc.

A firm with profit maximisation objective may refrain from payment of dividend to its Shareholders.

It ignores time pattern of returns.

Focus on short time.

It does not consider the effect of uncertainty / risk.

It is comparatively easy to determine the relationship between financial decision and profits.

Leads to too immature decisions e.g. (a) avoiding investments which result in immediate cash losses, but substantial revenues in the long-run, (b) postponing replacement expenditure to ensure short-term profits etc.

Focus on Entity's short term gains and Profits.

## Wealth Maximisation

It recognises effects of all future cash flow, dividends, EPS etc.

A firm with wealth maximisation objective may pay regular dividends to its Shareholders.

It recognises time pattern of return.

Focus on Medium / Long-Term.

It recognises the risk-return Relationship.

It offers no clear or specific relationship between financial decision and share market price.

Leads to systematic decisions using the tools and techniques of capital budgeting, Risk-Return Trade-off, Leverage Effect etc.

Focus on long-term wealth of entity, shareholders and Society as a whole.



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## AGENCY PROBLEM & AGENCY COST

Incorporates structure, owners are not active in management so, there is a separation between owner/ shareholders and managers. In theory managers should act in the best interest of shareholders, however in reality, managers may not try to maximise their individual goal like salary, perks etc. So there is a principal agent relationship between managers and owners, which is known as Agency Problem. In other words, Agency Problem is the chances that managers may place personal goals ahead of the goal of owners. Agency Problem leads to Agency Cost.

Agency cost is the additional cost borne by the shareholders to monitor the manager and control their behaviour so as to maximise shareholders wealth.

Generally, Agency Costs are of four types

i. Monitoring

ii. Bonding

iii. Opportunity

iv. Structuring

### Solution to the agency problem:

The agency problem arises if manager's interests are not aligned to the interests of the debt lender and equity investors. The agency problem of debt lender would be addressed by imposing negative covenants i.e. the managers cannot borrow beyond a point. This is one of the most important concepts of modern day finance and the application of this would be applied in the Credit Risk Management of Bank, Fund Raising, Valuing distressed companies.

Agency problem between the manager and shareholders can be addressed if the interests of the managers are aligned to the interests of the shareholders.

It is easier said than done.

However, following efforts have been made to address these issues:

Managerial compensation is linked to profit of the company to some extent and also with the long term objectives of the company.

Employee is also designed to address the issue with the underlying assumption that maximisation of the stock price is the objective of the investors.

Effective monitoring can be done.

## FINANCIAL DISTRESS & INSOLVENCY

There are various factors like price of the product/ service, demand, price of inputs e.g. raw material, labour etc., which is to be managed by an organisation on a continuous basis likewise, the proportion of debt also needs to be managed by an organisation very carefully.

Higher debt requires higher interest and if the cash inflow is not sufficient then it will put lot of pressure to the organisation. Both short term and long term creditors will put stress to the firm, If all the above factors are not well managed by the firm, it can create situation known as "distress", so financial distress is a position where cash inflows of a firm are inadequate to meet all its current obligations.

If distress continues for a long period of time, firm may have to sell its asset, even many times at a price lower than market price. Further when revenue is inadequate to revive the situation, firm will not be able to meet its obligations and may become insolvent. So, insolvency basically means inability of a firm to repay various debts and is a result of continuous financial distress.



# TIME VALUE OF MONEY

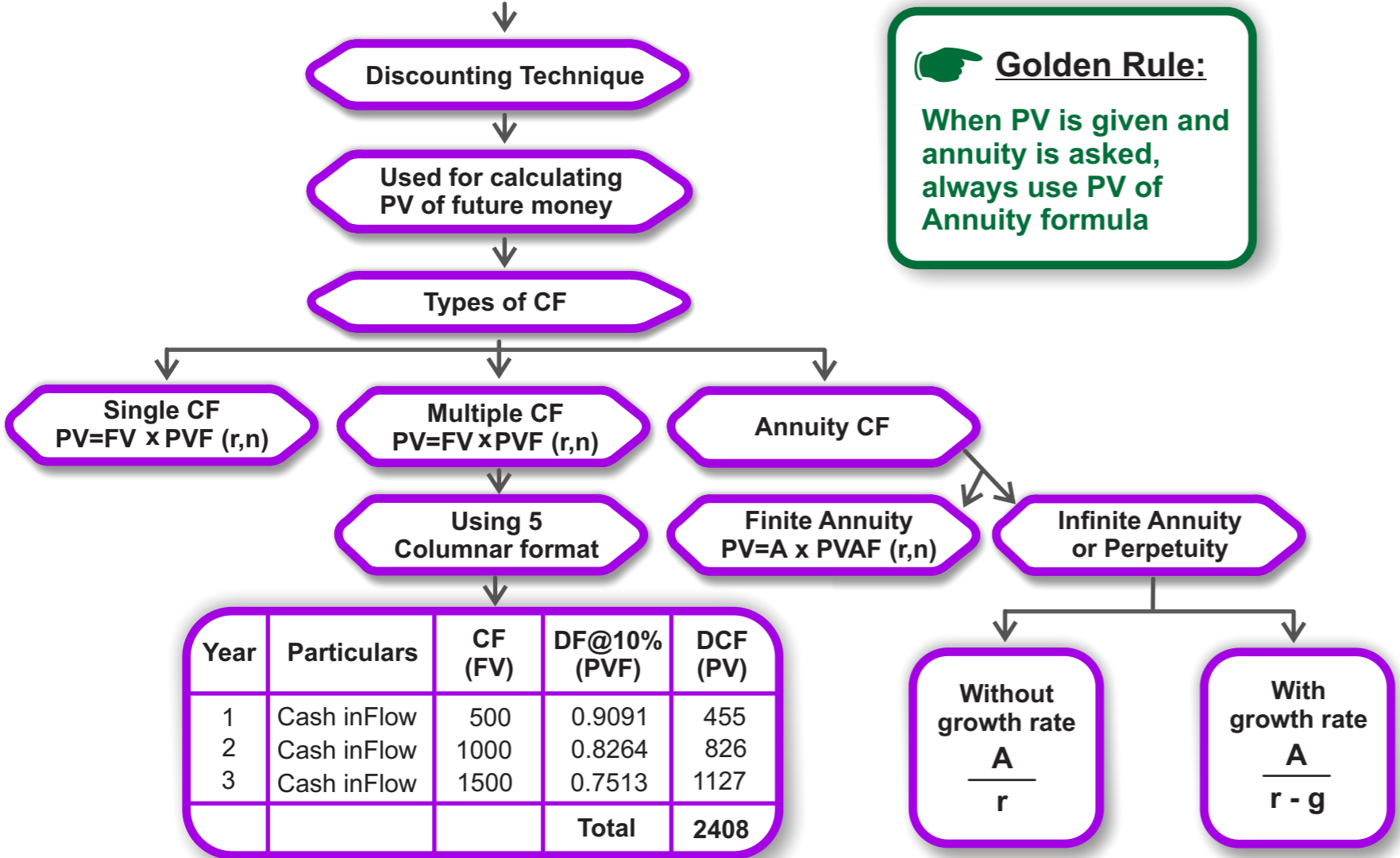
As the name suggest, "worth of a rupee received today is different from the worth of a rupee to be received in future."

Reasons for time preference of money (Relevance of Time Value of Money)

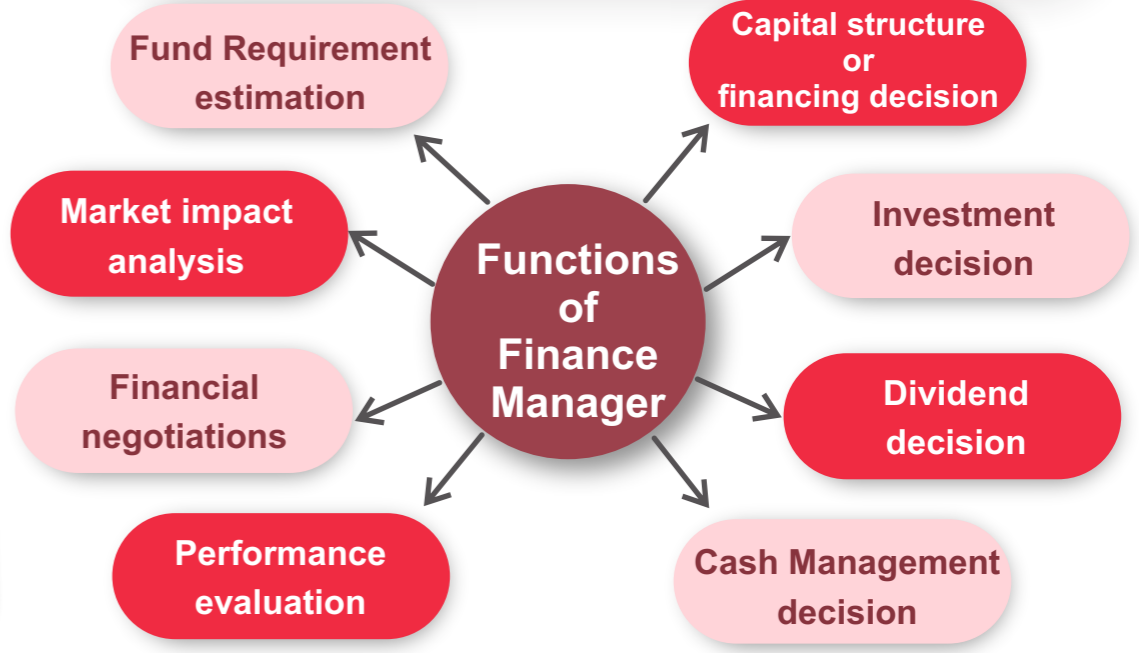
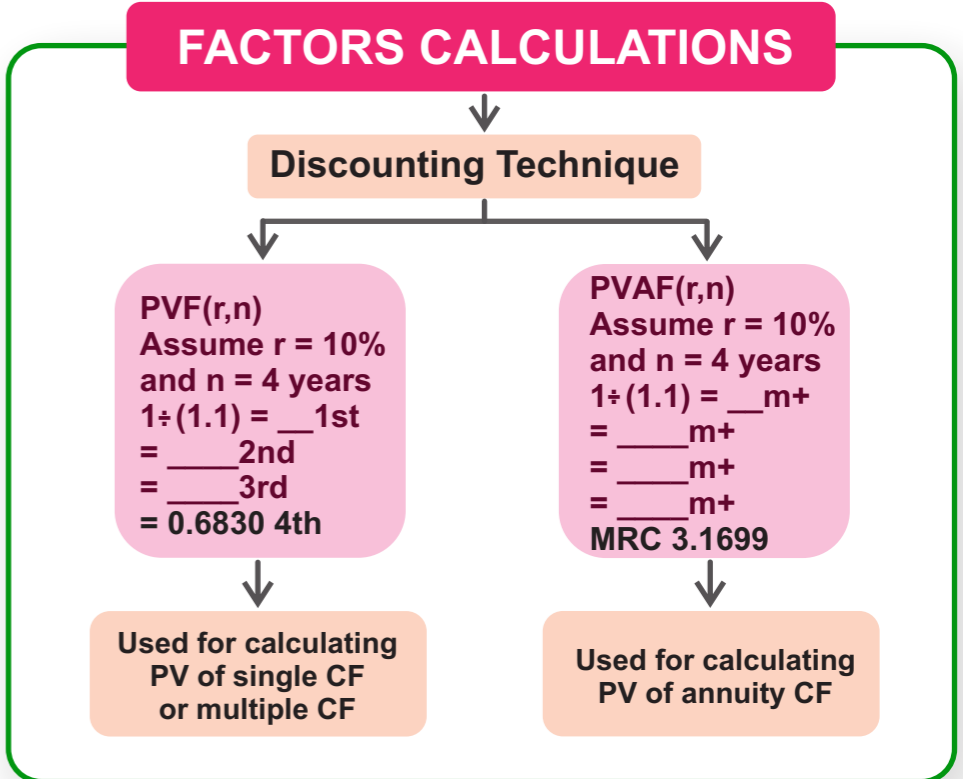
- ➔ Risk
- ➔ Preference of present consumption
- ➔ Investment opportunities
- ➔ Inflation

## Time value Of Money Techniques

**Golden Rule:**  
When PV is given and annuity is asked, always use PV of Annuity formula



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# CHAPTER-2 - LEVERAGE



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Leverage

Advantage gained for any purpose

Types of Leverages

Operating Leverage or Degree of operating Leverage (DOL)

Combined Leverage or Degree of combined Leverage (DCL)

Financial Leverage or Degree of Financial Leverage (DFL)

Taking advantage of operations of business i.e. operating fixed cost

Taking advantage of both operations and financial structure of business. i.e. fixed cost of operations + fixed cost of finance i.e. Interest

Taking advantage of financial structure of business i.e. fixed cost of finance - interest

By increasing the sales by a certain % we want to increase EBIT by a greater %

$$A) \therefore DOL = \frac{\% \text{ change in EBIT}}{\% \text{ change in Sales}}$$

OR

If other words, we are measuring the impact of fixed cost

$$B) \therefore DOL = \frac{\text{Contribution}}{\text{EBIT}}$$

Formula (a) to be used when two situations are given.

Whereas formula (b) to be used when only one situation is given

example: If DOL of a firm is 1.6 times it indicates 1% change in sales will lead to 1.6% change in EBIT.

If margin of safety is given in the question

$$C) \therefore DOL = \frac{1}{MOS}$$

Operating Break even Point =

$$\frac{\text{Fixed Cost}}{\text{Contribution Per Unit}} \quad \text{OR} \quad \frac{\text{Fixed Cost}}{\text{PV Ratio}}$$

Assuming that there are no preference shares

By increasing the sales by a certain % we want to increase EPS by a greatest %

$$A) \therefore DCL = \frac{\% \text{ change in EPS}}{\% \text{ change in Sales}}$$

OR

In other words we are measuring the impact of both fixed cost of operations and interest cost.

$$B) \therefore DCL = \frac{\text{Contribution}}{\text{EBT}}$$

OR

$$DCL = DOL \times DFL$$

Formula (a) to be used when two situations are given where as formula (b) to be used when only one situation is given

Now, Assuming that preference shares are given in question we can now take advantage of fixed cost of operations and Interest and preference dividend.

There will be no change in formula (a) as it already considers the complete impact till the EPS, but formula (b) will be now altered as:

$$\therefore DCL = \frac{\text{Contribution}}{\text{EBIT} - \text{Interest} - \frac{\text{PD}}{(1-t)}}$$

example: If DCL of a firm is 3 times, it indicates 1% change in sales will lead to 3% change in EPS or The impact of fixed cost of operations and interest cost of finance in 3 times

Assuming that there are no preference shares

By increasing the EBIT by a certain % we want to increase EPS by a greater %

$$A) \therefore DFL = \frac{\% \text{ change in EPS}}{\% \text{ change in EBIT}}$$

OR In other words, we are measuring the impact of interest cost.

$$B) \therefore DFL = \frac{\text{EBIT}}{\text{EBT}}$$

Formula (a) to be used when two situations are given where as formula (b) to be used when only one situation is given

Now, Assuming that preference shares are given in question we can now take advantage of interest and preference dividend.

There will be no change in formula (a) as it already considers the complete impact till the EPS, but formula (b) will be now altered as:

$$\therefore DFL = \frac{\text{EBIT}}{\text{EBIT} - \text{Interest} - \frac{\text{PD}}{(1-t)}}$$

example: If DFL of a firm is 3 times, it indicates 1% change in EBIT will lead to 3% change in EPS or The impact of interest cost of finance is 3 times.

$$\text{Financial Break even Point} = 1 + \frac{\text{PD}}{1 - \text{Tax Rate}}$$

Where, I = Interest, PD = Pref. Dividend

Assuming that there are no preference shares :

## MASTER CHART

Particulars	Amount
Sales	X X X
(-) Variable cost	X X
$\therefore$ Contribution	X X X
(-) Fixed cost	X X
$\therefore$ EBIT	X X X
(-) Interest	X X
$\therefore$ EBT	X X X
(-) Taxes	X X
$\therefore$ EAT or Net Income	X X
$\therefore$ EPS =	$\frac{\text{Net Income}}{\text{No. of Equity Share}}$

Assuming that there are preference shares :

## MASTER CHART

Particulars	Amount
Sales	X X X
(-) Variable cost	X X
$\therefore$ Contribution	X X X
(-) Fixed cost	X X
$\therefore$ EBIT	X X X
(-) Interest	X X
$\therefore$ EBT	X X X
(-) Taxes	X X
$\therefore$ EAT	X X X
(-) Preference Dividend	X X
$\therefore$ Net Income	X X X
$\therefore$ EPS =	$\frac{\text{Net Income}}{\text{No. of Equity Share}}$



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## Ideal Combination for combined Leverage

### Ideal Combination for combined Leverage

DOL	DFL	Effect	Reasons
High	High	Risky	DOL ↑ = F. C. ↑ = BEP ↑ = MOS ↓ DFL ↑ = Financial risk ↑
High	Low	Careful	DOL ↑ = impact is off setted by DFL ↓ ∴ less risky for shareholders
Low	Low	Cautious and conservative	DOL ↓ = operating risk ↓ and DFL ↓ = Financial risk ↓
Low	High	Preferable	DOL ↓ = Operating risk ↓ and DFL ↑ = small rise in EBIT will lead to rise in EBT & EPS.



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# CHAPTER-3-CAPITAL STRUCTURE



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## FACTORS DETERMINING CAPITAL STRUCTURE

- Nature of Industry (small / large scale)
- Gestation period (Time required to settle the business)
- Certainty of profits (more - debt & less - equity)
- Quantum of Return on Investment (ROI to be compared to cost of funds)
- Lending policy of bank (liberal / strict)
- Monetary and fiscal policy of govt.

