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FINANCIAL MANAGEMENT

EXAM REVISION NOTES

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MODULE I

FOUNDATIONS OF FINANCIAL MANAGEMENT AND TIME VALUE OF MONEY

Concept and Foundations of Financial Management: Financial management is the operational and strategic discipline concerned with the procurement, allocation, and administrative control of financial resources within an enterprise. Michael Armstrong and James C. Van Horne emphasize that financial management bridges corporate governance, economics, and quantitative accounting to ensure capital is mobilized at minimum cost and deployed into productive assets yielding maximum long-term economic returns. In modern corporate enterprises characterized by the separation of ownership from managerial control, financial management serves as the central steering mechanism directing corporate strategy, risk mitigation, and enterprise valuation.

The Traditional Versus Modern Financial Paradigm: The traditional paradigm was episodic, descriptive, and outsider-oriented, focusing exclusively on legal corporate formation, investment banking mechanics, and bankruptcy recapitalizations. The modern analytical paradigm is continuous, rigorous, and internal-oriented, integrating econometric modeling, portfolio theory, capital budgeting hurdle rates, and real-time cash flow optimization under conditions of market volatility.

The Three Fundamental Financial Management Decisions: Corporate financial management revolves around three interconnected strategic choices: **Investment Decision (Capital Budgeting)** determines long-term capital allocation across fixed revenue-generating assets and short-term working capital liquidity; **Financing Decision (Capital Structure)** establishes the optimal debt-equity mix minimizing the weighted average cost of capital (WACC) while preserving financial flexibility; **Dividend Decision (Surplus Distribution)** governs the proportion of net profits distributed to shareholders versus retained internally for capital compounding.

Profit Maximisation Versus Wealth Maximisation Criterion: Profit maximisation seeks to maximize accounting net income or earnings per share. It suffers from fatal conceptual deficiencies: ambiguity of the definition of profit, complete disregard for the time value of money, total neglect of cash flow risk, and the encouragement of short-sighted managerial cuts in R&D and maintenance. Conversely, **Wealth Maximisation** is the universally accepted operational standard in corporate finance. It maximizes the net present value (NPV) of shareholder wealth, reflected in the market price of ordinary shares, by explicitly discounting cash flows at the firm's cost of capital and integrating risk-return tradeoffs.

The Agency Problem and Corporate Governance: First formalized by Jensen and Meckling (1976), agency theory posits that self-interested managers (agents) may prioritize empire-building and perquisites over shareholder (principal) wealth. Agency costs comprise: **Monitoring Expenditures** (independent external audits and board oversight fees), **Bonding Expenditures** (contractual managerial commitments), and **Residual Loss** (unpreventable wealth destruction). Mitigation mechanisms include performance-linked stock options (ESOPs), independent board director mandates under the Companies Act 2013, and the disciplinary threat of hostile corporate takeovers.

Time Value of Money (TVM) Axioms and Mechanics: A rupee received today is worth more than a rupee received in the future due to investment earning opportunities, inflationary purchasing power erosion, and future default uncertainty. TVM operates across two inverse mathematical processes: **Compounding (Future Value)** converts present sums into accumulated future values (**$FV = PV \times [1 + r]^n$**); **Discounting (Present Value)** determines the current worth of expected future receipts (**$PV = FV \times [1 + r]^{-n}$**). The discount factor reflects the opportunity cost of capital.

Annuities, Perpetuities, and Loan Amortization: An **Ordinary Annuity** involves equal periodic cash flows at the end of each period, whereas an **Annuity Due** involves cash flows at the start of each period, earning an extra period of interest. A **Perpetuity** is an infinite stream of equal periodic cash flows (**$PV = C / r$**). A **Growing Perpetuity** expands at constant rate g (**$PV = C_1 / [r - g]$**). In a **Loan Amortization Schedule**, equal annual installments (EMI) are bifurcated into interest charges (which decline as principal reduces) and principal repayments (which increase over the repayment tenure).

The Indian Financial Environment and Regulatory Architecture: Corporate finance operates within: **Money Market** (short-term liquidity instruments up to 1 year: T-Bills, Commercial Paper, Certificates of Deposit, Call Money regulated by RBI); **Capital Market** (long-term equity and debt securities divided into Primary Issue Market and Secondary Stock Exchanges like NSE and BSE); **SEBI** (enforces LODR regulations, insider trading bans, and investor protection); **RBI** (regulates banking cash credits, benchmark interest rates, and FEMA foreign exchange compliance); and **Ministry of Corporate Affairs (MCA)** (administers the Companies Act 2013).

