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BBA	SEMESTER 2	CALICUT UNIVERSITY	COURSE CODE: BBA2CJ102

FINANCIAL MANAGEMENT

EXAM REVISION NOTES

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MODULE I

FOUNDATIONS OF CORPORATE FINANCE & TIME VALUE OF MONEY

Core Functions of Financial Management: Corporate financial management decomposes into three interrelated decision domains:

- **The Investment Decision (Capital Budgeting):** Determining which long-term productive assets the firm should acquire.
- **The Financing Decision (Capital Structure):** Determining how capital should be raised to fund operations and investments.
- **The Dividend Decision (Profit Allocation):** Deciding whether corporate earnings should be distributed to equity shareholders as cash dividends or retained within the firm to finance profitable growth opportunities.

Profit Maximization vs. Wealth Maximization: Historical financial literature evaluated corporate performance through Profit Maximization. However, contemporary corporate finance rejects profit maximization as a sole primary objective due to four fundamental deficiencies:

- **Ambiguity:** The term "profit" is ambiguous; it does not distinguish between accounting profit, economic profit, short-term earnings, or long-term cash flow generation.
- **Ignores the Time Value of Money:** A profit of $1 million received five years from today is treated identically to $1 million received today, violating basic economic principles.
- **Ignores Risk and Uncertainty:** Profit metrics fail to account for the risk profiles of alternative revenue streams.
- **Encourages Short-Termism:** Managers may cut essential research and development (R&D), employee training, or equipment maintenance to inflate immediate accounting margins at the expense of enterprise survival.

Agency Theory and Corporate Governance Frictions: In modern public corporations characterized by the separation of ownership (shareholders) and control (professional executives), Agency Problems inevitably arise.

- **Agency Costs:** To align managerial incentives with shareholder interests, firms incur , encompassing monitoring costs (independent audits, board governance), bonding expenditures (performance-contingent stock options, restrictive covenants), and residual loss.

Time Value of Money (TVM) Foundations: The Time Value of Money (TVM) is the foundational principle underpinning modern valuation and capital allocation: a rupee today is worth more than a rupee to be received in the future.

- **Investment Opportunity:** Capital held today can be deployed in financial or physical assets to earn a positive return.
- **Inflation Risk:** Purchasing power erodes over time as aggregate price levels rise.
- **Uncertainty / Default Risk:** Future cash flows are inherently exposed to credit default, market disruption, and volatility.
- **Ordinary Annuity:** Cash flows occur at the end of each period (mortgage payments, bond coupons): PVA = C cdot left[(1 - (1 + r)-n / r))
- **Annuity Due:** Cash flows occur at the inception of each period (lease payments, insurance premiums): extPVAextdue=extPVAextordinarycdot(1+r)PVAdue =PVAordinary cdot (1 + r)extPVAextdue=extPVAextordinarycdot(1+r)

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MODULE II

COST OF CAPITAL & CAPITAL STRUCTURE THEORIES

Component Costs of Capital: An enterprise mobilizes capital through diverse financial instruments, each carrying distinct risk-return expectations and legal claims on corporate cash flows.

Weighted Average Cost of Capital (WACC): The composite hurdle rate for corporate investment appraisal is the Weighted Average Cost of Capital (WACC), denoted as K0.

Capital Structure Theories: The Great Academic Debate: Capital structure theory investigates whether the financing mix affects total firm value (V) and overall cost of capital (K0).

- **Net Income (NI) Approach:** ; Directly positive; optimal structure is 100% debt.
- **Net Operating Income (NOI):** David Durand (1952); K0 and V remain completely independent of leverage.
- **MM Theory (No Taxes):** Modigliani & Miller (1958); In frictionless markets, firm value is determined solely by real productive assets, not financing mix.
- **MM Theory (With Taxes):** ; Maximizes firm value as debt approaches 100%.

Financial, Operating, and Combined Leverage: Leverage reflects the employment of fixed-cost assets or funds to magnify returns to shareholders:

- **Degree of Operating Leverage (DOL):** Measures the sensitivity of Operating Profit (EBIT) relative to changes in sales turnover, driven by fixed operating expenses: DOL =(% DeltaEBIT / % DeltaSales) = (Contribution / EBIT)
- **Degree of Financial Leverage (DFL):** Measures the sensitivity of Earnings Per Share (EPS) relative to fluctuations in operating profit, driven by fixed financing charges: DFL =(% DeltaEPS / % DeltaEBIT) = (EBIT / EBIT - I -(Dp / 1 - T))
- **Degree of Combined Leverage (DCL):** The aggregate magnification effect linking sales fluctuations directly to shareholder earnings: DCL =DOL imesDFL =(Contribution / EBT)

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MODULE III

CAPITAL BUDGETING & LONG-TERM CAPITAL ALLOCATION

The Capital Budgeting Process and Cash Flow Principles: A rigorous corporate capital allocation framework traverses five sequential stages: project identification and generation, engineering and financial evaluation, executive selection and authorization, implementation and monitoring, and post-completion audit.