SOURCE	RISK	COST	CONTROL
Equity	Lowest	Highest	Is diluted
Preference	Moderate	Moderate	Not diluted
Debt	Highest	Lowest	Not diluted

- Capital structure as the name says, it is the structure of capital chosen by a company.
- It refers to the mix of sources from where the long term funds required in a business may be raised.
- In other words, it refers to proportion of debt, preference capital and equity capital.

## CAPITAL STRUCTURE

Optimum Capital Structure

Appropriate Capital Structure

When cost of funds is minimum and wealth of firm is maximum. Here, EPS is also maximum.

It differs from company to company. In real life, appropriate capital structure is more relevant.  
Major features :  
1) Profitability 2) Flexibility 3) Conservation  
4) Solvency 5) Control



Other  
consideration  
in capital  
structure  
planning

Legal requirements

Trading on equity

Corporate Taxation

Government Policies

Period of Finance

Nature of Investors

Size of company

Timing of approach

Maneuverability (Options)

Flexibility

Purpose of financing

Future growth

Requirement of investors

Marketability



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### Over-Capitalisation V/S Under Capitalisation:

Both over capitalisation and under capitalisation are not good.

However, over capitalisation is more dangerous to the company, shareholders and the society than under capitalisation.

The situation of under capitalisation can be handled more easily than the situation of over-capitalisation.

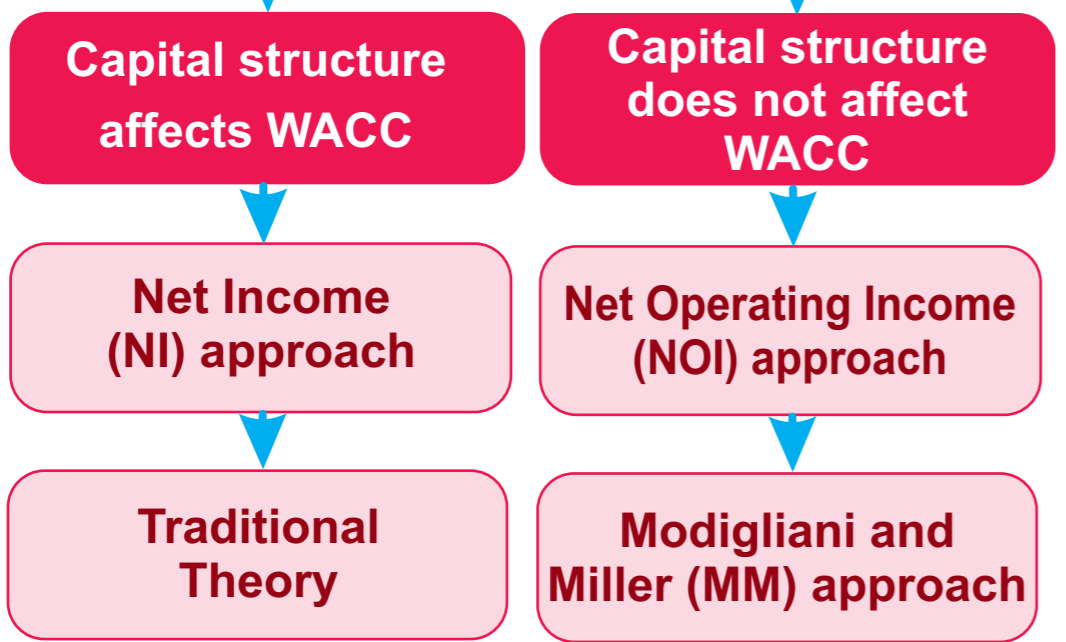
Moreover, under capitalisation is not an economic problem but a problem of adjusting capital structure. Thus, under capitalisation should be considered less dangerous but both situations are bad and every company should strive to have a proper capitalization.



# CAPITAL STRUCTURE THEORIES



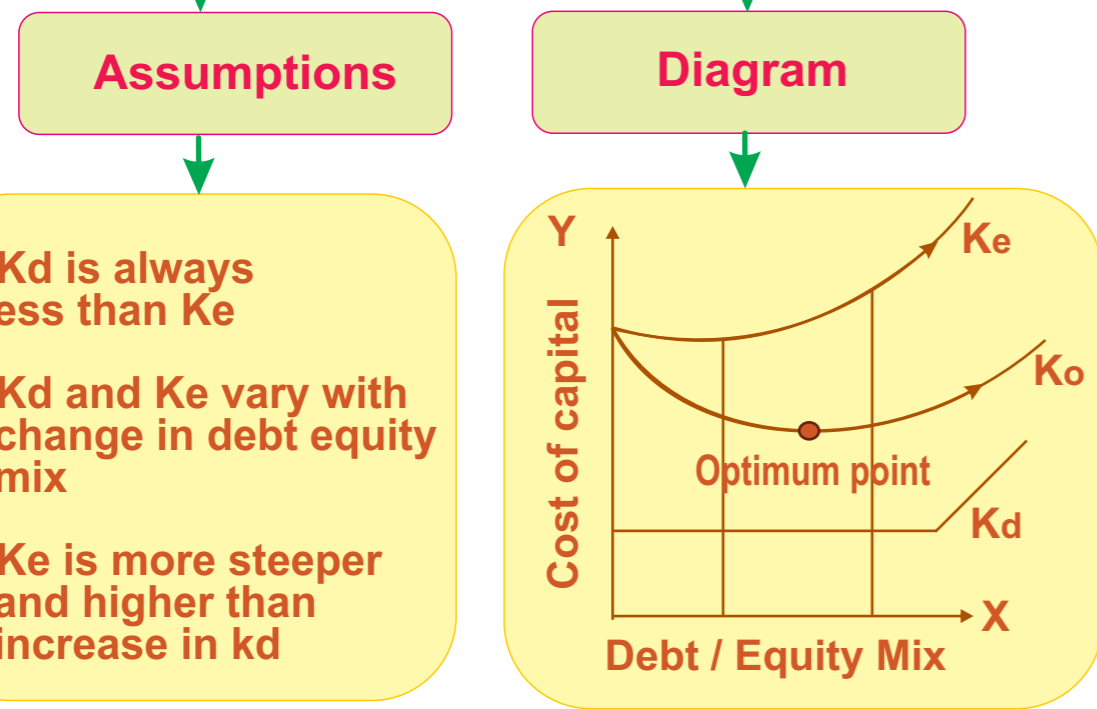
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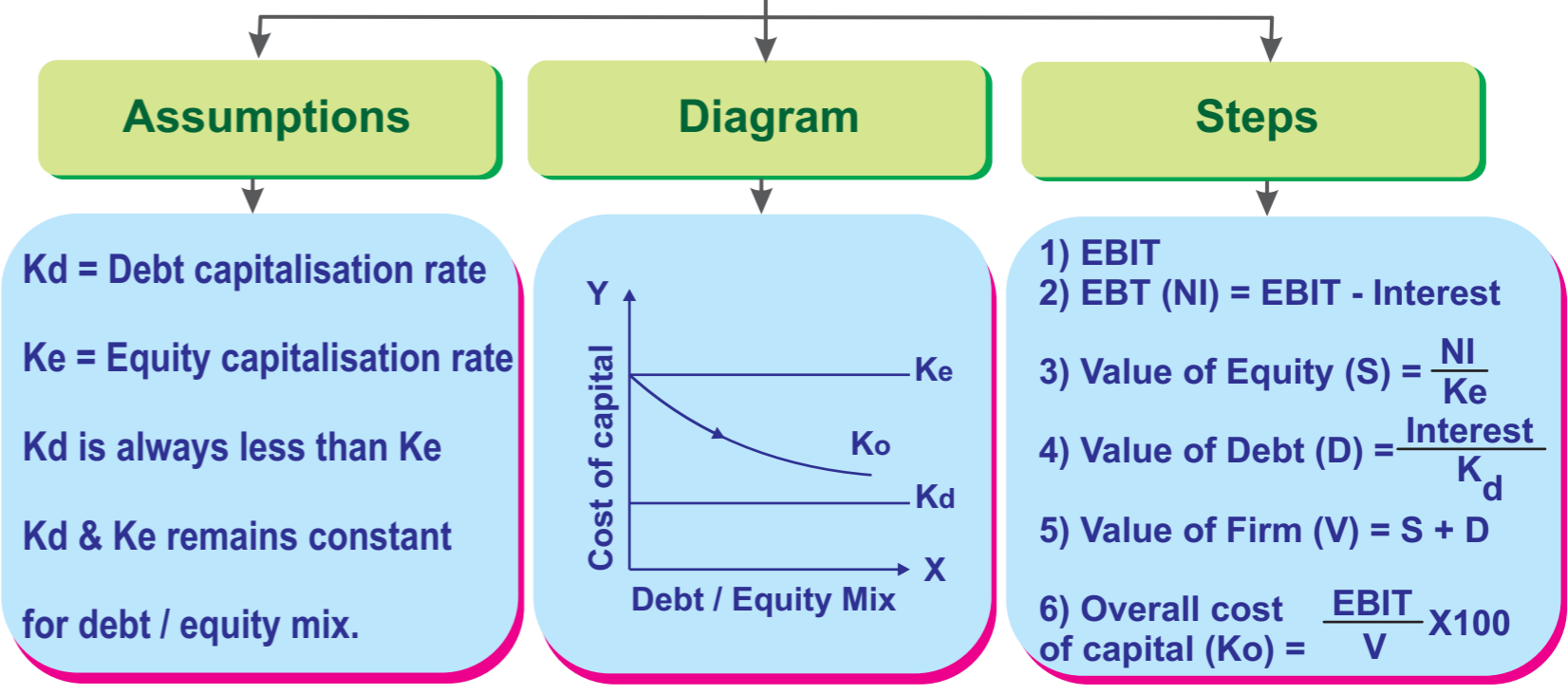
## General Assumptions for all theories :

- 1) Only two sources of fund i.e. debt and equity
- 2) No change in total capital employed
- 3) Capital structure can be changed
- 4) No retained earnings
- 5) No losses
- 6) No change in fixed cost of operations
- 7) No taxes
- 8) No difference in investors expectations

## TRADITIONAL THEORY



## NET INCOME (NI) APPROACH OF DURAND



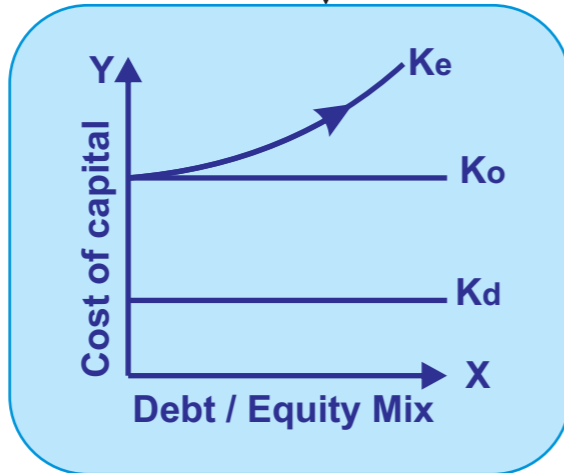


# NET OPERATING INCOME (NOI) APPROACH

## Assumptions

- 1)  $K_d$  is always less than  $K_e$
- 2)  $K_d$  remains constant at all levels of debt-equity mix.
- 3)  $K_e$  increases as debt content increases.
- 4) Market capitalises value of firm as a whole without giving any importance to debt-equity mix.

## Diagram



## Steps

- 1) EBIT
- 2)  $EBT = EBIT - \text{Interest}$
- 3) Value of Firm ( $V$ ) =  $\frac{EBIT}{K_o}$
- 4) Value of Debt ( $D$ ) =  $\frac{\text{Interest}}{K_d}$
- 5)  $S = V - D$
- 6)  $K_e = \frac{EBT \text{ or } NI}{S} \times 100$



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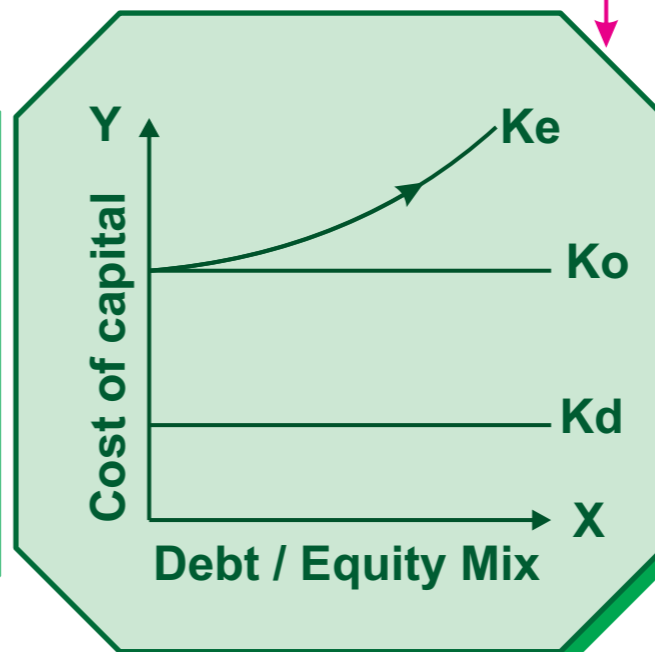
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# MODIGLIANI & MILLER APPROACH WITHOUT TAX

## Assumptions

- 1)  $K_d$  is always less than  $K_e$
- 2)  $K_d$  remains constant at all levels of debt-equity mix.
- 3)  $K_e$  increases as debt content increases.
- 4) Market capitalises value of firm as a whole without any importance to debt-equity mix.
- 5) Capital Market is perfect, investors are free to buy or sell securities, no transaction cost, investors can personally borrow without restrictions on same terms as the firms do.
- 6) Same risk class classification - if 2 firms have same capital employed and same EBIT.

## Diagram



## Proposition by Theory

- This theory is a copy of NOI Approach
- Additionally it states that :-
  - (a) If 2 firms belong to same risk class i.e., their capital employed is same and their EBIT is also same, then their market price per share should also be the same.
  - (b) If at any moment, the market price per share is not same, arbitrage process will make it same.



# MODIGLIANI & MILLER APPROACH WITH TAX

i) Value of levered company =  
Value of an unlevered company  
+  
PV of Interest Taxshield

Or,

$$V_g = V_u + TB$$

ii) Cost of Equity in a levered company ( $K_{eg}$ ) =

$$K_{eu} + (K_{eu} - K_d) \frac{\text{Debt}}{\text{Debt} + \text{Equity}}$$

## Marginal Cost of capital

- It is cost of raising an additional rupee of capital.
- The word marginal means additional.
- We compute cost of only additional / New capital.



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## OTHER IMPORTANT CONCEPTS



Financial BEP

Indifference Point

It is that level of EBIT at which EPS under a plan is zero

It is that level of EBIT at which EPS under two plans is same

Let the EBIT be 'X'

$$\frac{(X - \text{Interest}) (1 - t) - PD}{\text{No. of equity shares}} = 0$$

Let the EBIT be 'X' for plan A and Plan B.

Plan A	Plan B
$\frac{(X - \text{Interest}) (1 - t) - PD}{\text{No. of equity shares}}$	$= \frac{(X - \text{Interest}) (1 - t) - PD}{\text{No. of equity shares}}$



## THE TRADE OFF THEORY

It refers to the idea that a company chooses how much debt finance and how much equity finance to use by **balancing the costs and benefits**.

It primarily deals with the two concepts - cost of financial distress and agency costs.

It states that there is an **advantage** to financing with debt, the **tax benefits of debt** and there is a cost of financing with debt, the **costs of financial distress** i.e., bankruptcy costs of debt and **non-bankruptcy costs** like staff leaving, supplier's demanding terms, bondholder/stockholder power struggle, etc).

**Marginal benefit of further increase in debt declines as debt increases, while the marginal cost increases**, so that a firm that is optimizing its overall value will focus on this trade-off when choosing how much debt and equity to use for financing.

The firms may often **experience a disputes of interest** among the management of the firm, debt holders and shareholders.

These disputes generally give birth to **agency problems** that in turn give rise to the **agency costs**.

The agency costs may affect the capital structure of a firm. There may be two types of conflicts - **shareholders-manager conflict** and **shareholders-debt holders conflict**.



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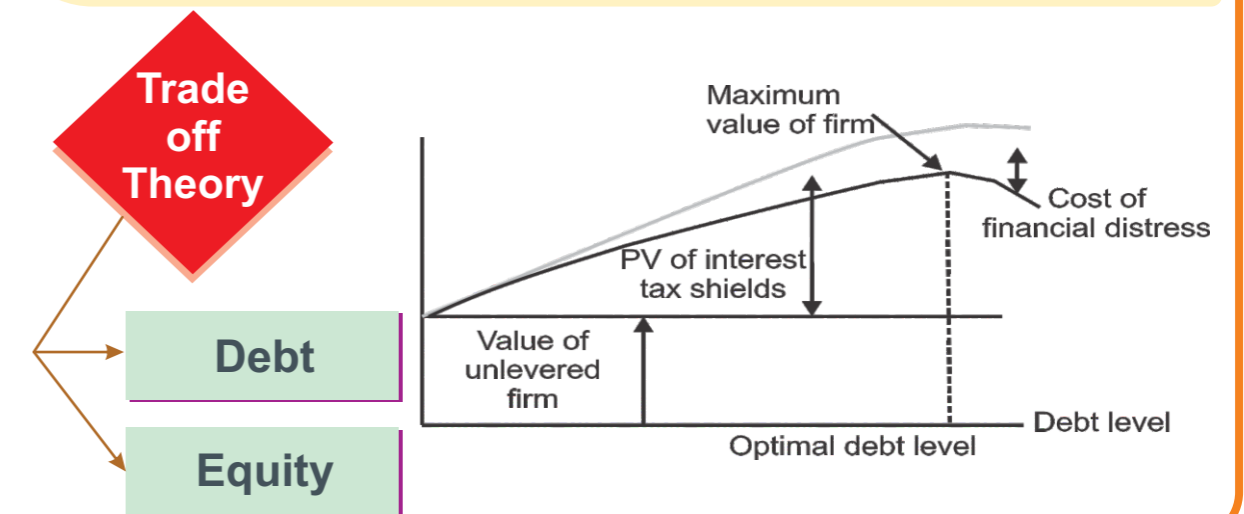
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The introduction of a dynamic Trade-off theory of capital structure makes the predictions of this theory a lot more accurate and thoughtful of that in practice.