Strategic Mandate of the Modern Corporate CFO: The modern Chief Financial Officer functions as strategic co-pilot, driving: **Digital Treasury Automation** (cloud ERP, robotic process automation, real-time liquidity tracking); **Strategic Capital Allocation** (M&A valuations, divestitures, global debt issuance); **Balance Sheet Hedging** (foreign exchange derivatives, interest rate swaps); and **ESG Sustainable Finance** (issuing green bonds, complying with SEBI Business Responsibility and Sustainability Reporting mandates).

MODULE II

INVESTMENT DECISION, CAPITAL BUDGETING, AND RISK ANALYSIS

Nature and Significance of Capital Budgeting: Capital budgeting is the long-term investment decision-making process committing substantial funds into durable fixed assets whose benefits unfold over multi-year horizons. It is characterized by high monetary magnitude, multi-year realization periods, substantial cash flow uncertainty, irreversibility without severe sunk capital loss, and the direct determination of enterprise market valuation.

Six-Stage Capital Budgeting Workflow: Corporate capital allocation follows a disciplined process: (1) **Project Identification** across replacement, expansion, cost-reduction, and statutory mandates; (2) **Incremental Cash Flow Estimation** tracking after-tax cash flows while excluding non-cash depreciation and factoring depreciation tax shields; (3) **Project Appraisal** using quantitative screening models; (4) **Selection and Capital Allocation** under budget constraints; (5) **Implementation** under EPC contracts; and (6) **Post-Audit Review** diagnosing systematic forecasting biases.

Principles of Incremental Cash Flow Modeling: Financial appraisal strictly enforces four cardinal principles: **Sunk Costs are Strictly Excluded** because past unrecoverable expenses cannot be altered by future decisions; **Opportunity Costs are Strictly Included** representing forgone cash flows from deploying existing assets away from alternative uses; **Side Effects and Cannibalization are Factored** deducting lost contribution margins from existing products; and **Working Capital Commitments** are treated as initial cash outflows at Year 0 and fully recovered as terminal inflows at project completion.

Traditional (Non-Discounted) Appraisal Methods: Payback Period (PBP) measures the exact years required to recover initial investment outlays from annual cash inflows (**PBP = Initial Outlay / Annual Inflow**). Advantages include computational simplicity and liquidity screening; fatal flaws include total neglect of the time value of money and complete disregard for cash flows occurring after the payback cutoff. **Accounting Rate of Return (ARR)** expresses average annual net profit after tax as a percentage of average investment. While considering total operating life, ARR relies on accrual accounting profits subject to depreciation manipulation and ignores the time value of money.

Discounted Cash Flow (DCF) Appraisal Methodologies: Net Present Value (NPV) is the gold standard of investment appraisal, measuring the difference between the present value of future cash inflows and initial capital outlay (**NPV = Σ $[CF_t / (1 + r)^t]$ - C_0**). Accept if NPV > 0. **Internal Rate of Return (IRR)** is the unique discount rate equating present value of inflows to initial outlay (NPV = 0). Accept if IRR > Cost of Capital (k). **Profitability Index (PI)** measures the benefit-cost ratio of present value of inflows to initial outlay (**PI = PV of Inflows / C_0**). Accept if PI > 1.0; indispensable for ranking projects under capital rationing.

NPV Versus IRR Ranking Conflicts in Mutually Exclusive Projects: For independent projects, NPV and IRR produce identical accept/reject decisions. In mutually exclusive projects, conflicts arise due to: (1) **Scale Disparities** where small projects yield high IRR but negligible absolute wealth; (2) **Cash Flow Timing Disparities** crossing at Fisher's Intersection Rate; and (3) **Reinvestment Rate Assumptions**. IRR unrealistically assumes intermediate cash flows are reinvested at the project's own internal yield, whereas NPV realistically assumes reinvestment at the corporate cost of capital (WACC). NPV is theoretically superior and must always govern project selection.

Capital Rationing and Integer Optimization: Occurs when the enterprise has more positive NPV projects than available capital. **Hard Capital Rationing** is externally imposed by credit market freezes; **Soft Capital Rationing** is self-imposed by corporate boards to preserve conservative balance sheets. For divisible projects, rank by descending Profitability Index. For indivisible projects, evaluate all feasible budget combinations to select the package maximizing aggregate Net Present Value.

Risk and Uncertainty Analysis Methodologies: Quantitative risk models include: **Risk-Adjusted Discount Rate (RADR)** which elevates the project hurdle rate above risk-free rate based on asset volatility; **Certainty Equivalent (CE) Approach** which converts risky cash inflows into guaranteed sums via coefficients (α_t) and discounts at the risk-free rate; **Sensitivity Analysis** measuring NPV elasticity when a single variable changes; and **Scenario Analysis** projecting pessimistic, base, and optimistic states.

