FINANCIAL MANAGEMENT

RMB204

**Unit I (6 Hrs**) Concept of Finance : Finance & its scope Financial Decisions, Sources of Finance Time Value of Money ,Profit maximization vs. Wealth maximization, Functions of Finance Manager in Modern Age, Indian Financial System : Primary and Secondary Market, Concept of Risk and Return , CAPM Model.

**Unit II (10 Hrs)** Investment Decision : Concept of Opportunity Cost, Cost of Debenture, Preference and Equity capital, Composite Cost of Capital ,Cash Flows as Profit and components of Cash Flows , Capital Budgeting Decisions, Calculation of NPV and IRR, Excel Application in Analyzing Projects.

**Unit III(10 Hrs)** Financial Decision :Capital Structure, Relevance and Irrelevancy theory ,Leverage analysis – financial, operating and combined leverage along with its implications, EBIT EPS Analysis, Point of Indifference .

**Unit IV (10 Hrs**) Dividend Relevance: Factors affecting Dividend Policy, Forms of Dividends , Types of Dividend Policies , Dividend Models :Walter and Gordon Model, Miller- Modigliani(MM) Hypothesis .

**Unit V (4 Hrs)** Working Capital Management: Concepts of Working Capital and its types, Determinants of Working Capital, Adequate Working Capital, Working Capital Financing

**UNIT-I**

**INTRODUCTION TO FINANCIAL MANAGEMENT**

**INTRODUCTION AND MEANING OF FINANCIAL MANAGEMENT**

Financial management is that managerial activity which is concerned with the planning and controlling of the firm’s financial resources. Though it was a branch of economics till 1890, as a separate activity or discipline it is of recent origin. Still it has no unique body of knowledge of its own and draws heavily on economics for its theoretical concepts even today. Financial management is about analyzing financial situation making financial decision setting financial objectives. Formulating financial plan to attain this objectives and providing effective system of financial control to ensure plan to progress towards the set of objective.

DEFINITIONS OF FINANCIAL MANAGEMENT:

1. **According to Weston and Brighan**, “Financial Management is an area of financial decision making, harmonizing individual motives and enterprise goals”.
2. **According to Howard and Upon**, “Financial Management is the application of the planning and controlling functions to the finance function”.
3. **According to Ezra Soloman and Pringle John**, “Financial Management is concerned with the effective use of an economic resource namely capital fund”.

A formal definition of finance would be determining acquisition, allocation, understanding and utilization of financial resources usually in the aim of achieving of some particular goals of objective.

**SCOPE OF FINANCIAL MANAGEMENT**

Financial Management means the entire excise of managerial efforts devoted to the management of finance, both its sources and uses of financial resources of an enterprise. Financial management has undergone significant changes over years as regards its scope and coverage. As such the role of finance manager has also undergone fundamental changes over the years. In order to have a better understanding of these changes, it will be appropriate to study both traditional approach and modern approach to the finance function.

**I.TRADITIONAL APPROACH:** The traditional approach, which was popular in the early part of this century, limited role of financial management to raising and administering of funds required by the enterprise to meet their financial needs. It broadly covered the following three aspects,

i) Arrangement of funds from financial institutions.

ii) Arrangement of funds through issue of financial instruments.

iii) Looking after the legal and accounting relationship between a corporation and its sources of funds.

Thus the traditional concept of financial management included the whole exercise of raising funds externally. The finance manager had a limited role to perform. He was expected to keep accurate financial records, prepare reports on the financial performance and manage cash in a way that the corporation is in a position to pay bills in time.

The term “Corporate Finance” was used in place of the present term “Financial Management”.

The traditional approach evolved during 1920 continued to dominate academic thinking during forties and through the early fifties. However, in the later fifties it started to be severely criticised and later abandoned on account of the following reasons:

1. **Outsiders looking in Approach**: This approach treated the subject of finance from the view point of suppliers of funds i.e., outsiders, bankers and investors etc. It followed an outsider-looking in approach and not the insider looking-out approach, since it completely ignored the viewpoint of those who had to take internal financing decisions.

2. **Ignored Routine Problems**: The approach gave undue emphasis to infrequent happenings in the life of an enterprise. The subject of financial management was confined to the financial problems arising during course of, incorporation, mergers, consolidations and reorganisation of corporate enterprise. As a result this approach did not give any importance to day-to-day financial problems of business undertakings.