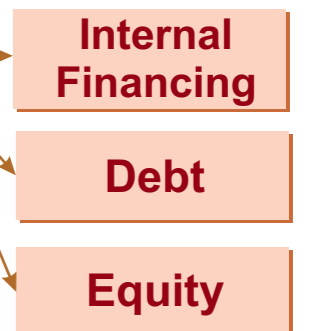


## Pecking Order Theory

It is based on **Asymmetric information**, which refers to a situation in which different parties have different information.

Pecking order theory suggests that managers may use various sources for raising of fund in the following order :-

- 1) Use internal financing first.
- 2) Issue debt next
- 3) Issue of new equity shares at last.







# CHAPTER-4- COST OF CAPITAL



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## Cost of Debt ( $k_d$ )

### Irredeemable Debt

$$K_d = \frac{I(1-t)}{NP} \times 100$$

### Redeemable Debt

$$K_d = \frac{I(1-t) + (RV - NP)/n}{(RV + NP)/2} \times 100$$

## Cost of Preference Share ( $K_p$ )

### Irredeemable Preference Shares

$$K_p = \frac{PD}{NP} \times 100$$

### Redeemable Preference Share

$$K_p = \frac{PD + (RV - NP)/n}{(RV + NP)/2} \times 100$$

## Cost of External Equity (Fresh Issue of Equity)

$$K_e = \frac{D_1}{P_0(1-f)} + g$$

With growth

$$K_e = \frac{D}{P_0(1-f)}$$

without growth

## Cost of Retained earning ( $K_r$ )

$$K_r = K_e(1-tp) - b$$

Where,  
tp = Personal tax rate of investors  
b = brokerage rate  
(1-tp) = after personal tax

## Cost of equity share ( $K_e$ )

### Dividend Price Approach

$$K_e = \frac{D_1}{P_0} \times 100$$

### Dividend Price + Growth Approach

$$K_e = \left[ \frac{D_1}{P_0} + g \right] \times 100$$

### Earning Price Approach

$$K_e = \frac{EPS_1}{P_0} \times 100$$

### Earning Price + Growth Approach

$$K_e = \left[ \frac{EPS_1}{P_0} + g \right] \times 100$$

### Realized Yield Approach

$$K_e = \frac{D_t + (P_t - P_{t-1})}{P_{t-1}} \times 100$$

### Capital Asset Pricing Model (CAPM) Approach

$$K_e = R_F + \beta (R_M - R_F)$$

Where,  
I = Interest amount  
t = tax rate  
NP = Net proceeds

RV = Redemable value  
P.D. = Preference dividend  
D<sub>1</sub> = Dividend of Next year  
[D<sub>1</sub> = D<sub>0</sub> + g]

g = growth rate  
EPS<sub>1</sub> = Earning Per share of next year  
[EPS<sub>1</sub> = EPS<sub>0</sub> + g]  
f = Floatation Cost as a % of P<sub>0</sub>

P<sub>0</sub> = Current market price  
D<sub>t</sub> = Dividend in time t (e.g. t = 2021)  
P<sub>t</sub> = Price in time t (e.g. t = 2021)

P<sub>t-1</sub> = Price in time t - 1 (e.g. t - 1 = 2020)  
R<sub>F</sub> = Risk free rate of return  
β = Beta  
R<sub>m</sub> = Return from market  
(R<sub>m</sub> - R<sub>F</sub>) = Market Risk Premium



## WEIGHTED AVERAGE COST OF CAPITAL (WACC)



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### Using Book value weights

The weights used are derived from book value of different sources of finance as per books of accounts.

Always calculate weights for total value of capital (Take proportion of total values as per books of accounts)

### Using Market value weights

The weights used are derived from market value of different sources of finance as per prevailing market rates.

Always calculate weights for total value of capital (Take proportion of total market values as per prevailing market prices)

## Format for calculation of WACC or $K_0$

Source of Finance	Book value or Market Value	Proportion (%)	Individual cost of capital	Product (Prop. × Individual Cost)
Equity capital		W1	$k_e$	$k_e \times W1$
Preference Capital		W2	$k_p$	$k_p \times W2$
Retained earning*		W3	$k_r$	$k_r \times W3$
Debt		W4	$k_d$	$k_d \times W4$
<b>Total</b>		<b>Total of above</b>		<b><math>K_0 = WACC</math></b>

\*Note : In case of book value method, we consider retained earnings but in case of market value method, retained earnings are considered only when  $K_r$  is not equal to  $K_e$ .



## MARKET VALUES AS WEIGHTS

### Advantages

- Not affected by accounting policies
- Represents opportunity cost
- Represents present economic values of various sources of finances.
- Consistent with definition of cost of capital i.e., to maintain market value of shares, cost of capital, rate of return should be earned by company.
- True reflection of firm's capital structure.

### Disadvantages

- Market values are not available for unlisted companies
- Not reliable when shares are not actively traded.
- Market prices fluctuate frequently and are affected by speculations.

## BOOK VALUES AS WEIGHTS

### Advantages

- Data is easily available from balance sheet.
- Firm sets their capital structure in terms of book value.
- Calculations are simple.
- Less fluctuations in book value.
- Useful when market prices are not available.
- Many investors use book value weights for their analysis.

### Disadvantages

- Affected by accounting policies.
- Does not truly represent the opportunity cost of capital.
- Does not represent the present economic values of various sources of finance.
- Not consistent with definition of cost of capital.



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**Q. WHAT DO YOU UNDERSTAND BY CAPITAL STRUCTURE? HOW DOES IT DIFFER FROM FINANCIAL STRUCTURE?**

**Ans.:** Capital structure refers to the combination of debt equity which a company uses to finance its long term operations. It is the long term financing of the company representing long term source of capital i.e. owner's equity and long term debts but excludes current liabilities.

Whereas financial structure is the entire left hand side of Balance sheet representing all the long term and short term sources of capital.

Thus we may say capital structure is only a part of financial structure.

**Capital structure**

**vs**

**Financial structure**



# CHAPTER-5- MANAGEMENT OF WORKING CAPITAL

- The 'Working Capital' as the name suggests is the capital required for day to day working of company.
- We estimate the working capital so that required working capital in a company should be sufficient for coming period.
- The working capital can be estimated as :

$$\text{Working capital} = \text{Current Asset} - \text{Current Liabilities}$$

Format for estimating working capital :

Sr.No.	Particulars	Basis	Computation	Amount (Rs.)
<b>A)</b>	<b>Current Assets</b>			
i)	Raw material stock	1 month	$\frac{\text{Raw material}}{12} \times 1$	xxxx
ii)	W.I.P. Stock*	½ month	-----	xxxx
iii)	Finished good stock	2 month	$\frac{\text{Cost of Production}}{12} \times 2$	xxxx
iv)	Sundry debtors	4 Weeks	$\frac{\text{Cost of Credit Sales}}{52} \times 4$	xxxx
v)	Cash / Bank balance	given	-----	xxxx
	<b>Sub-Total (A)</b>			<b>xxxxx</b>
<b>B)</b>	<b>Current Liabilities</b>			
i)	Trade Creditors	1 month	$\frac{\text{Credit Purchases}}{12} \times 1$	xxxx
ii)	Outstanding wages	½ month	$\frac{\text{Total Wages}}{12} \times 0.5$	xxxx
iii)	Outstanding overheads	20 days	$\frac{\text{Total Overheads}}{365} \times 20$	xxxx
	<b>Sub-Total (B)</b>			<b>xxxxx</b>
<b>C)</b>	<b>Net Working Capital</b>	<b>(A-B)</b>		<b>xxxxx</b>

\*Note : If nothing is given, always assume WIP is complete 100 % w.r.t. raw material & 50 % w.r.t. conversion cost i.e. wages and overheads.



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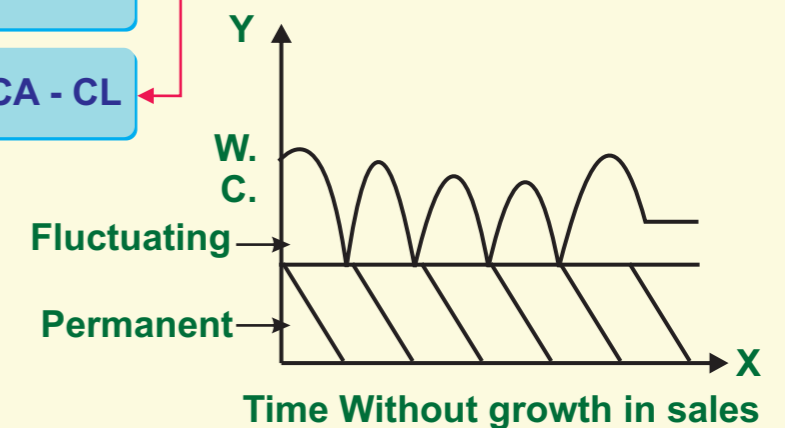
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## TYPE OF WORKING CAPITAL

Based on concept

$$\text{Gross WC} = \text{CA}$$

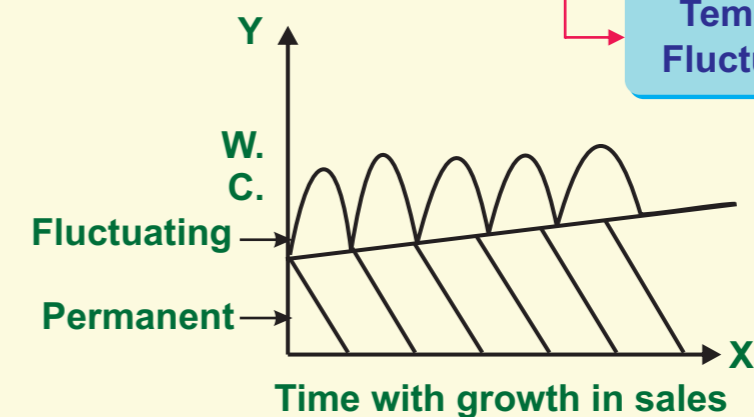
$$\text{Net WC} = \text{CA} - \text{CL}$$