Inflationary Adjustments in Capital Appraisal: The Fisher Effect dictates that nominal cash flows must be discounted using a nominal discount rate, whereas real cash flows must be discounted using a real discount rate: **$(1 + k_{nom}) = (1 + k_{real}) \times (1 + i)$**. Mixing real cash flows with nominal rates severely undervalues viable projects.

MODULE III

WORKING CAPITAL MANAGEMENT, CASH, AND RECEIVABLES

Working Capital Concepts and Operating Dynamics: Gross Working Capital represents the total monetary investment committed across all current assets. **Net Working Capital (NWC)** is the quantitative difference between current assets and current liabilities (**NWC = CA - CL**), measuring the firm's liquidity margin. **Permanent Working Capital** is the baseline current asset quantum permanently required year-round to support operations, requiring long-term financing. **Variable (Fluctuating) Working Capital** represents seasonal spikes in receivables and inventory, appropriately funded through short-term credit.

The Operating Cycle and Cash Conversion Cycle: The Operating Cycle measures the days required to purchase raw materials, manufacture goods, sell inventory on credit, and collect debtor receipts. **Gross Operating Cycle (GOC)** equals Raw Material Period (RMP) + Work-in-Progress Period (WIPP) + Finished Goods Period (FGP) + Receivables Collection Period (RCP). **Net Operating Cycle (Cash Conversion Cycle)** subtracts supplier Payable Deferral Period (PDP): **NOC = GOC - PDP**. Shortening the cash conversion cycle releases locked capital and expands profitability.

Working Capital Financing Strategies: Hedging (Maturity Matching) Approach finances permanent fixed and current assets with long-term capital and temporary current assets with short-term credit, eliminating refinancing risk. **Conservative Approach** funds all fixed assets, permanent current assets, and part of seasonal current assets with long-term funds, minimizing insolvency risk at the expense of lower ROE. **Aggressive Approach** funds temporary assets and part of permanent assets with cheap short-term debt, boosting ROE during expansions but risking liquidity collapse.

Inventory Management Models and Selective Control: Total inventory costs balance **Ordering Costs** (freight, inspection, invoice processing) against **Carrying Costs** (warehouse rent, insurance, spoilage, opportunity cost of capital). **Economic Order Quantity (EOQ)** identifies the purchase size minimizing aggregate annual costs (**EOQ = √[2AS / C]**). **ABC Analysis** applies Pareto's 80/20 rule: Category A (10% items, 70% value, continuous executive oversight); Category B (20% items, 20% value, periodic review); Category C (70% items, 10% value, two-bin visual reordering).

Cash Management Models and Treasury Architecture: Keynes identified Transaction, Precautionary, and Speculative motives for holding cash. **Baumol Model** adapts EOQ to determine optimal cash conversion lots against marketable security yields. **Miller-Orr Model** manages fluctuating cash via Upper Control Limit, Lower Control Limit, and Return Point. Modern digital treasury deploys Zero Balance Accounts (ZBA), Controlled Disbursement Accounts (CDA), RTGS, NEFT, IMPS, and overnight liquid mutual fund sweeps.

Receivables Management and Credit Policy Frameworks: Credit management coordinates: (1) **Credit Standards** vetted through the 5 Cs of Credit (Character, Capacity, Capital, Collateral, Conditions); (2) **Credit Terms** establishing duration and cash discounts (e.g., 2/10 net 30); (3) **Collection Policy and Aging Schedules** categorizing debts by age brackets (0–30, 31–60, 61–90+ days) to control defaults. Institutional mechanisms include **Factoring** (assigning receivables to specialized factors with or without recourse), **Forfaiting** (export trade bill discounting), and RBI's **TReDS Platform** for MSME invoice discounting.

Bank Financing and RBI Study Group Norms: Tandon Committee (1974) established Maximum Permissible Bank Finance (MPBF): First Method finances 75% of net working capital gap (current ratio 1.17); Second Method finances 75% of total current assets minus other current liabilities (current ratio 1.33, standard for medium/large corporates). **Chore Committee (1979)** mandated quarterly information systems and loan/cash credit bifurcations. **Nayak Committee (1991)** sanctioned MSME credit at 20% of projected annual turnover.