3. **Ignored Non-Corporate Enterprise**: The approach focused only the financial problems of corporate enterprise. Non-corporate industrial organizations remained outside its scope

4**. Ignored Working Capital Financing**: The approach laid emphasis on the problems of long term financing. The problems relating to financing short term or working capital were ignored.

**II. MODERN APPROACH**: The traditional approach outlived its utility due to changed business situations since mid-1950. Technology improvements, innovative marketing operations, development of strong corporate structure, keen business competition, all made it imperative for the management to make optimum use of available to the financial manager, based on which he could make sound decisions. The scope of financial management increased with the introduction of capital budgeting techniques. As a result of new methods and techniques, capital investment projects led to efficient allocation of capital within the firm.

1. During the next two decades various pricing models, valuation models and investment portfolio theories also developed.
2. Efficient allocation of capital became an important area of study under financial management.
3. Eighties witnessed an era of high inflation, which caused the interest rates to rise dramatically. Thus, raising loan on suitable terms became an important aspect of financial management.
4. In the new volatile environment investment and financing decisions became more risky than ever before.
5. These environmental changes enlarged the scope of finance. The concept of managing a firm as a system emerged. External factors now no longer could be evaluated in isolation.
6. Decision to arrange funds were to be seen in consonance with their efficient and effective use. This total approach to study of finance is being termed as financial management.
7. Thus, according to modern approach/concept, financial management is concerned with both acquisitions of funds as well as their allocation.

The new approach views the term financial management in a broader sense.

**i) Investment Decision**: The investment decision is a selection of assets in which funds will be invested by a firm. These are broadly divided into two parts; they are

**(a) Long-term Assets and**

**(b) Short-term Assets**.

a) **Long-term Assets**: These are the asset which yields over a period of time in future such as capital budgeting. The capital budgeting is a crucial financial decision and it is a process begin with identifications of potential investment opportunities. The capital budgeting decisions relates to the choice of assets out of the alternatives or reallocation of capital when an old assets fails to justify. It is a decision which analyze the risk and uncertainty The worth of long term project implies a certain standard for benefits.

b) **Short-term Assets:** It is also known as current assets. The short-term assets are resources of a firm in the form of cash or converted in cash without the diminution in value. Example: The working capital management. It is day to day activity of finance which deals with current assets and current liabilities.

The two basic ingredients of working capital are

1. An overview of working capital management as a whole
2. Efficient management of the individual current assets such as cash, Bills receivables and inventory.

**(b) Financial Decision**: The financial decision is process perform by financial manager to decide, when, where from and how to acquire funds to meet the investment needs. The main aspect is to determine the appropriate proportion of debt and equity mix known as capital structure.

**(c) Dividend Decision**: The financial manager must decide whether the firm should distribute all profit or return to them or distribute a portion. The proportion of profit distributed as dividend is known as dividend payout ratio and retained portion of profit is called retention ratio.

**FUNCTIONS OF FINANCIAL MANAGEMENT**

There are two approaches to identify the functions that must be performed by financial management.

One classification system links the functions with the twin goals of liquidity and profitability.

The second classification method focuses on what is being a managed asset or funds.

I. **Liquidity Functions**: In seeking sufficient liquidity to carry out the firm’s activities, the financial manager performs tasks such as the following:

**1) Forecasting Cash Flows**:

* The day-to-day operations require the firm to be able to pay its bills properly. This is largely a matter of matching cash inflows against cash outflows.
* The firm must be able to forecast the sources and timing of inflows from¬ customers and use them to pay creditors and suppliers.

**2) Raising Fund:**

The firm receives financing from a variety of sources. At different times some sources will be more desirable than others. The possible source may not at a given time, have sufficient funds available to meet firm’s need. The financial manager must identify the amount of funds available from each source and the periods when they will be needed. Then the manager must take steps to ensure that the funds will actually be available and committed to the firm.

**3) Managing the Flow of Internal Funds:**

A large firm has a number of bank accounts for various operating division. The money that flows among these internal accounts should be carefully monitored. Frequently, a firm has excess cash in one bank account when it has a need for cash elsewhere. By continuously checking on the cash balances in the head quarters and each operating division’s accounts, the manager can achieve a high degree of liquidity with minimum external borrowing.