Based on Time Factor

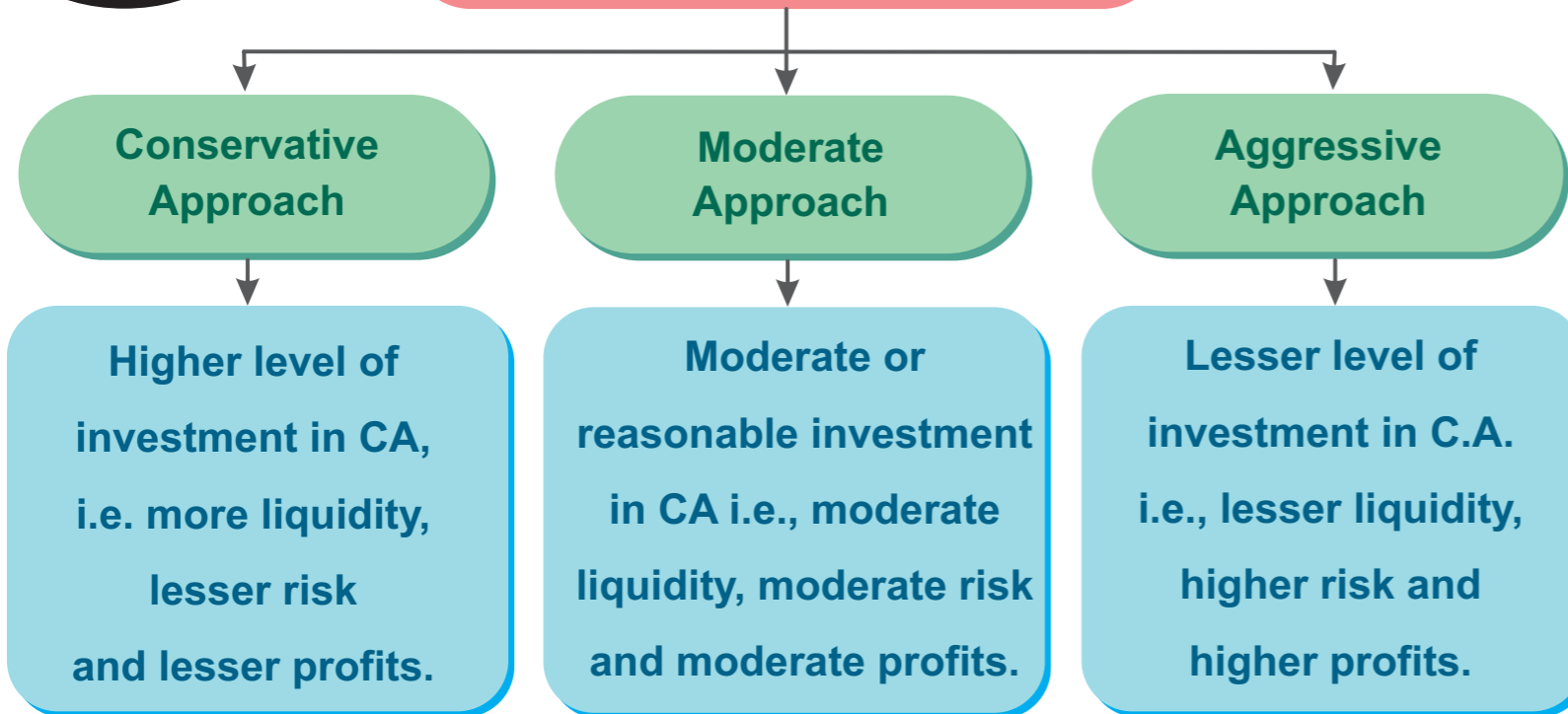
Permanent or Core WC

Temporary or Fluctuating WC





## APPROACHES OF WORKING CAPITAL



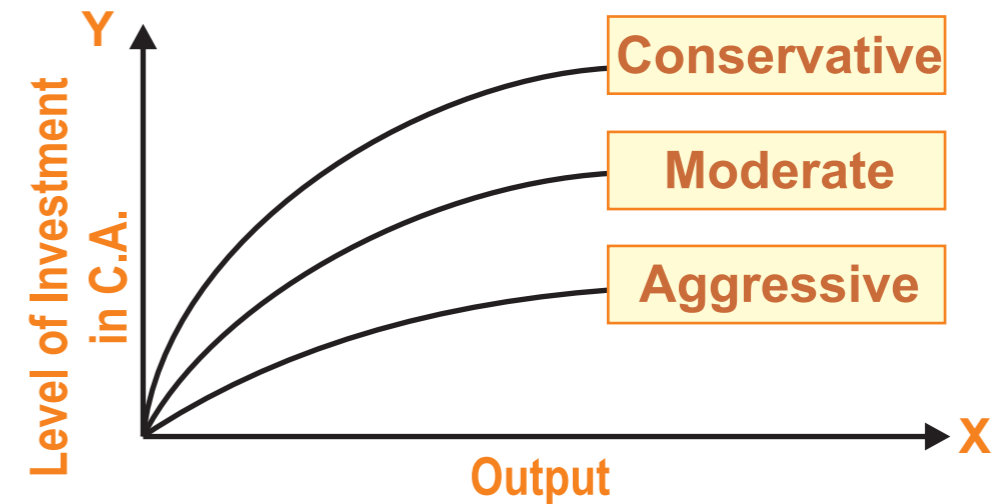
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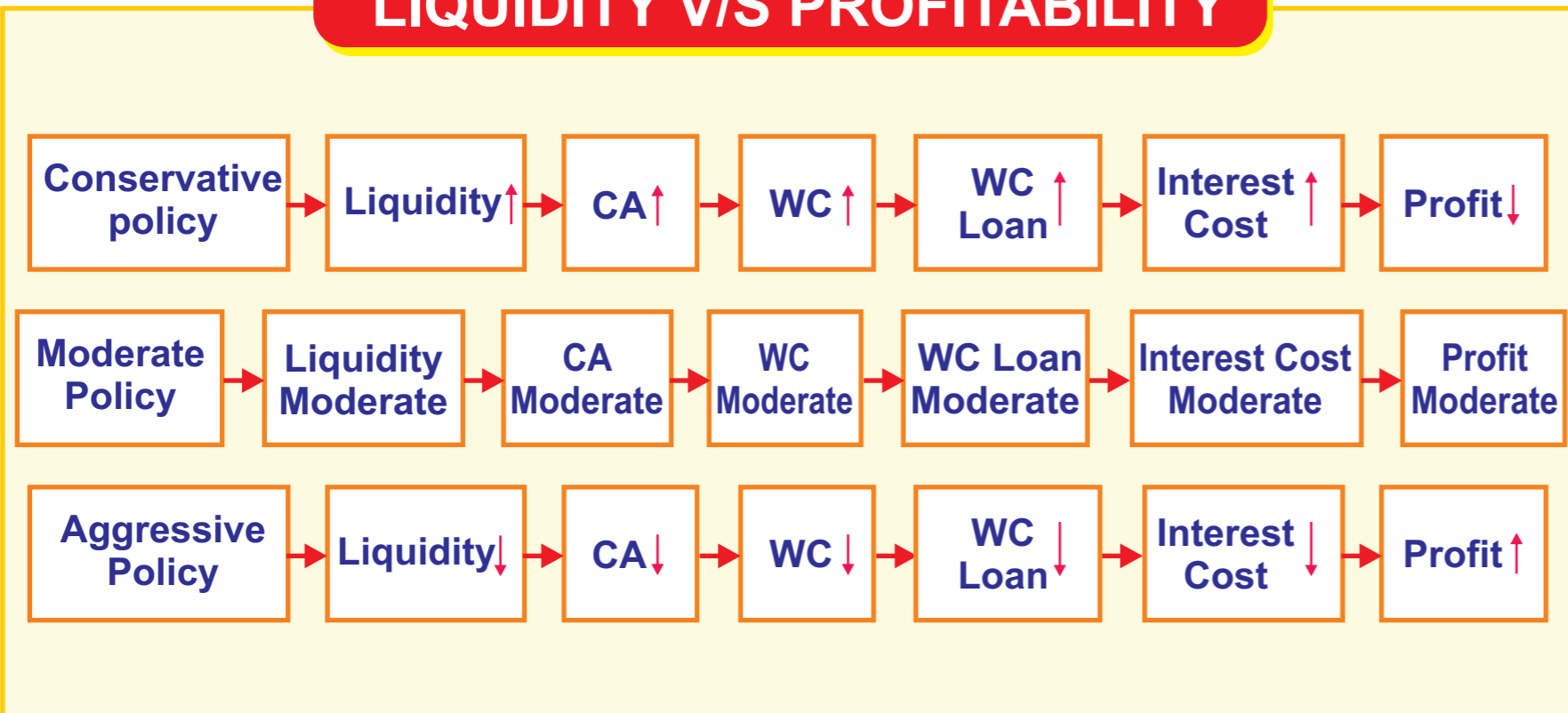
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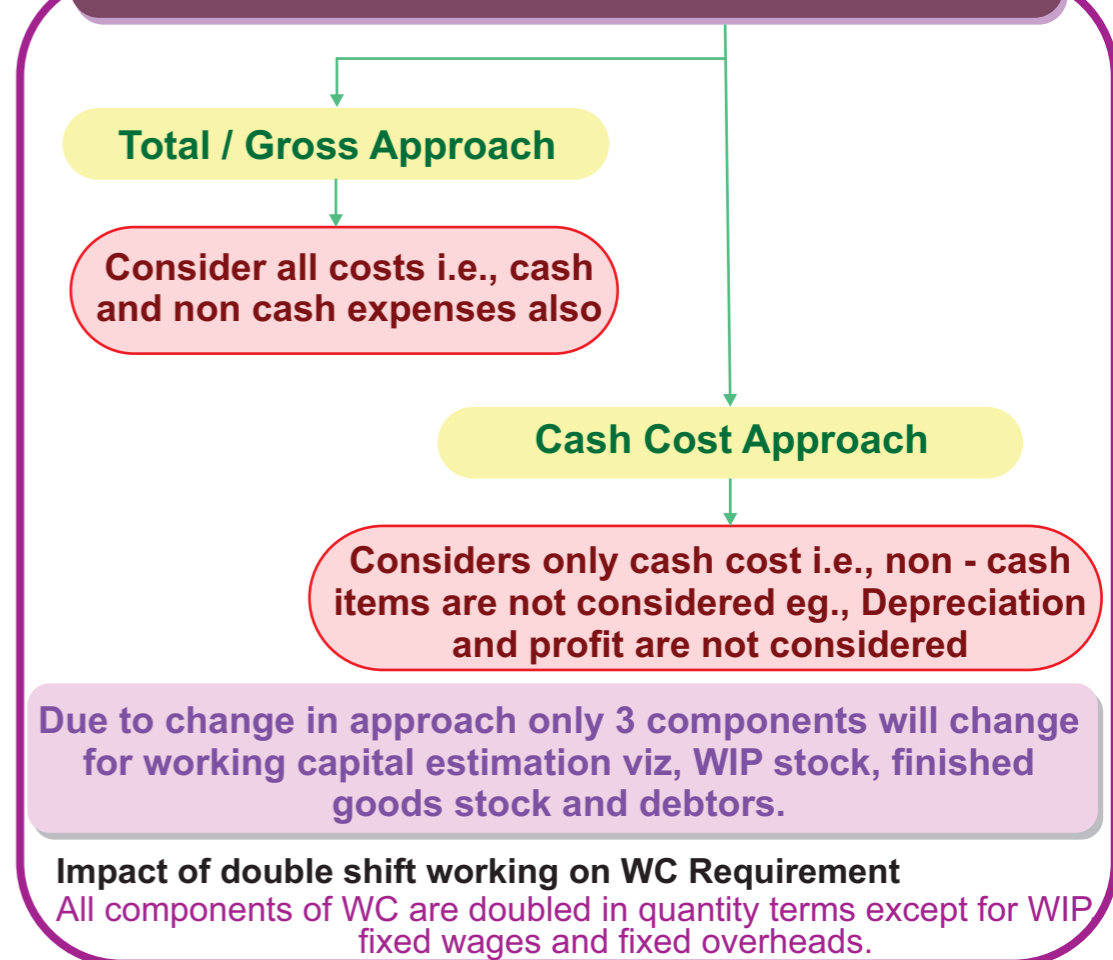
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## LIQUIDITY V/S PROFITABILITY



## APPROACHES FOR WC ESTIMATION

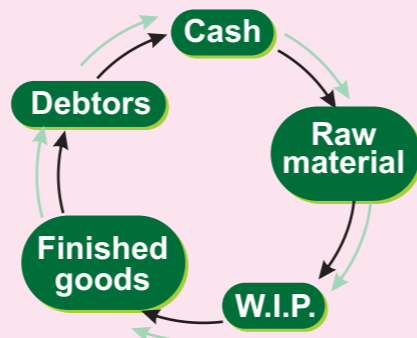




## CONCEPT OF OPERATING CYCLE/ W.C. CYCLE / CASH CYCLE

- It is the time duration for conversion of cash into cash equivalents like raw materials, W.I.P., finished goods, debtors and thereafter back into cash.
- It can be explained through the following diagram :-

**Gross operating Cycle** = R.M. storage period + W.I.P. holding period + Finished goods storage period + Debtors Collection period



**Net Operating Cycle** = Gross operating cycle - Creditors payment period

**No. of Cycles p.a.** =  $\frac{365 \text{ Days}}{\text{Net Operating Cycle Period}}$

**Working capital required (based on normal approach)** =  $\frac{\text{Sales}}{365} \times \text{Net Operating Cycle Period}$

**Working capital required (based on cash cost approach)** =  $\frac{\text{Cash Cost of Sales}}{365} \times \text{Net Operating Cycle Period}$

OR

**Working capital required (based on cash cost approach)** =  $\frac{\text{Cash Cost of Sales}}{\text{No. of operating cycles per annum}}$

**Components of operating cycle can be calculated as :-**

1) **Raw material storage period** =  $\frac{\text{Avg. stock of Raw Materials}}{\text{Avg. cost of RM consumed / day}}$

2) **W.I.P storage period** =  $\frac{\text{Avg. stock of WIP}}{\text{Avg. cost of Production / day}}$

3) **F.G. storage period** =  $\frac{\text{Avg. stock of F.G}}{\text{Avg. cost of goods sold / day}}$

4) **Debtors collection period** =  $\frac{\text{Avg. Accounts Receivable}}{\text{Avg. Credit Sales / day}}$

5) **Creditors payment period** =  $\frac{\text{Avg. Accounts Payable}}{\text{Avg. Credit Purchases / day}}$

## FACTORS AFFECTING WC REQUIREMENT



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- Production policy (Production ↑ = WC ↑)
- Production process (Labour intensive = WC ↑)
- Length of manufacturing process (Length ↑ = WC ↑)
- Nature of business (Manufacturing = WC ↑)
- Credit policy towards Debtors (Liberal ↑ = WC ↑)
- Market standing (Newly started = WC ↑)
- Inventory policy (High storage = WC ↑)
- Market conditions (Buyer's market = WC ↑)
- Inflationary conditions (Inflationary condition = WC ↑)
- Business Cycle (Peak or boom conditions = WC ↑)

## FUNCTIONS OF TREASURY MANAGEMENT

- Cash management (by forecasting cash requirements)
- Currency management (mainly for imports & exports)
- Financing management (capital structure)
- Bank Liaison (for borrowing at cheapest possible cost)
- Corporate Finance (for raising of funds)

## CONCEPT OF MPBF (MAXIMUM PERMISSIBLE BANK FINANCE)

It is the maximum amount of finance given from banker's side for financing working capital of company.

There are 3 methods for computing MPBF given by tandon committee are:

- 75% of (CA - CL)
- (75% of CA) - CL
- (75% of fluctuating CA) - CL (where fluctuating CA = Total CA - Core CA)



# UNIT - MANAGEMENT OF ACCOUNTS RECEIVABLE



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## FACTORS TO BE ANALYSED BEFORE CREDIT IS GRANTED TO A CUSTOMER

- ➔ Credit worthiness of customer
- ➔ Nature of product (Perishable / Durable)
- ➔ Nature of customer (New / Valuable)
- ➔ Quantity purchased (Minimum lot to be purchased)
- ➔ Value of sales
- ➔ Risk of Bad Debts

## VARIOUS SOURCES OF CREDIT RATING INFORMATION

- ➔ Trade references
- ➔ Bank references
- ➔ Credit bureau reports (Specialised agency to provide credit information)
- ➔ Past experiences in dealing.
- ➔ Published financial statements. (In case of public ltd. companies)
- ➔ Salesman's interview and report.

## COST OF MAINTAINING RECEIVABLES

- ➔ Interest on investment / finance cost (for V.C. and F.C. i.e., Total cost)
- ➔ Administration cost (Keeping records, etc.)
- ➔ Delinquency cost (reminders, phone, calls, etc.)
- ➔ Collection cost (contacting customers, cheque collection)
- ➔ Defaulting cost (Bad Debts, Legal Charges, etc.)

## STANDARD FORMAT FOR CREDIT POLICY EVALUATION

Particulars	30 Days Credit	60 Days Credit
Sales	xxxx	xxxx
(-) Variable cost	xxxx	xxxx
∴ Contribution	xxxx	xxxx
(-) Fixed cost	xxxx	xxxx
∴ EBIT	xxxx	xxxx
(-) Bad Debts / collection expenses / other indirect exp.	xxxx	xxxx
∴ Net Profit	xxxx	xxxx
(-) Taxes	xxxx	xxxx
∴ Profit after tax	xxxx	xxxx
(-) Finance cost	xxxx	xxxx
$\left[ \frac{\text{Total Cost} \times \text{Rate} \times \text{no. of days}}{365} \right]$		
∴ Net Benefit	xxxx	xxxx

➔ Select the policy with higher net benefit



## UNIT - MANAGEMENT OF CASH AND MARKETABLE SECURITIES

The cash should be managed such that we should carry sufficient cash balance for business i.e., cash should not be excess as idle cash has opportunity cost and cash should not be in shortage as goodwill of business will be hampered if payments are not made on time. Thus, finance manager should ensure sufficiency of cash. He uses cash budget for management of cash wherein future cash inflows and outflows are forecasted.

### FORMAT OF CASH BUDGET IS AS UNDER

Sr.No.	Particulars	Jan.	Feb.	March
A)	<u>Cash Receipts / Inflows :</u> - Cash sales - Collection from Debtors - Sale of assets / investments - Issue of shares / Debenture / Preference Shares - Rent / Commission received			
	Sub-total (A)			
B)	<u>Cash Payments / Outflows :-</u> - Cash Purchases - Payment to creditors - Purchase of assets / investments - Redemption of Debenture / Preference Shares - Rent / Commission / Salary / expenses paid - Taxes paid			
	Sub-total (B)			
C)	Surplus / Deficit (A - B)			
D)	Opening balance of cash / bank			
E)	Closing balance of cash / bank (C + D)			



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### William J. Baumol's EOQ model for optimum Cash Balances

Assumptions :

- (1) Uniform cash outflows.
- (2) Fixed transaction cost per transaction
- (3) Fixed interest cost per rupee / p.a.
- (4) Free marketability

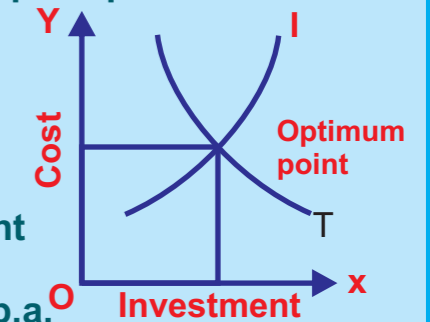
Optimum Investment Size (EOQ) =  $\sqrt{\frac{2AT}{I}}$

Where,

A = Annual cash requirement

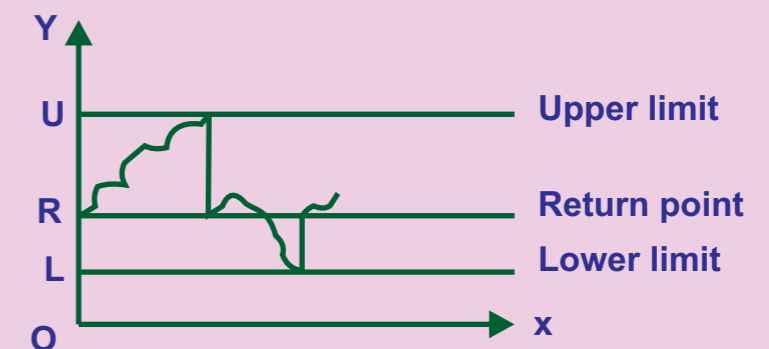
T = Cost per transaction

I = Interest rate per rupee / p.a.



### Miller Or Cash Management Model :-

Assumption : Stochastic (uneven) cash out flow.

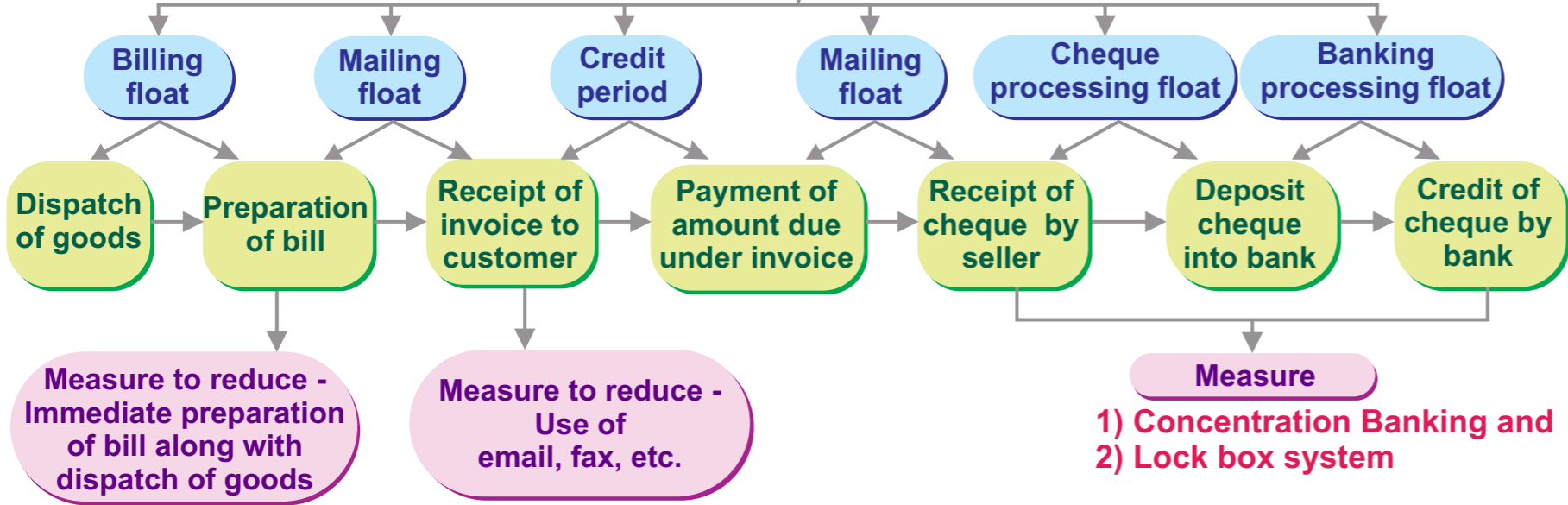


- Investment excess cash if cash balance touches upper limit
- Withdraw from investment if cash balance touches lower limit.
- It ensures right time invest and right time withdrawal.