Liquidity Versus Profitability Trade-Off Dilemma: Conservative policies maintain high current asset cushions, yielding zero default risk but lower return on assets. Aggressive policies operate with minimal current assets, maximizing capital velocity but risking supply chain stoppages and insolvency during trade disruptions. Optimal corporate management deploys matching policies calibrated to cash conversion volatility.

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MODULE IV

FINANCING DECISION, CAPITAL STRUCTURE, COST OF CAPITAL, AND LEVERAGE

Foundations of Capital Structure and Financial Leverage: Capital structure refers to the permanent proportionate mix of long-term debt, preferred equity, and ordinary shareholder equity. An **Optimal Capital Structure** minimizes the firm's Weighted Average Cost of Capital (WACC) while maximizing market equity valuation. Employing fixed-cost debt creates **Financial Leverage (trading on equity)**; interest tax-deductibility magnifies percentage gains in EPS when operating profits expand, but exposes the firm to bankruptcy risk during economic contractions.

Classical and Modern Theories of Capital Structure: Net Income (NI) Approach (Durand) argues capital structure is relevant; substituting expensive equity with cheap debt continuously lowers WACC and elevates firm value toward 100% debt. **Net Operating Income (NOI) Approach (Durand)** argues leverage is irrelevant; equity holders demand higher returns to compensate for financial risk, offsetting cheap debt benefits and keeping WACC constant. **Traditional Approach** posits a U-shaped cost curve; moderate debt initially lowers WACC until bankruptcy risk forces equity and debt costs upward to an optimal inflection point.

The Modigliani-Miller (MM) Hypotheses: Proposition I (Without Taxes - 1958) proves that in perfect, frictionless capital markets, firm value is independent of capital structure ($V_L = V_U$), restored via the **Arbitrage Mechanism** where investors substitute personal homemade leverage for corporate debt. **Proposition II (With Corporate Taxes - 1963)** incorporates tax-deductible interest: the value of a levered firm exceeds the unlevered firm by the present value of the interest tax shield ($V_L = V_U + tD$).

Component Costs of Capital Formulation: Cost of Debt (k_d) incorporates the corporate tax shield: $k_{d(after\text{-}tax)} = (I / NP) \times (1 - t)$. **Cost of Preference Capital (k_p)** reflects non-tax-deductible fixed payouts: $k_p = D_p / NP$. **Cost of Equity (k_e)** is determined via Gordon's Dividend Growth Model ($k_e = D_1/P_0 + g$) or the Capital Asset Pricing Model ($k_e = R_f + \beta[R_m - R_f]$). **Weighted Average Cost of Capital (WACC)** weights component costs by market or book value: $k_o = \Sigma (w \times k)$.

Comprehensive Leverage Analysis Framework: Degree of Operating Leverage (DOL) measures the percentage sensitivity of operating earnings (EBIT) to changes in sales revenue, driven by fixed operating costs: **DOL = Contribution / EBIT**. **Degree of Financial Leverage (DFL)** measures the responsiveness of EPS to changes in EBIT, driven by contractual interest and preference dividends: **DFL = EBIT / EBT**. **Degree of Combined Leverage (DCL)** captures total enterprise risk exposure: **DCL = DOL × DFL = Contribution / EBT**.

EBIT-EPS Indifference Point Analysis: Identifies the exact operational EBIT level where two financing alternatives generate identical Earnings Per Share. Below the indifference point, a conservative low-debt structure delivers higher EPS. Above the indifference point, an aggressive high-debt structure delivers superior EPS due to favorable financial leverage. Mathematical resolution equates EPS formulas across both financing plans.

Trade-Off Theory Versus Pecking Order Theory: Static Trade-Off Theory balances the tax benefits of debt against the deadweight costs of financial distress and bankruptcy. **Pecking Order Theory (Myers & Majluf)** asserts that information asymmetry dictates a financing hierarchy: firms prioritize internal retained earnings first, issue safe debt second, hybrid convertibles third, and issue external equity only as a last resort to prevent market underpricing dilution.

Venture Capital, Private Equity, and Term Sheet Governance: Fast-growing enterprises raise private risk capital across Seed, Series A, Series B, and Mezzanine stages. Protective term sheet covenants include: **Liquidation Preference** (1x non-participating senior recovery), **Anti-Dilution Protection** (broad-based weighted average formula during down rounds), **Tag-Along Rights** (protecting minority shareholders upon promoter exit), and **Drag-Along Rights** (mandating acquisition compliance).