**4) Profitability Functions:**

In seeking profits for the firm the financial manager provides specific inputs into the decision making process, based on the financial training and actions. With respects to profitability, the specific functions are,

1. **Cost Control**: Most large corporations have detailed cost accounting systems to monitor expenditure in the operational areas of the firm. Data are fed into a system on a daily basis and computer-processed reports containing important information on activities are displayed on a screen.
2. **Pricing**: Some of the important decisions made by a firm involve the prices established for products and service. The philosophy and approach to pricing policy are critical elements in the company’s marketing efforts, image and sales level. Determination of the appropriate price should be a joint decision of marketing manager provides information on how differing price will affect demand in the market and firm’s competitive position. The financial manager can supply information about changes in costs at varying levels of production and the profit margins needed to carry on the business successfully. In effect, finance provides tools to analyze profit requirements in pricing decisions and contributes to the formation of pricing policies.
3. **Forecasting Profits**: The financial manager is responsible for gathering and analysing the relevant data and making forecasts of profits levels. To estimate profits from future sales, the firm must be aware of current costs likely increases in costs and likely changes in the ability of the firm to sell its products at the planned selling prices.
4. **Measuring Required Return**: Every time a firm invests its capital, it must make a risk return decision. Is the level of return offered by the project adequate for the level of risk there in? The required rate of return that must be expected from a proposal before it can be accepted. It is sometimes called the cost of capital. Determining the firm’s required return or cost of capital is a profitability function.
5. **Management functions**: In performing many functions leading to liquidity and profitability, the financial manager operates in two distinct roles. One role is manager, decision maker, a participant in the corporate team trying to maximise the value of the firm over the long run. The other role is an expert of financial matters and money markets, an individual with specific knowledge and skills in the area of money management. These roles are recognised in the two categories of functions performed by the financial manager.
6. **Managing Assets**: Assets are the resources by which the firm is able to conduct business. The term assets include buildings, machinery, vehicles, inventory, money and other resources owned or leased by the firm. A firm’s assets must be carefully managed and a number of decisions must be made concerning their usage. The function of asset management attests to the decision making role of the financial manager. Finance personnel meet with other officers of the firm and participate in making decisions affecting the current and future utilisation of the firm’s resources. The decision making role crosses liquidity and profitability lines, converting idle equipment to cash, so as to improve liquidity, reducing costs and improving profitability.

**II. Managing Funds:**

Funds may be viewed as the liquid assets of the firm. The term funds includes cash held by the firm, money borrowed by the firm, money borrowed by the firm, money gained from purchases of common and preferred stock. In the management of funds, the financial manager acts as a specialised staff officer to the CEO of company. The manager is responsible for having sufficient funds for the firm to conduct its business and to pay its bills.

Money must be allocated to finance receivables and inventories, to make arrangements for the purchase of assets and to identify sources of long term financing. Cash must be available to pay dividends declared by the company. The management of funds has both liquidity and profitability aspects. If the companies are inadequate, the firm may default on the payment of bills, interest on its Debt or repayment of principle when a loan is due. If the firm does not carefully choose its financing sources it may pay excessive interest costs with a subsequent decline in profits.

**FINANCE FUNCTIONS**

Although it may difficult to separate the finance functions from production, marketing and other functions, yet the functions themselves can be readily identified. The functions of raising funds, investing them in assets and distributing returns earned from assets to shareholders are respectively known as financing, investment and dividend decisions. While performing these functions, a firm attempts to balance cash inflows and outflows. This is called liquidity decision and we may add it to the list of important finance decision or functions. Finance functions or decisions include,

1. Investment or long term asset-mix decision.

2. Financing or Capital- mix decision.

3. Dividend or Profit allocation decision.

4. Liquidity or Short term asset-mix decision.

A firm performs finance functions simultaneously and continuously in the normal course of the business. They do not necessarily occur in a sequence. Finance functions call for skilful planning, control and execution of a firm’s activities.

**I.Investment Decision**:

Investment decision or capital budgeting involves the decision of allocation of capital or commitment of funds to long term assets that would yield benefits in the future.

Two Important aspects of the investment decision are,

1. The evaluation of the prospective profitability of new investments and

2. The measurement of a cut off rate against that the prospective return of new investments could be compared.

i. Future benefits of investments are difficult to measure and cannot be predicted with certainly.

ii. Because of the uncertain future, investment decisions involve risk. Investment proposals should, therefore, be evaluated in terms of both expected return and return.

iii. Besides the decision to commit funds in new investment proposals, capital budgeting also involves decision of recommitting funds when an asset becomes less productive or non-profitable.

iv. There is a broad agreement that the correct cut off rate is the required rate of return or the opportunity cost of capital.

v. However, there are problems in computing the opportunity cost of capital in practice from the available data and information. A decision maker should be aware of these problems.