## TYPES OF FLOATS (DELAYS) IN MANAGEMENT OF CASH



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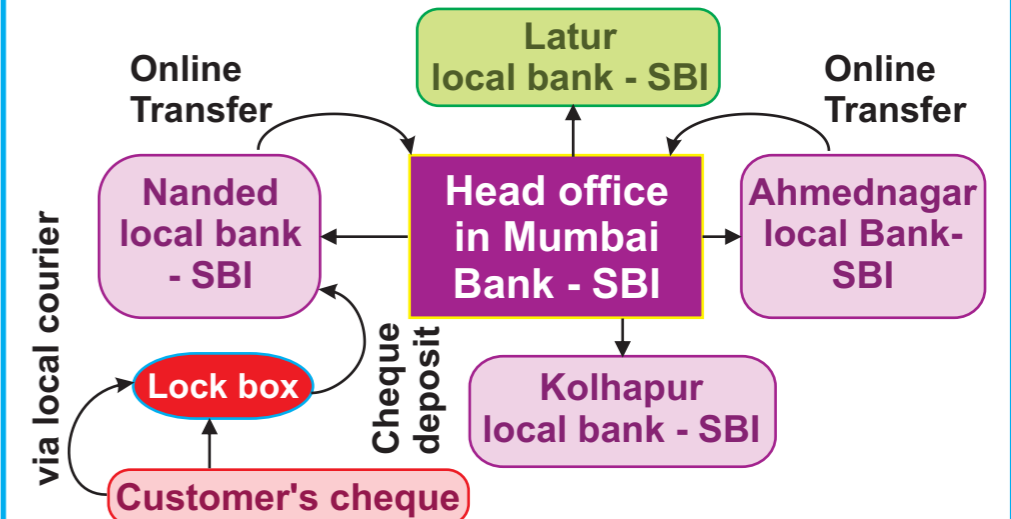


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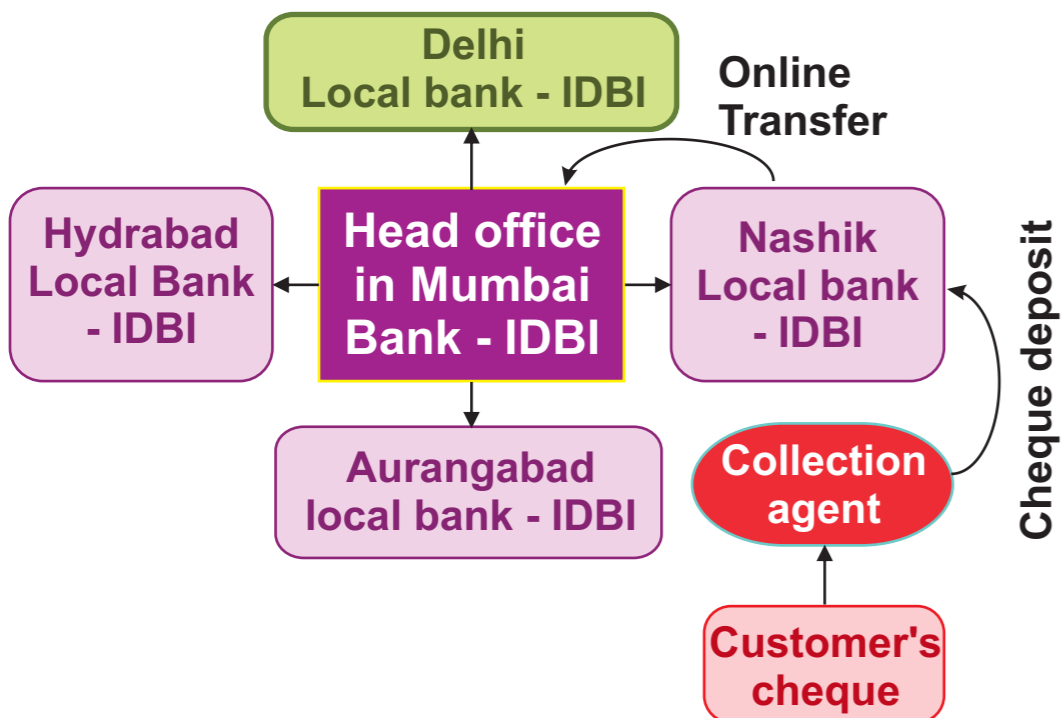
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## LOCK BOX SYSTEM



- \* In each city where we have major sales, we will ask our banker (eg SBI) to provide us lock box facility. The customers will be requested to send cheques on due date to SBI bank, P.O. Box No. -, local bank of their city.
- \* Bank will then open lock box daily and deposit the cheque to our account.
- \* We can then transfer the amount to H.O. account online and manage cash centrally.

## CONCENTRATION BANKING



- \* In each city where we have major sales, we appoint collection agent who will collect the cheques from customers on due date and deposit the same in local bank of that city.
- \* We can then transfer the amount to H.O. account online and manage cash centrally.



# CHAPTER-6- CAPITAL BUDGETING

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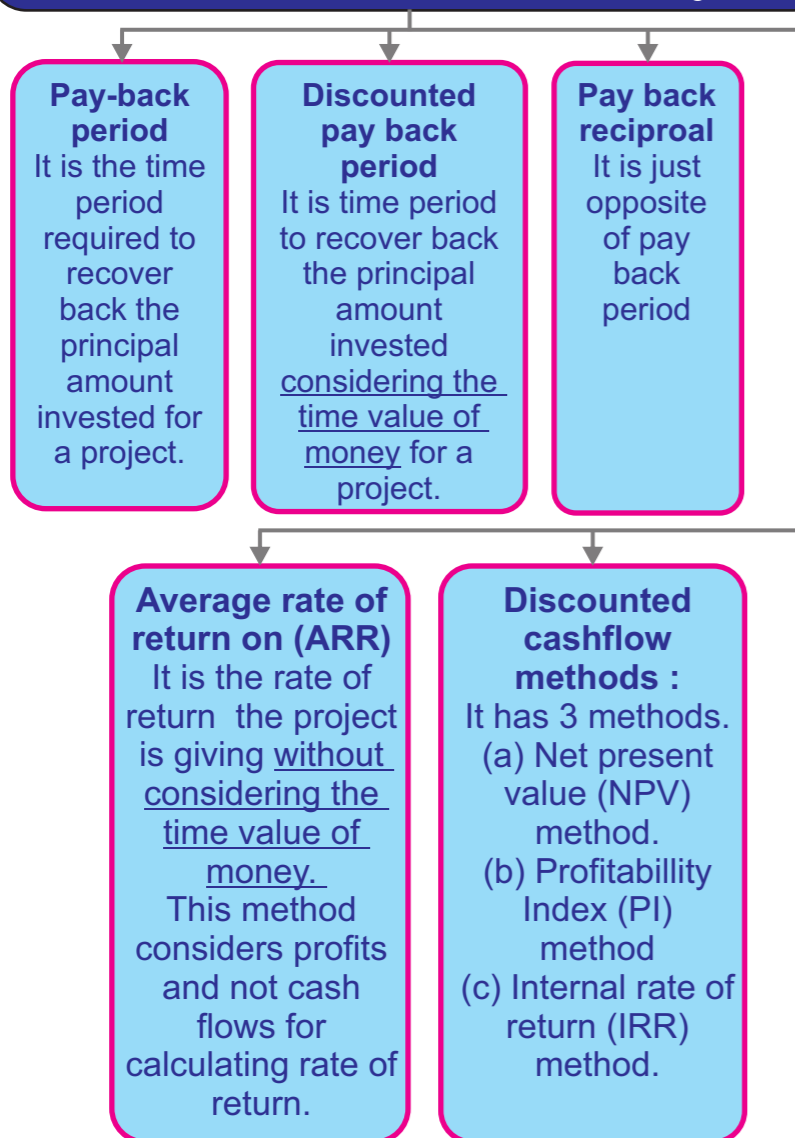
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- Capital budgeting includes the techniques which are used to evaluate capital expenditure decision.
- The capital expenditure decisions are very important for a financial manager mainly because
  - They are irreversible in nature
  - They involve huge amount of investment
  - They have long term implications
- Capital expenditures should be properly evaluated using capital budgeting techniques :-

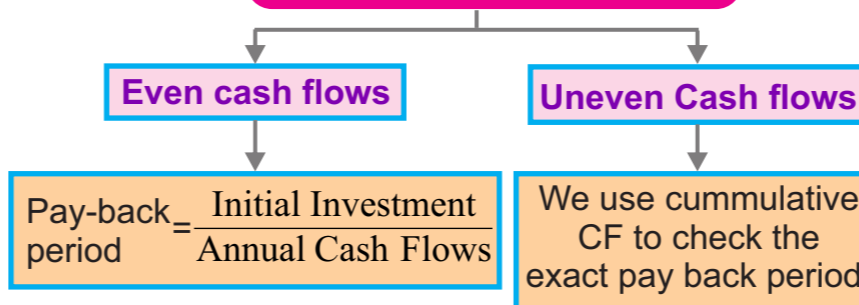
## CAPITAL BUDGETING TECHNIQUES



Each of the above techniques is discussed in detail as under :-

### I) Pay-back period

#### TYPES OF CASH IN FLOW



☛ Selection criteria : Lesser the pay back period better the project.

### II) Discounted pay-back period :

- ➔ We first discount the CFs of future years to PV.
- ➔ Then discounted CFs are cumulated to check the exact discounted pay back period
- ➔ It is same like pay back period, except that here future years cash flows are discounted and then cumulated

☛ Selection criteria : Lesser the discounted pay back period better the project.

### III) Pay-back Reciprocal :

- ➔ As the name suggests, it is exactly opposite of pay back method.
- ➔ Here pay back reciprocal is calculated as :

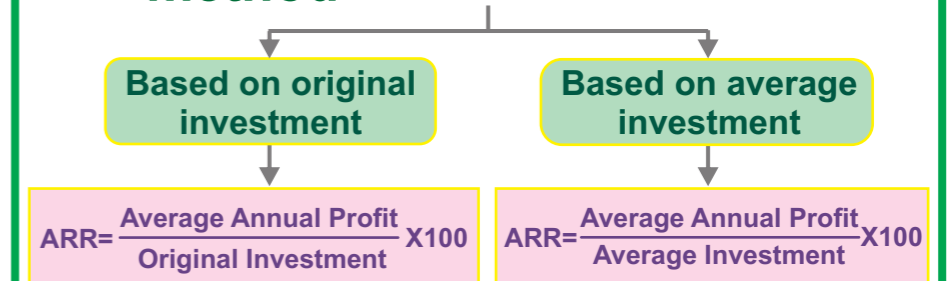
$$= \frac{\text{Average Annual Cash Flows}}{\text{Initial Investment}} \times 100$$

- ➔ Where, Average Annual Cash Flows =  $\frac{\text{Total Cash Flows}}{\text{No. of years}}$

- ➔ It indicates the annual rate of return on Initial Investment, without considering time value of money.

☛ Selection criteria : Higher the pay back reciprocal, better the project.

### IV ) Average rate of return (ARR) method



where, Average Annual Profit =  $\frac{\text{Total Profit}}{\text{No. of years}}$  and

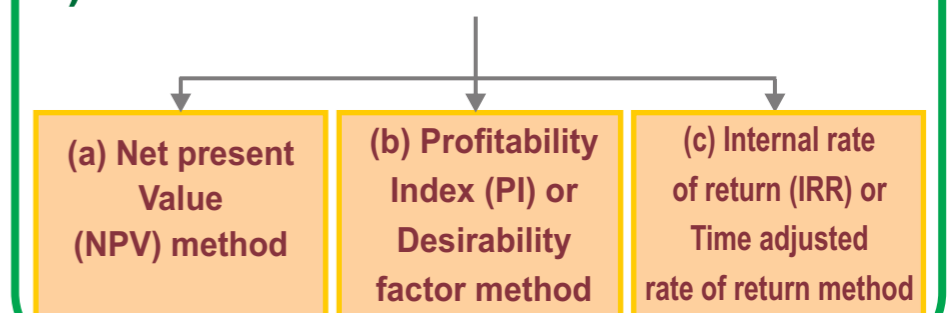
$$\text{Average Investment} = \frac{\text{Opening WDV} + \text{Closing WDV}}{2}$$

Or

$$\frac{\text{Original Investment} - \text{Scrap Value}}{2} + \frac{\text{Additional working Capital} + \text{Scrap Value}}{2}$$

Selection criteria : Higher the ARR, better the project.

### V) Discounted Cash Flow methods





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### (A) NET PRESENT VALUE (NPV) METHOD:

- As the name suggests it is the net present value of all cash inflows and cash outflows
- ∴ Net present value = Present value of cash inflows – Present value of cash outflows (NPV)
- It indicates by investing the project cost today how much extra we are getting in today's value.
- The cashflows are discounted using cost of capital.
- If NPV is +ve, we accept the project.
- Between 2 projects the projects with higher NPV will be selected
- Where the life of 2 projects under consideration is not same EAV is used as :

$$\text{Equated Annual Value(EAV)} = \frac{\text{NPV}}{\text{PVAF for life of project}}$$

### (B) PROFITABILITY INDEX (PI) METHOD

$$\text{PI} = \frac{\text{PV of Cash in Flows}}{\text{PV of Cash out Flows}} \quad \text{Or} \quad \text{PI} = \frac{\text{NPV} + \text{Initial Investment}}{\text{Initial Investment}}$$

- It indicates that for every 1 rupee invested in the project of how much we are getting in today's value.
- ☛ Selection Criteria : Higher the PI Better the project

### (C) INTERNAL RATE OF RETURN (IRR) METHOD :-

$$\text{IRR} = \text{Start rate} + \frac{\text{Surplus}}{\text{Surplus} + \text{Deficit}} \times \text{Difference in rate}$$

- It is the rate of return given by the project.
- If IRR is taken as discounting rate, the NPV is always zero & PI is 1.
- Selection Criteria :
- ☛ If there is single project under consideration, IRR should be compared with cut off rate. We accept the project if, IRR > cut off rate. Here cut off rate is minimum required rate of return.
- ☛ Between 2 projects, project with higher IRR should be selected.

### Important points to remember :

- (1) Depreciation is non cash expense.
- (2) Still we consider depreciation for calculating tax amount.
- (3) If there is no tax rate given, we ignore depreciation.
- (4) If tax amount is given, we ignore depreciation.
- (5) Calculation of cash inflows / outflows during project life, if tax rate is given :

If profits are given		If expenses are given	
Profit / Income	xxxx	Expenses	xxxx
(+) Any other Income	xx	(+) Any other expense	xx
	-----		-----
	xxxx		xxxx
(-) Expenses	xx	(+) Depreciation	xx
(-) Depreciation	xx		-----
	-----	Total expenses	xxxx
Profit before tax	xxxx	(-) Tax shield @ 30% on total expenses	-----
(-) Tax @ 30% on PBT	xx		xxxx
	-----	(-) Depreciation	xxx
Profit after tax	xxxx		-----
(+) Depreciation	xx	Cash out flows	xxxx
	-----		-----
Cash inflows	xxxx		
	-----		

### Effective Interest Rate (EIR) : It is same like Internal rate of return (IRR)

Definition of 'Effective Interest Rate': It is 'the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial asset or financial liability to the gross carrying amount of a financial asset or to the amortised cost of a financial liability.'



# CHAPTER-7- FINANCIAL ANALYSIS AND PLANNING



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## 1. LIQUIDITY RATIOS

Sr.No.	Ratio	Formula	Significance
1	Current Ratio	$\frac{\text{Current Assets}}{\text{Current Liabilities}}$	→ Indication of availability of Current Assets to pay off Current liabilities.
2	Liquid Ratio or Quick Ratio	$\frac{\text{Quick Assets}}{\text{Current Liabilities}}$	→ Indication of availability of quick assets to honour its current liabilities .
3	Absolute cash Ratio	$\frac{\text{Cash \& Bank Balance + Marketable Securities}}{\text{Current Liabilities}}$	→ Indication of ready cash available to meet current liabilities.
4	Basic Defence/ Interval Ratio	$\frac{\text{Cash \& Bank Balance + Marketable Securities}}{\text{Operating exp./ No. of Days}}$	→ It measures the ability of firm to meet regular cash expenditures with the available cash.
5	Net working Capital Ratio	$\text{Current Assets} - \text{Current Liabilities}$	→ Indication of short term liquidity position of business.

## 2. CAPITAL STRUCTURE RATIOS :

Sr.No.	Ratio	Formula	Significance
1	Equity ratio	$\frac{\text{Share Holders Equity}}{\text{Capital Employed}}$	→ It indicates the composition of shareholder's funds in capital employed
2	Debt Ratio	$\frac{\text{Total outside LT liabilities}}{\text{Capital employed}}$	→ It indicates the composition of outside liabilities in total capital employed.
3	Debt to Equity Ratio	$\frac{\text{Total Outside LT Liabilities}}{\text{Shareholder's equity}}$	→ The ratio is useful for deciding upon the capital structure → Indicator of financial leverage.
4	Debt to Total assets Ratio	$\frac{\text{Total Outside LT Liabilities}}{\text{Total Assets}}$	→ It measures how much of the total assets are financed by debt.
5	Capital Gearing Ratio	$\frac{\text{Preference Share Capital+ Debentures + other borrowed funds}}{\text{Equity Share Capital + Reserves and Surplus-losses}}$	→ The ratio is useful to show the proportion of fixed interest (dividend) bearing capital to funds belonging to equity shareholders.
6	Proprietary Ratio	$\frac{\text{Proprietary Fund}}{\text{Total Assets}}$	→ The ratio indicates proprietor's stake in total assets. Higher the ratio, lower the risk

## 3. COVERAGE RATIO:

Sr.No.	Ratio	Formula	Significance
1	Debt Service Coverage Ratio or (DSCR)	$\frac{\text{Earning available for debt service}}{\text{Interest + Principal installments}}$	→ Ratio of 1.6 is treated by financial institutions as satisfactory ratio.
2	Interest Coverage Ratio	$\frac{\text{EBIT}}{\text{Interest}}$	→ The ratio indicates adequacy of profit to cover interest.
3	Preference dividend coverage ratio	$\frac{\text{Net profit / Earning after taxes (EAT)}}{\text{Preference dividend liability}}$	→ The ratio indicates adequacy of profit to cover preference dividend.
4	Fixed Charges Coverage Ratio	$\frac{\text{EBIT + Depreciation}}{\text{Interest + } \frac{\text{Re-payment of loan}}{1 - \text{Tax rate}}}$	→ The ratio indicates adequacy of profit to cover fixed commitments of a company.

# Earnings available for debt service = Net Profit after taxation + Non Cash operating expenses like depreciation and other amortisations + Non-operating adjustments + Interest on long term loans.

\* The ratio is also worked out as =  $\frac{\text{Earnings before interest on term loan but after taxation}}{\text{Interest on term loans}}$

## 4. ACTIVITY RATIO/ EFFICIENCY RATIO/ PERFORMANCE RATIO/TURNOVER RATIO :

Sr.No.	Ratio	Formula	Significance
1	Total Assets turnover Ratio	$\frac{\text{Sales}}{\text{Total Assets (Average)}}$	→ Indicator of utilisation of Total assets → In case of significant change, take 'Average Total Assets' available for use.
2	Fixed Assets Turnover ratio	$\frac{\text{Sales}}{\text{Fixed Assets (Average)}}$	→ Indicator of utilisation of fixed assets → In case of significant change, take 'Average Fixed Assets' available for use
3	Capital Turn-over Ratio	$\frac{\text{Sales}}{\text{Capital Employed}}$	→ Indicator of utilisation of capital employed
4	Working Turnover ratio	$\frac{\text{Sales}}{\text{Net Working Capital}}$	→ In case of significant change, take 'Average Working Capital' employed



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Sr.No.	Ratio	Formula	Significance
5	Inventory (FG) Turnover Ratio	$\frac{\text{Sales/ Cost of goods sold}}{\text{Average Inventory (FG)}}$	→ Stock holding ratio can be calculated as : Average Inventory Average daily or monthly cost of sales
	Inventory (RM) Turnover Ratio	$\frac{\text{RM Consumed}}{\text{Average Inventory (RM)}}$	
6	Debtors Turn-over Ratio	$\frac{\text{Credit Sales}}{\text{Average Account Receivable}}$	→ Accounts Receivable = Sundry Debtors + Bills Receivable
7	Receivable (Debtors) velocity	$\frac{\text{Average accounts receivable}}{\text{Average Daily credit sales}}$	→ More the velocity, better the management.
8	Payables turnover Ratio	$\frac{\text{Credit Purchases}}{\text{Average Accounts Payables}}$	→ Lesser the velocity, better the management.