MODULE V

DIVIDEND DECISIONS, VALUATION THEORIES, AND REGULATORY COMPLIANCE

Nature and Strategic Significance of Dividend Decisions: Determines the allocation of post-tax profits between current cash distributions to shareholders and retention within the firm as retained earnings. Retained earnings represent autonomous equity requiring zero flotation costs or ownership dilution; cash dividends eliminate investor uncertainty, satisfy institutional income requirements, and provide positive market signaling regarding balance sheet health.

Forms of Corporate Dividend Distribution: Cash Dividends represent direct electronic fund transfers reducing corporate cash and equity reserves; **Stock Dividends (Bonus Shares)** represent a capitalization of free reserves, issuing additional fully paid shares without altering cash or net worth; **Scrip Dividends** issue promissory certificates during temporary liquidity shortages; **Property Dividends** distribute physical assets or subsidiary securities during corporate reorganizations.

Dividend Relevance Valuation Models: Walter's Model demonstrates that dividend policy affects firm value based on the relationship between internal investment return (r) and cost of capital (k): Growth Firms (r > k) maximize value with a **0% Payout Ratio**; Declining Firms (r < k) maximize value with a **100% Payout Ratio**; Normal Firms (r = k) are indifferent to payout ratios ($P = [D + (r/k)(E - D)] / k$). **Gordon's Growth Model** incorporates investor risk aversion ("Bird-in-the-Hand" fallacy); investors discount distant capital gains more heavily than current dividends ($P_0 = D_1 / [k_e - g]$).

Modigliani-Miller Dividend Irrelevance Proposition: MM (1961) proved that in perfect capital markets without taxes or transaction costs, dividend policy has zero effect on share prices or firm valuation. On the ex-dividend date, the market share price drops by the exact monetary amount of the dividend paid ($P_0 = [D_1 + P_1] / [1 + k_e]$). Any dividend received by the shareholder is precisely offset by a drop in per-share value; fresh equity issued to fund investments dilutes existing shares by the exact dividend value.

Lintner's Behavioral Dividend Smoothing Model: John Lintner (1956) established that corporate managers exhibit behavioral resistance to cutting dividends. Corporations formulate long-run target payout ratios based on sustainable earnings and adjust current dividends gradually toward the target via a speed of adjustment factor: $\Delta Div_t = a + c \times [r(EPS_t) - Div_{t-1}]$. Dividends are raised only when higher future earnings are sustainable.

Bonus Shares Versus Stock Splits: Bonus Shares capitalize accumulated free reserves and securities premium under Section 63 of the Companies Act 2013, expanding paid-up capital while keeping nominal face value constant. **Stock Splits** merely sub-divide existing shares into smaller denominations under Section 61, reducing face value without altering reserves, thereby dramatically boosting secondary market trading liquidity.

Statutory Compliance under Indian Companies Act 2013: Key legal requirements include: Section 123 (dividends declared only out of current profits after Schedule II depreciation or past reserves); Board recommends dividend and AGM approves (shareholders cannot increase recommended rate); mandatory deposit into a separate scheduled bank account within **5 days**; payment within **30 days**; transfer of unpaid dividends to Unpaid Dividend Account within **7 days**; and mandatory transfer of unclaimed funds after **7 years** to the Investor Education and Protection Fund (IEPF).

Dividend Taxation Reforms and Share Buybacks: The **Finance Act 2020** abolished Dividend Distribution Tax (DDT) under Section 115-O, adopting the classical system where dividends are taxed directly in the hands of shareholders at personal slab rates with mandatory 10% TDS under Section 194. Section 80M eliminates cascading tax on inter-corporate dividends. **Share Buybacks** (governed by Section 68 and SEBI Regulations) serve as a tax-efficient alternative to cash dividends, signaling undervaluation, retiring floating shares, and permanently boosting Earnings Per Share.

Investor Clientele Effects and Signaling Dynamics: Different categories of investors gravitate toward companies with dividend policies aligned with their tax brackets and income needs. Tax-exempt institutions favor high-dividend yields, while high-income individuals prefer corporate retention generating low-tax capital gains. Furthermore, changes in dividend declarations operate as powerful information signals: dividend increases communicate sustained earnings growth, whereas unanticipated dividend reductions trigger rapid stock price selloffs.

Dividend Metrics and Capital Market Evaluation Ratios: Corporate analysts assess dividend performance through three core indicators: **Dividend Yield** (Annual Dividend per Share / Current Market Price per Share) measuring cash return on market investment; **Dividend Payout Ratio** (Dividends Paid / Net Profit After Tax) measuring the proportion of earnings distributed; and **Dividend Coverage Ratio** (Net Profit After Tax / Total Dividend Paid) indicating the margin of safety protecting dividend sustainability against operational earnings shocks.

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