- **Incremental Principle:** Appraise only the incremental cash flows directly attributable to project execution: DeltaextCFt=extCFextwithproject,t−extCFextwithoutproject,tDeltaCFt =CFwith project, t -CFwithout project, tDeltaextCFt =extCFextwithproject,t−extCFextwithoutproject,t
- **Sunk Cost Irrelevance:** , past feasibility studies, preliminary site surveys) cannot be recovered and must be excluded from evaluation.
- **Opportunity Cost Inclusion:** The commercial value of existing enterprise assets deployed into the project must be treated as a cash outflow.
- **Working Capital Commitments:** Incremental net working capital required to support inventory and receivables during operations must be treated as an initial cash outflow and recaptured as an inflow at project liquidation.

Traditional (Non-Discounted) Capital Budgeting Techniques: The Payback Period measures the exact duration required for undiscounted cumulative cash inflows to fully recover the initial capital outlay (C0).

- **Even Cash Flows:** PBP =(C0 / Annual Cash Inflow)
- **Uneven Cash Flows:** Cumulative cash flows are tallied until the cumulative Sum of equals C0.
- **Limitations:** Completely ignores the time value of money, treats cash flows beyond the payback cutoff as completely worthless, and ignores overall project profitability.

Modern (Discounted Cash Flow - DCF) Valuation Techniques: The Internal Rate of Return (IRR) is the intrinsic discount rate (r*) that equates the aggregate present value of projected cash inflows to the initial capital outlay, forcing Net Present Value strictly to zero:

NPV vs. IRR: Theoretical Superiority and Conflicts: For independent projects with conventional cash flows, NPV and IRR yield identical accept-reject decisions. However, when evaluating mutually exclusive projects, conflicts frequently emerge due to three structural factors:

- **Scale Disparity:** A project with a massive capital base may generate higher total wealth (NPV) despite a lower percentage return (IRR) compared to a small project.
- **Cash Flow Timing Differences:** Projects with front-loaded cash flows yield artificially inflated IRRs compared to back-loaded projects under low discount rate reg × .
- **Reinvestment Rate Assumption:** The critical academic divide: NPV assumes intermediate cash flows are reinvested at the realistic, observable cost of capital (k), whereas IRR assumes cash flows are reinvested at the internal rate of return (extIRRIRRextIRR), which is unrealistic for exceptionally lucrative projects.

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MODULE IV

WORKING CAPITAL MANAGEMENT & DIVIDEND POLICY FORMULATION

Working Capital Concepts and the Operating Cycle: In financial terminology, working capital is analyzed through two distinct definitions:

- **Gross Working Capital:** Represents total capital committed to all current assets (cash, marketable securities, receivables, inventories).
- **Net Working Capital (NWC):** The surplus of current assets over current liabilities: extNWC=extCurrentAssets−extCurrentLiabilitiesNWC =Current Assets -Current LiabilitiesextNWC=extCurrentAssets−extCurrentLiabilities A positive NWC signifies that a portion of liquid operating assets is funded through stable, long-term financing, providing a liquidity cushion.
- **Cash Conversion Cycle (CCC):** The measures the net time elapsed between cash disbursement for raw materials and cash collection from customers:

Working Capital Financing Strategies: Firms fund their current assets across three strategic postures reflecting differing risk-return trade-offs:

- **Hedging / Matching:** ; Optimal balance between financing cost and solvency safety.
- **Conservative:** ; Lowest profitability due to idle cash drag and higher long-term interest rates.
- **Aggressive:** ; Highest potential profitability due to cheaper short-term borrowing.

Management of Cash, Receivables, and Inventory

- **Cash Management Models:** The Baumol Model adapts inventory EOQ logic to compute optimal cash transaction balances (C^* = √(2bT / i)), trading off transaction broker fees against interest opportunity costs.
- **Receivables Management:** Balancing the profit expansion from lenient credit sales against bad debt write-offs, collection administrative expenses, and working capital carrying costs.
- **Inventory Management:** Optimizing inventory levels using Economic Order Quantity (EOQ = √(2DS / H)), ABC classification (Pareto principle separating high-value Class A items from routine Class C items), and safety stock buffers.

Corporate Dividend Policy Theories: Dividend policy determines the payout ratio (D/EPSD/EPSD/EPS). Economists divide dividend theory into relevance and irrelevance models:

- **Growth Firm (r>kr > kr>k):** Optimal payout ratio is 0%.
- **Declining Firm (r Optimal payout ratio is 100%.**
- **Normal Firm (r=kr = kr=k): Dividend payout ratio is neutral; share price is indifferent to dividends.**

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