### 5. PROFITABILITY RATIO BASED ON SALES:

Sr.No.	Ratio	Formula	Significance
1	Gross Profit Ratio	$\frac{\text{Gross Profit}}{\text{Sales}} \times 100$	→ Indication of gross margin available on ₹ 100 Sales
2	Net Profit Ratio	$\frac{\text{Net Profit}}{\text{Sales}} \times 100$	→ Indication of net margin of profit available on ₹ 100 Sales.
3	Operating Profit Ratio	$\frac{\text{Operating Profit}}{\text{Sales}} \times 100$	→ Indication of operating profit margin available on ₹ 100 Sales.

### 6. EXPENSES RATIO:

Sr.No.	Ratio	Formula	Significance
1	Cost of goods sold (COGS) Ratio	$\frac{\text{COGS}}{\text{Sales}} \times 100$	→ Indication of COGS as proportion of sales
2	Operating Expenses Ratio	$\frac{\text{Administrative exps.+ Selling \& Distribution overhead}}{\text{Sales}} \times 100$	→ Indication of Indirect Expenses as proportion of sales
3	Operating Ratio	$\frac{\text{COGS + Operating Exps.}}{\text{Sales}} \times 100$	→ Indication of Direct & Indirect Cost of Operation as proportion of sales
4	Financial expenses Ratio	$\frac{\text{Financial Expenses}}{\text{Sales}} \times 100$	→ Indication of Financial Expenses as proportion of sales

### 7. PROFITABILITY RATIOS RELATED TO OVERALL RETURN ON ASSETS/ INVESTMENT:

Sr.No.	Ratio	Formula	Significance
1	Return on Investment (ROI)	$\frac{\text{Return /Profit /Earnings}}{\text{Investments}} \times 100$	→ It is an indicator of overall efficiency
2	Return on Assets (ROA)	$\frac{\text{Net Profit after taxes}}{\text{Average Total Asset}}$	
3	Return on Capital employed ROCE (Pre-tax)	$\frac{\text{EBIT}}{\text{Capital Employed}} \times 100$	
4	Return on Capital employed ROCE (Post-tax)	$\frac{\text{EBIT (1-t)}}{\text{Capital Employed}} \times 100$	
5	Return on Equity (ROE)	$\frac{\text{Net Profit after taxes - Preference dividend}}{\text{Equity shareholder's fund}} \times 100$	→ Indication of a firm's profitability and potential growth

### 8. PROFITABILITY RATIOS REQUIRED FOR ANALYSIS FROM OWNER'S POINT OF VIEW:

Sr.No.	Ratio	Formula	Significance
1	Earning per share (EPS)	$\frac{\text{Net Profit available to Equity Shareholders}}{\text{No. of equity share outstanding}}$	→ EPS is the measure to relate the return to equity shareholders.
2	Dividend per Share	$\frac{\text{Dividend paid to equity shareholders}}{\text{No. of equity share outstanding}}$	→ It is the proportion of Profit distributed per equity share
3	Dividend payout Ratio (DP)	$\frac{\text{Dividend per equity Share}}{\text{Earning per share(EPS)}}$	→ Indication of distribution of profit as percent of Earning



## 9. PROFITABILITY RATIOS RELATED TO MARKET / VALUATION/ INVESTOR:

Sr.No.	Ratio	Formula	Significance
1	Price- Earnings per share(P/E Ratio)	$\frac{\text{Market Price per share(MPS)}}{\text{Earnings per Share(EPS)}}$	→ Indication of payback period to the investor
2	Dividend Yield	$\frac{\text{Dividend} \pm \text{change in share price}}{\text{Initial share price}} \times 100$ OR $\frac{\text{Dividend per share(DPS)}}{\text{Market price per share(MPS)}} \times 100$	→ It relates Dividend paid to the market price of the shares
3	Earning Yield	$\frac{\text{Earning per share(EPS)}}{\text{Market price per share(MPS)}} \times 100$	→ It relates Earning per share to the market price of the shares → It is inverse of P/E ratio.
4	Market value / Book value per share	$\frac{\text{Market value per share}}{\text{Book value per share}}$	→ It indicates Market response of the shareholder's investment.
5	Q Ratio	$\frac{\text{Market value of equity and liabilities}}{\text{Estimated replacement cost of assets}}$	→ It measures market value of Equity share as well as debt in comparison to all assets at their replacement cost.

## 10. OTHER RATIOS :

Sr.No.	Ratio	Formula	Significance
1	Appropriation Ratios	$\frac{\text{Interest}}{\text{EBIT}} \times 100$ $\frac{\text{Tax}}{\text{EBIT}} \times 100$ $\frac{\text{Pref. Dividend}}{\text{EBIT}} \times 100$ $\frac{\text{Transfer to dividend Equalisation Fund}}{\text{EBIT}}$ $\frac{\text{Retained Earnings (out of current profits)}}{\text{EBIT}}$ $\frac{\text{Equity Dividend}}{\text{EBIT}}$	→ Indication of Disposal or appropriation of Income. → These ratios are usually calculated with reference to EBIT.



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## USERS & OBJECTIVE OF FINANCIAL ANALYSIS:

Sr.No.	User	Objectives	Ratios used in general
1	Shareholders	Being owners of the organisation they are interested to know about profitability and growth of the organization	<ul style="list-style-type: none"> <li>Mainly Profitability Ratio [In particular Earning per share (EPS), Dividend per share (DPS), Price Earnings (P/E), Dividend Payout ratio (DP)]</li> </ul>
2	Investors	They are interested to know overall financial health of the organisation particularly future perspective of the organisations.	<ul style="list-style-type: none"> <li>Profitability Ratios</li> <li>Capital structure Ratios</li> <li>Solvency Ratios</li> <li>Turnover Ratios</li> </ul>
3	Lenders	They will keep an eye on the safety perspective of their money lent to the organisation	<ul style="list-style-type: none"> <li>Coverage Ratios</li> <li>Solvency Ratios</li> <li>Turnover Ratios</li> <li>Profitability Ratios</li> </ul>
4	Creditors	They are interested to know liability position of the organisation particularly in short term. Creditors would like to know whether the organisation will be able to pay the amount on due date.	<ul style="list-style-type: none"> <li>Liquidity Ratios</li> <li>Short term solvency Ratios/ Liquidity Ratios</li> </ul>
5	Employees	They will be interested to know the overall financial wealth of the organisation and compare it with competitor company	<ul style="list-style-type: none"> <li>Liquidity Ratios</li> <li>Long terms solvency Ratios</li> <li>Profitability Ratios</li> <li>Return of investment</li> </ul>
6	Regulator / Government	They will analyse the financial statements to determine taxations and other details payable to the government.	<ul style="list-style-type: none"> <li>Profitability Ratio</li> </ul>
7	Managers a) Production managers b) Sales managers	They are interested to know various data relating to input output, production quantities etc  Data related to quantities of sales for various years, other associated figures and produced future sales figure will be an area of interest for them	<ul style="list-style-type: none"> <li>Input output Ratio</li> <li>Raw material consumption</li> <li>Turnover ratios (basically receivable turnover ratio)</li> <li>Expenses Ratios</li> </ul>



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Sr.No.	User	Objectives	Ration used in general
	c) Fianancial managers	They are interested to know various ratios for their future predictions of financial requirement.	<ul style="list-style-type: none"> <li>Profitability Ratios (particularly related to Return on investment)</li> <li>Turnover ratios</li> <li>Capital Structure Ratios</li> </ul>
	(d) Chief Executives/ General Manager	They will try to find the entire perspective of the company, starting from Sales, Finance, Inventory, Human resources, Production etc.	<ul style="list-style-type: none"> <li>All Ratios</li> </ul>
8	Different Industry a) Telecom b)Bank c)Hotel d)Transport	Finance Manager /Analyst will calculate ratios of their company and compare it with Industry norms.	<ul style="list-style-type: none"> <li>Ratio related to 'call'</li> <li>Revenue and expenses per customer</li> <li>Loan to deposit Ratios</li> <li>Operating expenses and income ratios</li> <li>Room occupancy ratio</li> <li>Bed occupancy Ratios</li> <li>Passenger -kilometre</li> <li>Operating cost - per passenger kilometre.</li> </ul>

## CALCULATION OF RETURN ON EQUITY

To calculate the return on equity using the DuPont model, simply multiply the three components (net profit margin, asset turnover, and equity multiplier).

$$\text{Return on Equity} = (\text{Net Profit Margin}) (\text{Asset Turnover}) (\text{Equity Multiplier})$$

$$\text{Return on Equity (ROE)} = \text{PAT} \div \text{NW}$$

$$\text{Return on Net Assets (RONA)} = \text{EBIT} \div \text{NA}$$

$$\text{Financial Leverage (Income)} = \text{PAT} \div \text{EBIT}$$

$$\text{Financial Leverage (Balance Sheet)} = \text{NA} \div \text{NW}$$

$$\text{Profit Margin} = \text{EBIT} \div \text{Sales}$$

$$\text{Assets Turnover} = \text{Sales} \div \text{NA}$$

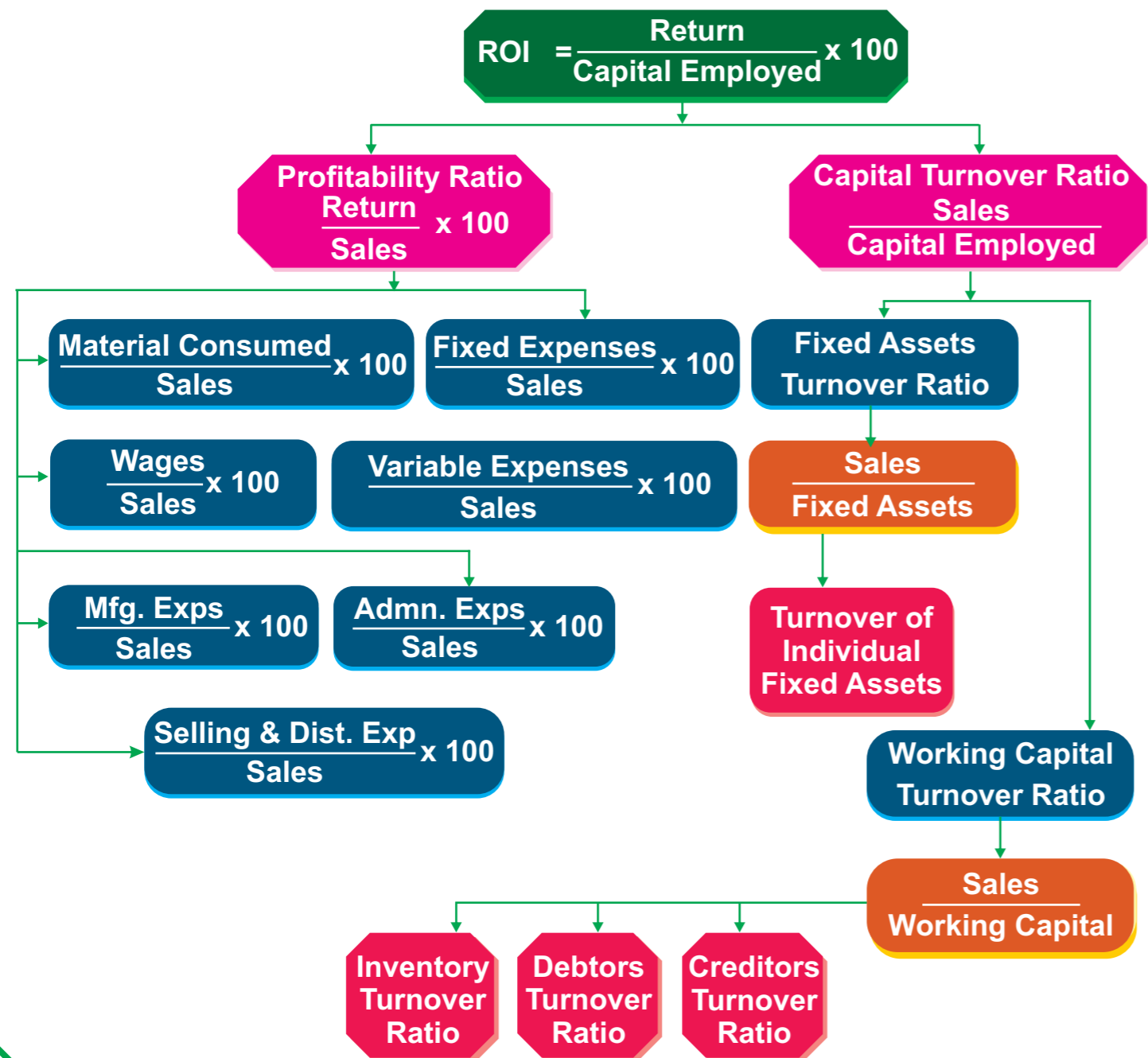
### LIMITATIONS OF FINANCIAL RATIOS:

1. The primary data on which ratios are based must be absolutely reliable and non manipulated.
2. Differences in accounting policies, interpretation of financial terms and accounting periods make accounting data of two firms non-comparable as also the accounting ratios. Adjustments are necessary to sort out such differences.
3. There is no standard set of ratios.
4. Seasonal factors may influence financial data (i.e. resorting to favourable year-end adjustments)
5. Window dressing can change the character of financial ratios.
6. In case of diversified product lines aggregate data cannot be used for inter-firm comparisons.
7. Financial data are badly distorted by inflation.
8. Financial ratios are inter related, not independent. Viewed in isolation may lead to erroneous conclusions. Such inter dependence among the ratios can be taken care of through multi-variate analysis.
9. Timely ratio analysis provide clues but not conclusions. These are tools in the hands of experts for their own interpretations.



## DU PONT CONTROL CHART

Return on investment (ROI) represents the earning power of the company.



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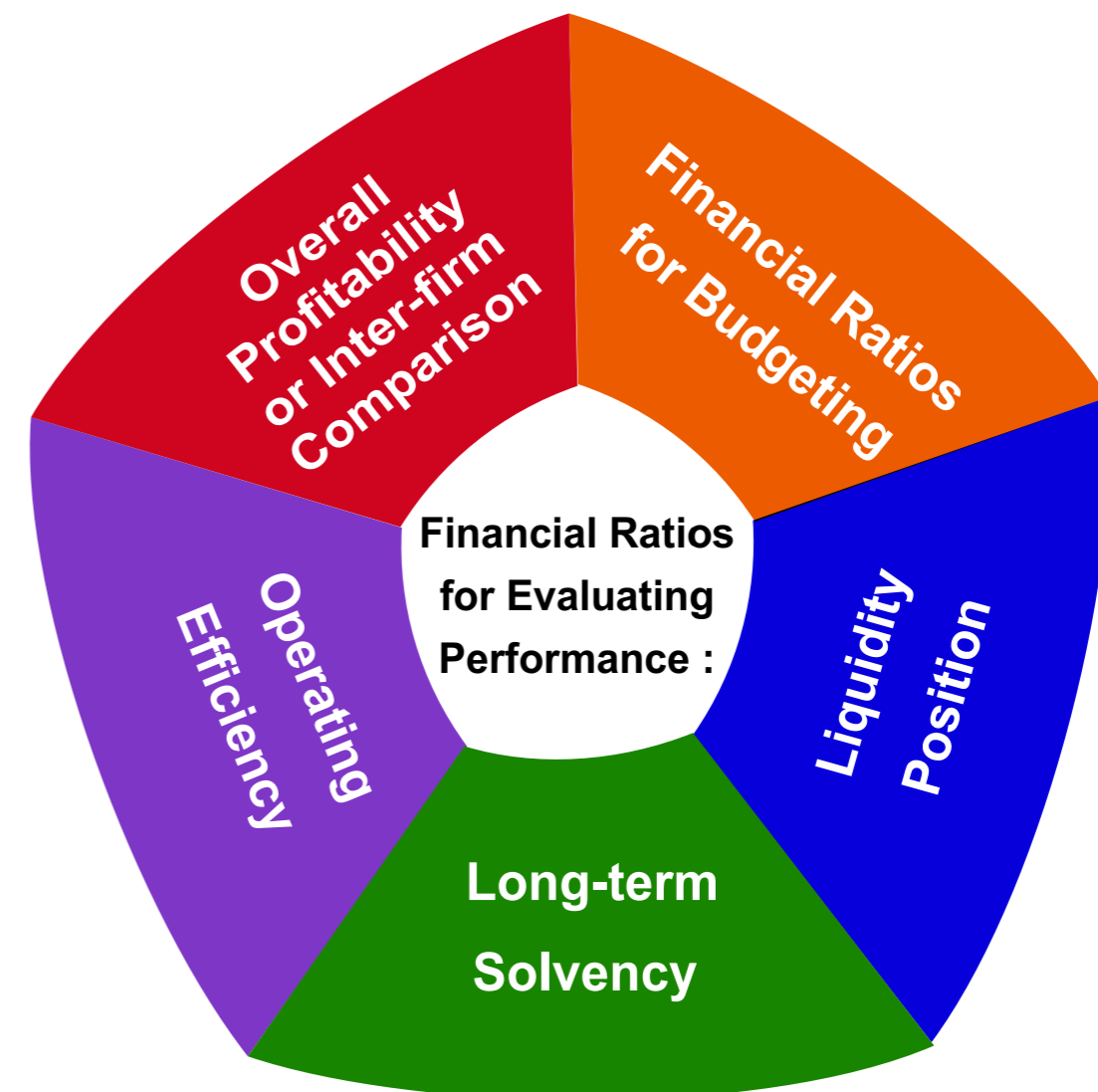
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## I. FINANCIAL RATIO ANALYSIS

It is a process of determining, interpreting and presenting numerical relationships of items and group of items in the financial statements.