**II. Financing Decision**:

1. Financing decision is the second important function to be performed by financial manager.
2. Broadly, he or she must decide when, where and how to acquire funds to meet the firm’s investment needs.
3. The central issue before him or her is to determine the proportion of equity and debt.
4. The mix of debt and equity is known as the firm’s capital structure for his or her firm.
5. The firm’s capital structure is considered to be optimum when the market value of shares is maximised.
6. The use of debt affects the return and the risk of shareholders, it may increase the return on equity funds bit it always increases risk.
7. When the shareholders return is maximised with minimum risk, the market value per share will be maximised and the firm’s capital structure would be considered optimum.
8. Once the financial manager is able to determine the best available sources.
9. In practice, a firm considers many other factors such as control, flexibility, loan convenient, legal aspects etc., in deciding its capital structure.

**III. Dividend Decision:**

1. Dividend decision is the third major financial decision.
2. The financial manager must decide whether the firm should distribute all profits or retain them or distribute a portion of profit and retain the balance in the business.
3. Like the debt policy, the dividend policy is one that maximises the market value of the firm’s shares.
4. Thus, if shareholders are not indifferent to the firm’s dividend policy, the financial manager must determine the optimum dividend-payout ratio.
5. The pay-out ratio is equal to the percentage of dividends to earnings available to shareholders.
6. The financial manager should also consider the questions of dividends regularly.
7. Periodically, additional shares called bonus shares (or stock divided) are also issued to the existing shareholders in addition to the cash dividend

**IV. Liquidity Decision:**

1. Current assets management that affects a firm’s liquidity is yet another r important fiancé function, in addition to the management of long-term assets.
2. Current assets should be managed efficiently for the safeguarding the firm against the dangers of liquidity and insolvency.
3. Investment in current assets affects the firm’s profitability, liquidity and risk. A conflict exists between profitability and liquidity while managing current assets.
4. If the firm does not invest sufficient funds in current assets, it may become liquid.
5. But it would lose profitability, as idle current assets would not earn anything.
6. Thus, a proper trade-off must be achieved between profitability and liquidity.
7. In order to ensure that neither insufficient nor unnecessary funds are invested in current assets.
8. He or she should estimate firm’s needs for current assets and make sure that funds would be made available when needed.
9. It would be clear that financial decision directly concern the firm’s decision to acquire or dispose off assets and require commitment or recommitment of funds on a continuous basis.
10. It is in this context that finance functions are said to influence production, marketing and other functions of the firm. xi. This is in consequence finance functions may affect the size, growth, profitability and risk of the firm and ultimately, the value of the firm.

**I. PROFIT MAXIMISATION**:

i. Profit maximization means maximising the rupee or any other currency such as dollar, pound or both income of firms.

ii. Profit is a primary motivating force for any economic activity. Firm is essentially being an economic organisation, it has to maximise the interest of its stakeholders. To this the firm has to earn profit from its operations.

iii. In fact, profits are useful intermediate beacon (encouragement/inspiration/ guiding light/symbol of hope/signal) towards which a firm’s capital should be directed.

iv. McAlpine rightly remarked that profit cannot be ignored since it is both a measure of the success of business and means of its survival and growth.

v. Profit is the positive and fruitful difference between revenues and expenses of a business enterprise over a period of time.

vi. If an enterprise fails to make a profit, capital invested is eroded /wrinkled/windswept and this situation prolongs, the enterprise ultimately ceases to exist.

vii.The overall objective of business enterprise is to earn at least satisfactory returns on the funds invested, consistent with maintaining a sound financial position.

**Limitations:**

The goal of profit maximisation has, however, been criticised in recent times because of the following reasons:

1. **Vague**:

i. The term “profit” is vague and it does not clarify what exactly it means. It has different interpretations for different people. Does it mean short-term or long-term; total profit or net profit; profit before tax or profit after tax; return on capital employed.

ii. Profit maximisation is taken as objective, the question arises which of the about concepts of profit should an enterprise try to maximise. Apparently, vague expression like profit can form the standard of efficiency of financial management.

2. **Ignores Time Value of Money**:

i. Time value of money refers a rupee receivable today is more valuable than a rupee, which is going to be receivable in future period.

ii. The profit maximisation goal does not help in distinguishing between the returns receivable in different periods.

iii. It gives equal importance to all earnings through the receivable in different periods. Hence, it ignores time value of money.