# CHAPTER-8- DIVIDEND DECISIONS



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## Factors Affecting Dividend Policy

### External Factors

1. General State of Economy  
(Depression & Prosperity → Dividend ↓)
2. State of capital market  
(Easy access → Dividend ↑)
3. Legal restrictions (By law & order)
4. Contractual restrictions (By lenders)
5. Tax Policy (Corporate Tax & DDT)

### Internal Factors

1. Desire of shareholders  
(Generally dividend expectations ↑ because of  
a) Strength Indication.  
b) Uncertainty ↓  
c) Need for current income
2. Financial needs of company  
(Most important amongst all)
3. Nature of earnings (Stable income = Dividend ↑)
4. Desire of control (Control desire ↑ = Dividend ↓)
5. Liquidity Position (Liquidity ↓ = Dividend ↓)

$$\begin{aligned} \text{Dividend Rate} &= \frac{\text{DPS}}{\text{FV}} \times 100 \\ \text{Dividend Payout} &= \frac{\text{DPS}}{\text{EPS}} \times 100 \\ \text{Dividend Yield} &= \frac{\text{DPS}}{\text{MPS}} \times 100 \\ \text{Earning Yield or Capitalisation Rate (Ke)} &= \frac{\text{EPS}}{\text{MPS}} \text{ or } \frac{1}{\text{P/E Ratio}} \end{aligned}$$

Where, DPS = Dividend per share  
FV = Face value  
EPS = Earning per share  
MPS = Market price per share  
P/E = Price Earning

### Alternative to Dividend

- ☛ Stock Split
- ☛ Reverse Stock Split
- ☛ Bonus Shares
- ☛ Buy Back of Shares
- ☛ Right Shares

### Pricing of buy-back :-

$$\text{Buy back Price} = \frac{S \times P_0}{(S - N)}$$

Where, S = No. of shares outstanding before buy-back  
P<sub>0</sub> = Current Market price  
N = No. of shares bought back

### Right Shares :- $P = \frac{M \times N + S}{N + 1}$

Where, M = Cum-right market price  
N = No. of old share entitled to purchase one right share  
S = Subscription price of new share

Value of right alone = Ex-right price (-) Subscription Price

$$\text{Value of right per share} = \frac{\text{Value of right alone}}{\text{No. of old share entitled to purchase right}} \text{ Or}$$

Value of right per share = Cum-right Price (-) Ex-right Price



## Approaches to Dividend Policy

### 1. Walter's Approach

$$\text{Theoretical Market Value of Equity share} = \frac{D + \frac{R(E-D)}{K_e}}{K_e}$$

Where, D = Dividend per share  
E = Earning per share  
Ke = Cost of Equity capital  
R = Internal rate of return

### 2. Gordon's Model

$$P = \frac{E(1-b)}{K_e - br}$$

Where, P = Theoretical share price  
E = Earning per share  
b = Retention Ratio  
(1-b) = Dividend Payout ratio  
Ke = Cost of equity capital  
br = Growth Rate

Conclusion : If  $R > K_e \rightarrow$  Payout of dividend should be minimum  
If  $R < K_e \rightarrow$  Payout of dividend should be maximum &  
If  $R = K_e \rightarrow$  Dividend Payout can be any where between 0-100%

### 5. Traditional or Graham & Dodd Model

$$P = m \left[ \frac{D + E}{3} \right]$$

Where, P = Market Price  
m = multiplier  
D = Dividend per share  
E = Earning per share



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### 4. Lintner's Model

$$D_1 = D_0 + [(EPS \times \text{Target Payout}) - D_0] \times Af$$

Where,  $D_1$  = Dividend of Period 1  
 $D_0$  = Dividend of Period 0  
EPS = Earning per share  
Af = Adjustment factor

### 3. Modigliani & Miller's Approach (MM Hypothesis)

$$P_0 = \frac{D_1 + P_1}{1+K_e} \quad \text{Or} \quad P_1 = P_0(1+K_e) - D_1$$

Where,  $P_0$  = Prevailing Market price of share  
 $D_1$  = Dividend of next period  
 $P_1$  = Market price of share at end of period one.  
Ke = Cost of equity capital

$$\Delta n = \frac{I - (E - nD_1)}{P_1}$$

$$\text{\& Value of firm} = \frac{(n + \Delta n) P_1 - (I - E)}{1 + K_e}$$

Where,  $\Delta n$  = No. of shares to be issued  
I = Investment amount required  
E = Total earning of firm  
n = Existing number of shares  
 $nD_1$  = Total Dividend paid during year



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# CHAPTER-1- Introduction to Strategic Management



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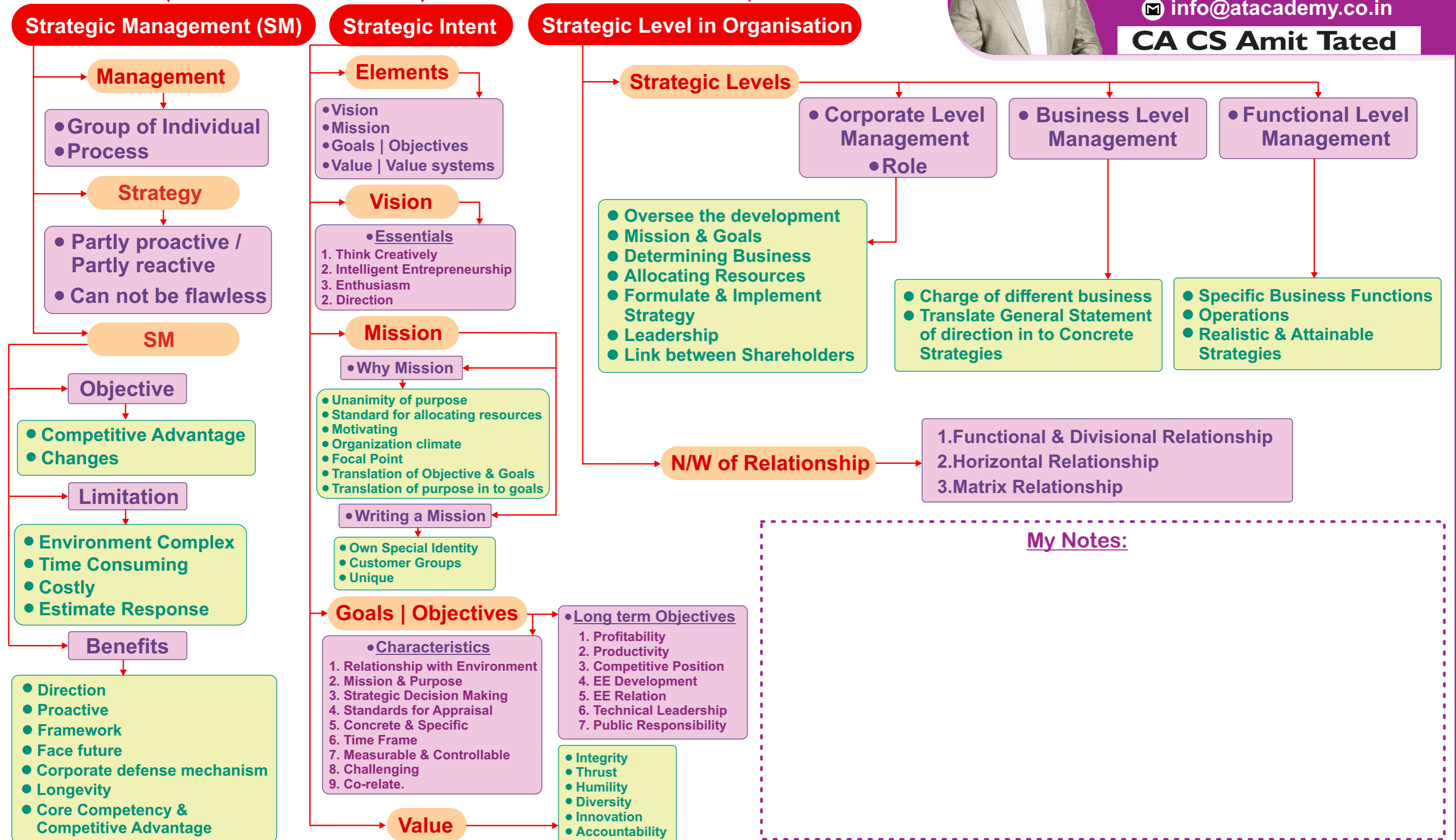


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My Notes:



# CHAPTER-2- Strategic Analysis : External Environment



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## Strategic Analysis

### Issues

- Strategy evolved over a period of time
- Balance of Internal & External Factors

### Strategic Risk

- **Short time**
  - (a) External - Errors
  - (b) Internal - Cope up
- **Long Time**
  - (a) External - Obsolete
  - (b) Internal - In consistencies

### Strategic Analysis

- **Internal**
  - Performance Analysis
  - Determinants Analysis
- **External**
  - Customer Analysis
  - Competitor Analysis
  - Market Analysis
  - Environment Analysis

### PESTLE

- Political
- Economic
- Socio Cultural
- Technological
- Legal
- Environment

## Business Environment

### Helps Business

1. Opportunities & Threats
2. Direction for Growth
3. Continuous Learning
4. Image Building
5. Meeting Competition

### Micro / Macro

- **Micro Environment**
  1. Employees
  2. Customer
  3. Finance
  4. Firm Supplier
  5. Local Community
  6. Direct Competition

### • Macro Environment

- **Demographic Environment**
  - Market Size
  - Opportunity

- **Socio Cultural Environment**
  - Social Trends
  - Culture
  - Beliefs
  - Literacy

- **Economic Environment**
  - Purchasing Power
  - Income
  - Debt
  - Credit Availability

- **Political | Legal Environment**

- **Technological Environment**
  - R & D

- **Globalisation**
  - Internationalization

## Internationalisation

### Characteristics

- Conglomerate
- Common pool of Resources
- Common Strategy

### Steps

- Evaluate Opportunity & Threat
- Scope
- Objectives
- Distinct Corporate Strategies

### Why Global

- Need to Grow
- Time & Distance
- Domestic Market not enough
- Resources
- Transportation Cost
- Grow Big
- World Economy
- Trade Barrier Collapse
- Strategic Alliance

### Assessment of International Environment

- Multinational Environment Analysis
- Regional Environment Analysis
- Country Environment Analysis

## Product & Industry

## Market & Customer

## Competitive Strategy

### Market 4P's

- Product
- Place
- Pricing
- Promotion

### Customer

- Customer Analysis

- Customer Behaviour Elements
- External Influences
- Internal Influences
- Decision Making
- Post-Decision Process

### Competitive Landscape

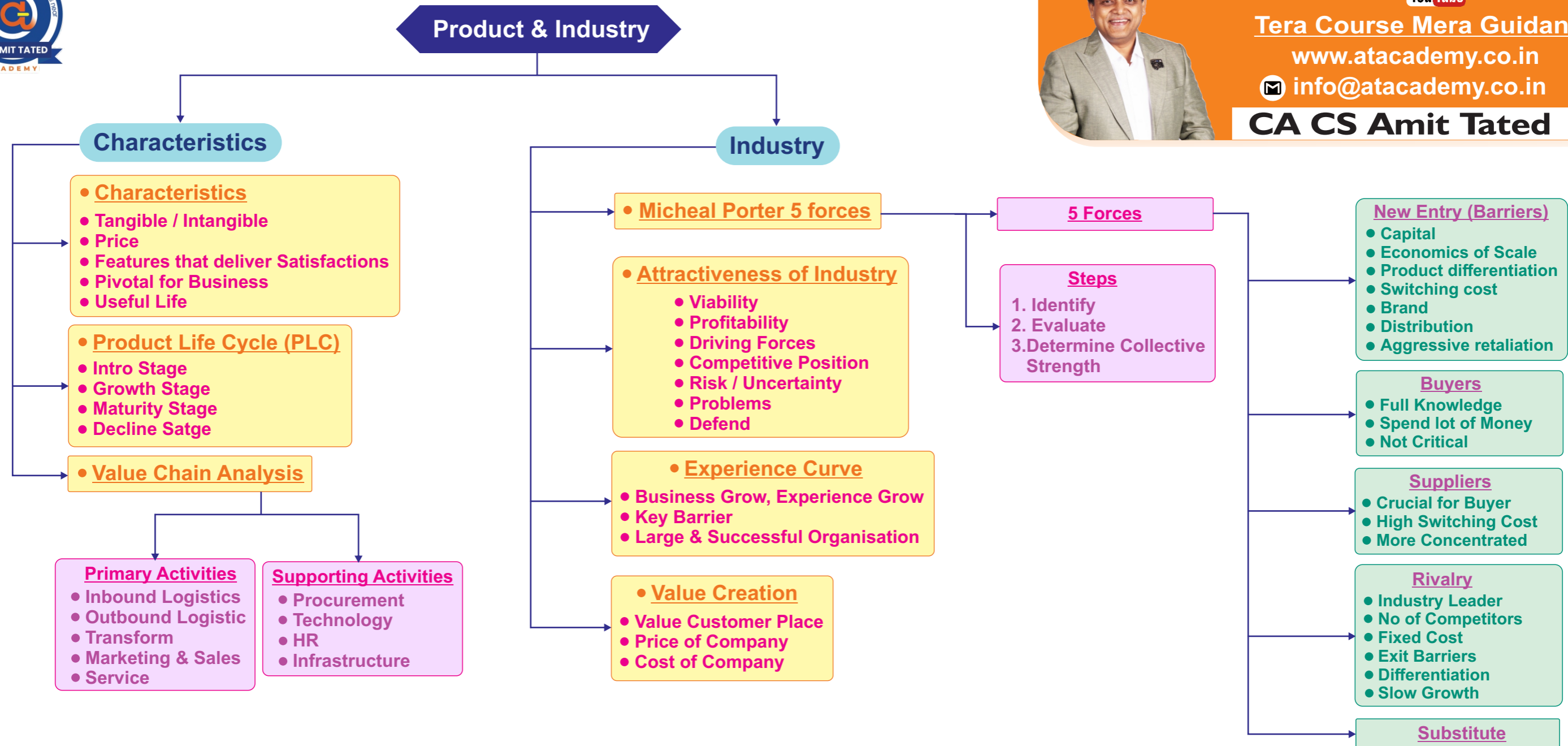
1. Identify Competitor
2. Understand Competitor
3. Determine Strengths
4. Determine Weakness
5. Put all Information Together

### Key Success Factor

1. On what basis customer choose
2. Resources & Capabilities
3. Sustainable Competitive Advantage

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# CHAPTER-3- Strategic Analysis : Internal Environment



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## Stakeholders

### Understanding Key Stakeholders



## Strategic Drivers

### Industry & Markets

- **Strategic Group Mapping**
  1. Identify Competitive Characteristics
  2. Plot the firms on 2 Variable Maps
  3. Assign Firms
  4. Draw Circle

### Customer

- **Pricing Customer**
- **Value Creation Consumer**

## Core Competency, SWOT, Competitive Advantage

### Core Competency

- **Areas (C.K. Prahalad)**
  1. Competitor Differentiation
  2. Customer Value
  3. Application to Other markets

### Criteria

1. Valuable
2. Costly to imitate
3. Non - Substitutable
4. Rare

## Michel, Porter's, Generic Strategies

### Competitive Advantage

- **Sustainability**
  1. Durability
  2. transferability
  3. Imitability
  4. Appropriability

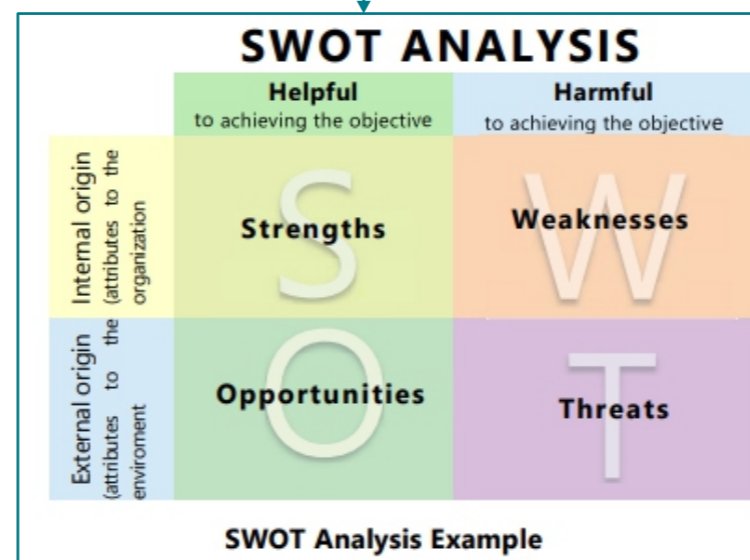
### Products / Service

1. Social Marketing
2. Augmented Marketing
3. Direct Marketing
4. Relationship Marketing
5. Service Marketing
6. Person Marketing
7. Organisation Marketing
8. Place Marketing
9. Enlightened Marketing
10. Differential Marketing
11. Synchro Marketing
12. Concentrated Marketing
13. De-marketing