**3. Ignores Quality of Benefits:**

i. Quality refers to the degree of certainty with which benefits can be expected.

ii. The more certain expected benefits, the higher are the quality of the benefits and vice versa.

iii. Two firms may have same expected earnings available to shareholders, but if the earnings of one firm show variations considerably when compared to the other firm, it will be more risky.

* Profit maximisation objective leads to exploiting employees and consumers. It also leads to colossal /vast inequalities and lowers human values that are an essential part of ideal social systems.
* It assumes perfect competition and in the existence of imperfect competition, it cannot be a legitimate/lawful/legal objective of any firm. It is suitable for self-financing, private property and single ownership firms.
* A company is financed by shareholders, creditors and financial institutions and managed and controlled by professional managers. A part from these people, there are some others who are interested towards company (i.e., employees, government, customers and society).
* Hence one has to take into consideration all these parties interests, which is not possible under the objective of profit maximization. Wealth maximization objective is the alternative of profit maximization.

**II. SHAREHOLDERS WEALTH MAXIMISATION (SWM)**:

1. On account of above discussed limitations of profit maximizations shareholders wealth maximization is an appropriate goal for financial decision making.
2. It is operationally feasible since it satisfies all the three requirements of a suitable operational objective of financial courses of action namely exactness, quality of benefits and the time value of money.
3. The objective of Shareholders wealth maximization is an appropriate and operationally feasible criterion to choose among the alternative financial actions.
4. It provides an unambiguous measure of what financial management should seek to maximise in making investment and financing decisions on behalf of owners (shareholders).
5. Shareholders Wealth Maximisation means maximising the net present value (or wealth) of a course of action to shareholders.
6. The Net Present Value (NPV) of course of action is the difference between the present value of its benefits and present value of its costs.
7. A financial action that has a positive NPV creates wealth for ordinary shareholders and therefore, desirable/preferable and vice versa.
8. A financial action resulting in negative NPV should be rejected since it would destroy shareholders wealth. Between a numbers of mutually exclusive projects the one with the highest NPV should be adopted. The NPV of firm’s projects add. Therefore, the wealth will be maximised if this criterion is followed in making financial decisions.
9. The wealth will be maximised if this criterion is followed in making financial decisions.
10. From shareholders point of view, the wealth created by corporation through financial decisions or any decision is reflected in the market value of company shares.
11. For example, take Infosys Co., whose share price is increasing year by year, even by issue of bonus shares, and the company is trying to put its shares at popular trading level.
12. Therefore, the wealth maximisation principle implies that the fundamental objective of a firm is to maximise market value of its shares.
13. In other words, the market value of the firm is represented by its market price, which in turn is a reflection of a firm’s financial decisions.
14. Hence market price acts as a firm’s performance indicator.
15. A shareholders wealth at a period of time can be computed by the following formula:
16. SWt = NS X MPt
17. Where SWt = shareholders wealth at ‘t ’period.
18. NS = Number of equity shares owned (outstanding)
19. MPt = Market price of share at ‘t’ period.

**PROFIT MAXIMIZATION Vs WEALTH MAXIMISATION**

Profit maximisation is basically a single period or almost, short term goal, to be achieved within one year, it is usually intercepted to mean the maximisation of profits within a given period of time. A corporation may maximise its short term profits at the expense of its long term profitability. In contrast, stockholder wealth maximisation is a long term goal, since stakeholders are interested in future as well as present profits. Wealth maximisation is generally preferred because it consider,

1) Wealth for the long term.

2) Risk or uncertainty.

3) The timing of return.

4) The stakeholders return.

Timing of returns is important, the earlier the return is received, the better, since a quick return reduces the uncertainty about receiving the return and the money received can be reinvested sooner. The following Table summarizes the advantages and disadvantages of these two often conflicting goals.

|  |  |  |  |
| --- | --- | --- | --- |
| **Goal** | **Objective** | **Advantages** | **Disadvantages** |
| Profit Maximisation. | Large amount of profits. | 1) Easy to calculate profits | 1) Emphasises the short term. |
|  |  | 2) Easy to determine the link between financial decisions and profits. | 2) Ignores risk or uncertainty.  3) Ignores the timing of returns.  4)Requires immediate Resources |
| Stakeholders Wealth Maximisation. | Highest market value of common stock. | 1) Emphasises the long run | 1) Offers no clear relationship between financial decision and stock price |
|  |  | 2) Recognises risk or uncertainty | 2) It can lead to management anxiety and frustration |
|  |  | 3) Recognises the timing of return. |  |
|  |  | 4) Consider the stockholders return. |  |

**Functions of Finance Manager**

The following are the new functions of finance manager:

1. Continuous focus on margins and ensure that the organisation stays committed to value creation.

2. Work across the functional divide of the company and exhibit leadership skills.

3. Understand what’s driving the numbers and provide operation insights, including a sense of external market issues and internal operating trends and become key strategy player.

4. Aware and use the highly innovative financial instruments.

5. Know the emergence of capital market as central stage for raising money.

6. Adding more value to the business through innovations in impacting human capital.

7. Must balance the need to cut overhead with the need to create a finance organisation able to meet long-term goals by---designing financial processes, systems and organise that can support the business in the future and initiating cost reductions that further cut organisational fat, but not operational muscle.

8. Liaison / connection to the financial community, investors and regulators (rating agencies, investment and commercial bankers and peers), which are valuable information sources for strategic and tactical decisions.

9. Assess probable acquisitions, contemplating initial negotiation, carrying out due diligence, communicating to employees and investors about the horizontal integration.

10. Deal with the post-merger integration in the light of people issues.

11. Deal with the new legislation (New Companies Bill, limited liability of Partnership) and regulations merely add more formality and , to an extent , bureaucracy, to what most already subscribe to as best practices in financial reporting.

12. Be one of the undisputed arbiters in matters of financial ethics, with the backing of legislation and stiff penalties.

13. Finance managers are central to changes in audit and control practices. Corporate governance is a key issue that must be continuously monitored and he/she should not push the limit of the P&L and growth.

14. Be aware of the proposed changes in financial reporting systems such as International Finance Reporting Standards (IFRS), Goods and Services Tax (GST), Direct Tax Code(DTC) and Extensible Business Reporting Language(EBRL). Adapting and optimizing within changing tax reforms would become imperative for them and their organization.

15. Research reports reveal that today companies want to see how they collaborate with and influence of CEO and board of directors; how they can go beyond books of accounts and contribute to the business with a better understanding of customer needs and issues; understand why a particular market is an important; Why a business tie-up is necessary; why sales are not happing; how a company can motivate and retain people; how to rightsizing; and how to take strategic decisions related to supply chains, pricing and production.

16. Therefore, finance function should have to face lightening changes taking place in business environment and coping with such changes is critical for any finance manager to ensure that the business and function remain contemporary and socially relevant

RISK-RETURN TRADE-OFF

1. Risk is present in every business decision, whether it is corporate decision or personal decision.
2. When we say risk, most of us think in the negative sense
3. According to the business dictionary risk refers, threat or damage injury or liability or loss of other negative occurrence caused by external or internal vulnerabilities.
4. But, from business point of view risk is the variability in an expected return. In other words, business people see the risk in broader perspective. They see risk in the business when they realize less return than expected.
5. Actual return may be less than the expected return, because of risks like, business risk, financial risk, default risk, delivery risk, interest rate risk, exchange rate risk, liquidity risk, investment risk and political risk.
6. For example, selection of an asset for production department or developing a new product or financial decisions like- developing capital structure, working capital management, and dividend decision. Therefore, the decision makers have to assess risk and return of investing on asset before taking any financial decision.

**TIME VALUE OF MONEY**

1. The simple concept of time value of money is that the value of the money received today is more than the value of same amount of money received after a certain period.
2. In other words, money received in the future is not as valuable as money received today. The sooner one receives money, the better it is.
3. Taking the case of a rational human being, given the option to receive a fixed amount of money at either of two time periods, he will prefer to receive it at the earliest.
4. If you are given the choice of receiving Rs.1,000 today or after one year, you will definitely opt to receive today than after one year.
5. This is because of you value the current receipt of money higher than future receipt of money after one year.
6. The phenomenon is referred to as time preference for money.

**Capital Asset Pricing Model/ Approach**

This method separates the cost of equity into risk free return which is available for investing in government bonds and an additional risk premium which is for investing in a specific share or investment. The risk premium involves the average return on the overall market portfolio and the beta factor i.e., the risk factor of the particular investment.

The cost of equality for an investment with the help of CAPM approach is calculated as follows:

a. Ke = Rf +bi (Rm – Rf)

b. Where Ke = Cost of Capital, Rf= Risk free rate of return,

c. bi = Beta of the Investment, Rm= Average Market Return.