### Channels

1. Sales Channel
2. Product Channel
3. Service channel

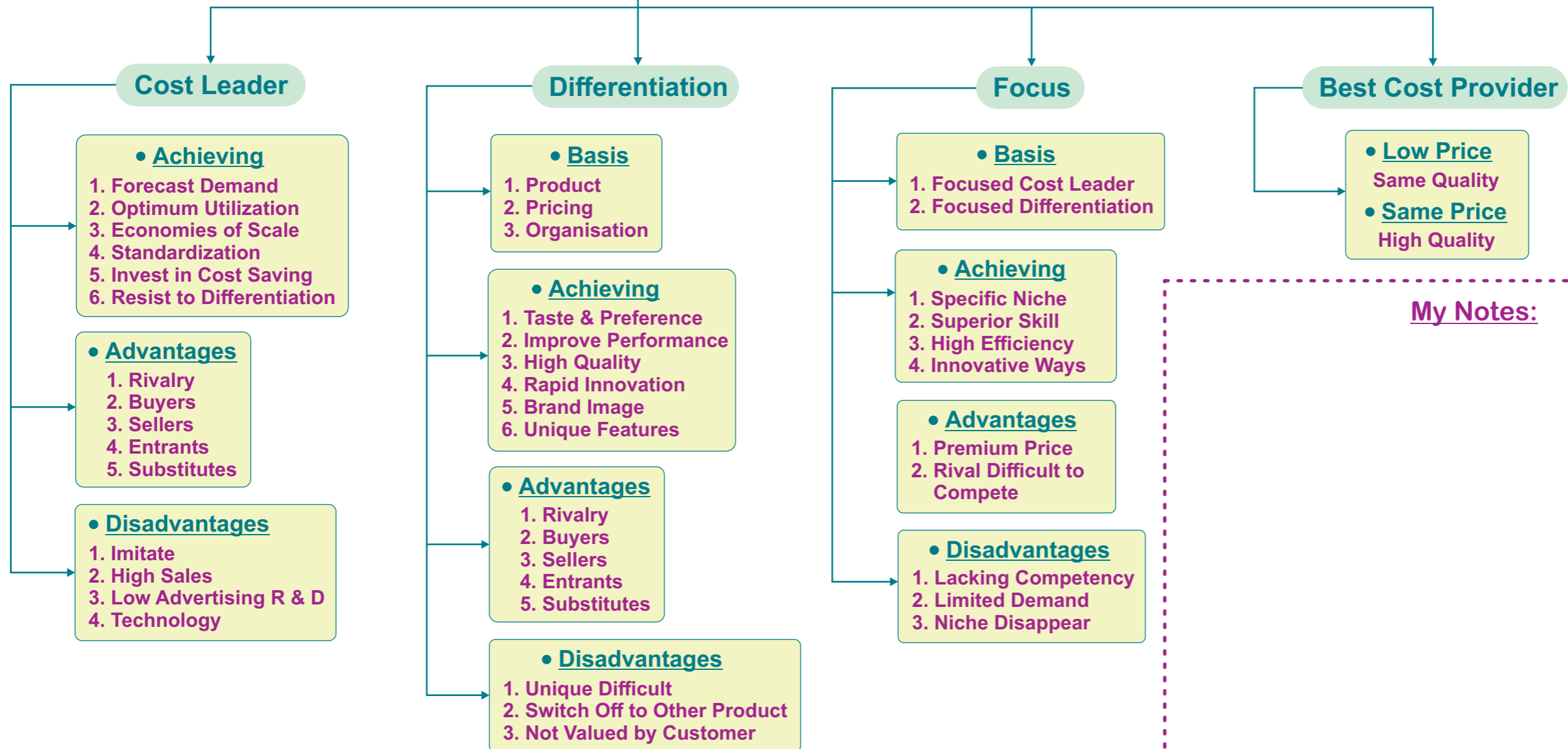
## SWOT



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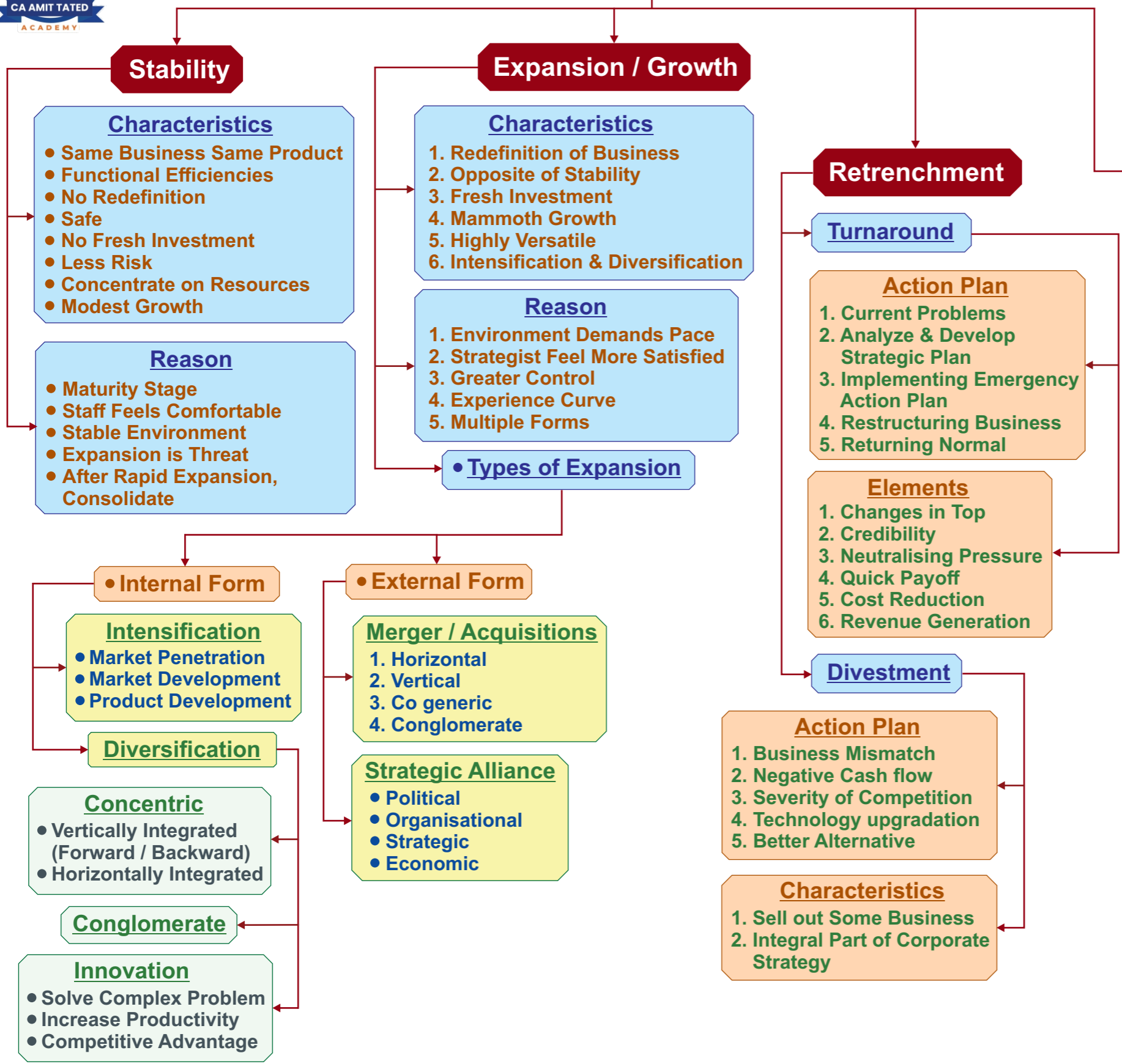
## Michel Porter's, Generic Strategies



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# CHAPTER-4- Strategic Choices



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## Strategic Options

- Ansoff's Matrix
- ADL Matrix
- BCG Matrix
- GE Matrix



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### Ansoff's Matrix

	Existing Products	New Products
Existing Markets	Market Penetration	Product Development
New Markets	Market Development	Diversification

Ansoff's Product Market Growth Matrix

2

### GE Matrix

		Relative Market Share	
		High	low
Market Growth Rate	High	Stars 	Question Marks 
	Low	Cash Cows 	Dogs 

BCG Growth-Share Matrix

3

### ADL Matrix

Stage of industry maturity - Arthur D. Little (ADL) Matrix				
Competitive position	Embryonic	Growth	Mature	Ageing
Dominant	- Fast grow - Build barriers - Act offensively	- Fast grow - Attend cost leadership - Renew - Defend position - Act offensively	- Defend position - Attend cost leadership - Renew - Fast grow - Act offensively	- Defend position - Renew - Focus - Consider withdrawal
Strong	- Differentiate - Fast grow	- Differentiate - Lower cost - Attack small firms	- Lower cost - Focus - Differentiate - Grow with industry	- Find niche - Hold niche - Harvest
Favorable	- Differentiate - Focus - Fast grow	- Focus - Differentiate - Defend	- Focus - Differentiate - Harvest - Find niche - Hold niche - Turnaround - Grow with industry - Hit smaller firms	- Harvest - Turnaround
Tenable	- Grow with industry - Focus	- Hold niche - Turnaround - Focus - Grow with industry - Withdraw	- Turnaround - Hold niche - Retrench	- Divest - Retrench
Weak	- Find niche - Catch-up - Grow with industry	- Turnaround - Retrench - Niche or withdraw	- Withdraw - Divest	- Withdraw

Arthur D. Little Strategic Condition Matrix

### BCG Matrix

#### Business strength

4

		Strong	Average	Weak
Market attractiveness	High	Invest/Expand	Invest/Expand	Select/Earn
	Medium	Invest/Expand	Select/Earn	Harvest/Divest
	Low	Select/Earn	Harvest/Divest	Harvest/Divest



# CHAPTER-5- STRATEGY IMPLEMENTATION & EVALUATION



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SM Process

Strategic Change

Organisational Structure

Leadership

Control

## Process

1. Vision, Mission, Goals, Objectives
2. Organisation & Environmental Analysis
3. Formulation
4. Implementation
5. Evaluation & Control.

## Planning

### Strategic Planning

1. Shape organisation
2. Assess the impact
3. Take holistic view
4. Overall Objectives
5. Long term success
6. Senior Management

### Operational Planning

1. Deployment of resources
2. Develop tactics
3. Projection of operation
4. Make modification to function
5. Functional managers

### Uncertainty

1. Flexibility
2. Diversification
3. Monitoring
4. Resilience
5. Collaboration

## Formulation & Implementation

Strategic Formulation	Sound	A	B
	Flawed	C	D
		Weak	Excellent

		Strategic Formulation	
		Effective	Ineffective
Operational Management	Efficient	1 Thrive	2 Die Slowly
	Inefficient	3 Survive	4 Die Quickly

### Linkage

1. Forward
2. Backward

## Strategic Leadership

### Leadership Roles

1. Staying on top of what is happening
2. Esprit de corps
3. Responsive to changing conditions
4. Exercising ethical leadership
5. Corrective actions

### Responsibility

1. Making strategic decisions
2. Formulating policies
3. Ensuring effective communication
4. Managing human capital
5. Managing change
6. Creating & sustaining strong corporate culture
7. Sustaining high performance over time

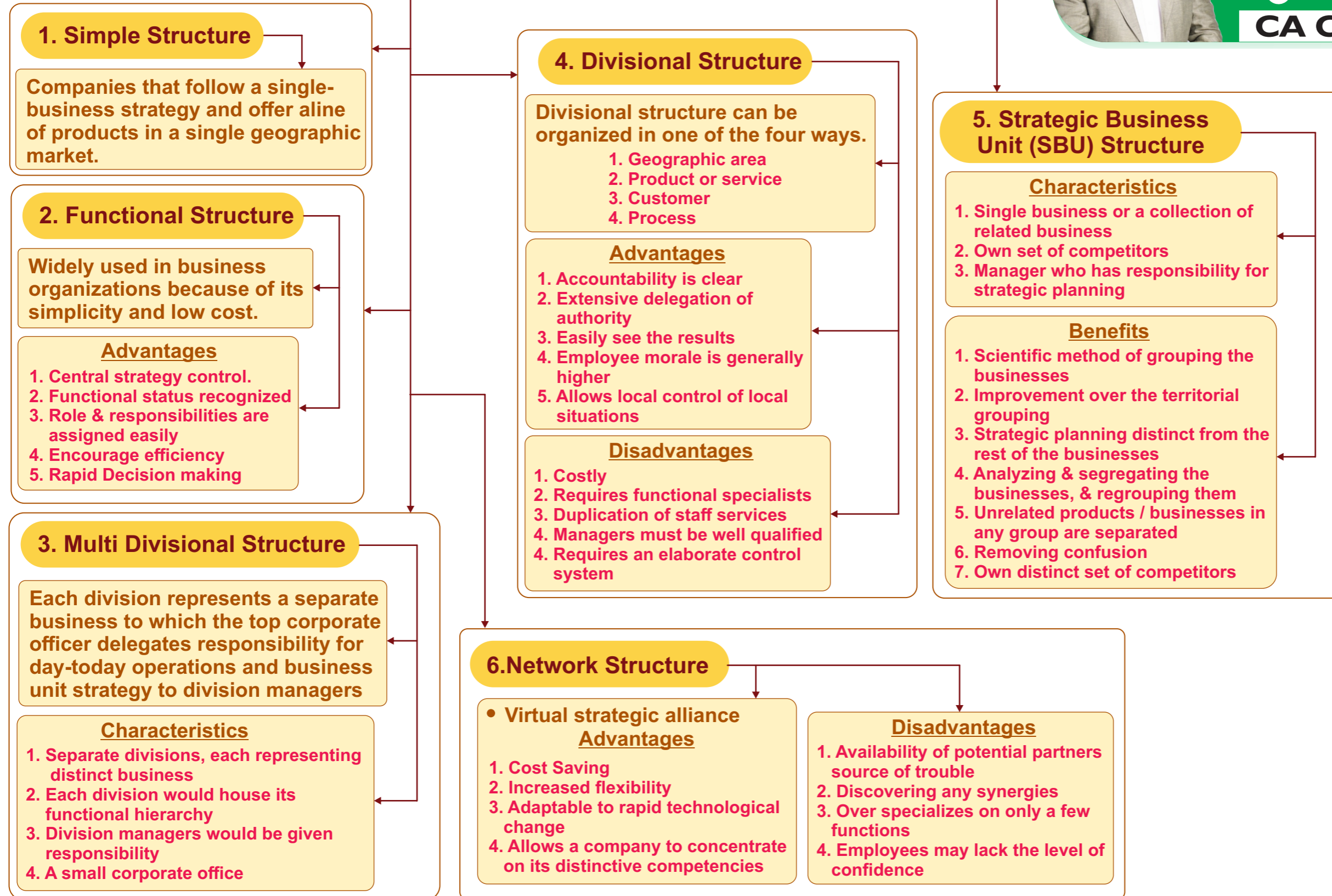
### Approaches

1. Transformational Leadership Style
2. Transactional Leadership Style

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# Organisational Structure



# Organisational Structure



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## 7. Matrix Structure

### Advantages

1. Project objectives are clear
2. Better project control
3. Employee can see results very clearly
4. Shutting down a project is accomplished relatively easily
5. Suitable for large organizations with several projects

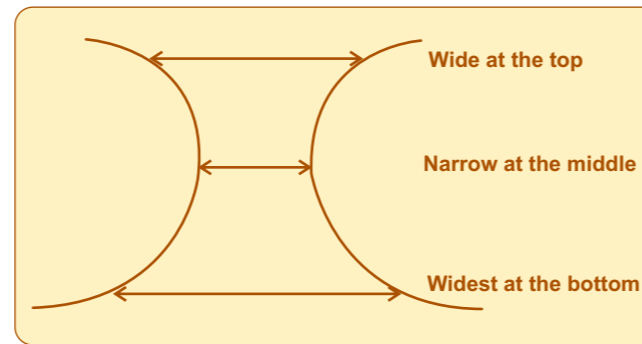
### Disadvantages

1. Complexity in implementation
2. Costly
3. Dual reporting channels
4. Shared authority
5. It requires effective communication system

### Phases Proposed by Davis & Lawrence for Development of Matrix Structure

- Cross-functional task forces
- Product / brand management
- Mature matrix

## 8. Hourglass Structure



### Advantages

1. Reduced costs
2. Enhancing responsiveness

### Disadvantages

1. Promotion opportunities diminish
2. Bring monotony & lack of interest

My Notes:



# Strategic Change

## Issues in Strategy Implementation

- Project Implementation
- Procedural Implementation
- Resource Allocation
- Structural Implementation
- Functional Implementation
- Behavioural Implementation

## Change

### Steps to Initiate Strategic Change

1. Recognize the need for change
2. Create a shared vision to manage change
3. Institutionalize the change

### Kurt Lewin's Model Of Change

1. Unfreezing the situation
2. Changing to the new situation
  - a. Compliance
  - b. Identification
  - c. Internalization
3. Refreezing

## Digital Transformation

### Change Management

1. Goals & objectives
2. Current state
3. Road map for change
4. Implementing & managing change

### Can Help Organisation

1. Parameters
2. Procedures
3. Plan
4. Involve
5. Track progress

### 5 Best Practices

1. Begin at the top
2. Change is necessary & desired
3. Reduce disption
4. Encourage leadership
5. Change is norm

### How to Manage

1. Specify objectives
2. Communicate
3. Resistance
4. Gradually
5. Training

## Organisation Framework

### MCKinsey 7's Model

#### 7's Model

#### Soft S's

1. Shared values
2. Style
3. Staff
4. Skills

#### Hard S's

1. Strategy
2. Structure
3. System

#### Limitation

1. Ignore External
2. Not clearly explain effectiveness
3. Static
4. Missing real gaps

## Control

### Process

1. Objectives of business system
2. Monitoring & Measuring
3. Actual results & standards
4. Corrective & Adaptive Information

### Organizational Control

1. Operational Control
2. Management Control
3. Strategic Control

### Strategic Control

1. Premise Control
2. Strategic Surveillance
3. Special Alert Control
4. Implementation Control

### Strategic Performance Measures

#### Types

1. Financial
2. Customer Satisfaction
3. Marker
4. Employee
5. Innovation
6. Environmental

#### Importance

1. Goal Alignment
2. Resource Allocation
3. Continuous Improvement
4. External Accountability

#### Factors

1. Reference
2. Data Quality
3. Data Availability
4. Data Timeliness

My Notes: