BUSINESS FINANCE - 1

Assignment - 2

Q.1] i) Liquidity preference.

Liquidity preference refers to the relationship between the quantity of money the public wishes to hold and the interest rate.

In other words, it is the premium that wealthholders demand for exchanging ready money ~~or bon~~ for safe, non-liquid assets such as government bonds. It is money demand as measured through liquidity.

Ex. A three-year government bond might pay 2% interest rate, a 10-year government bond may pay 5% interest rate and a 30-year government bond may pay 7% interest rate.

For an investor to sacrifice liquidity, they must receive a higher rate of interest.

Q.2]

Q.3. The factors that influence the dividend policy of a company.

1. Stock Markets.

Stock market is an indicator of the company's performance. Therefore, they react adversely to the notice of dividend cut or no dividend. ~~If the comp~~ Therefore managers tend to conservatism in the good years.

A change in the dividend policy can have a major impact on a company's market rating and its capacity to raise finance.

~~2. Tax~~

~~If the company has a large proportion of investors (shareholders) who don't pay taxes i.e their income comes in the~~

2. Tax.

If the companies have a large proportion of non-tax paying shareholders, then they should distribute dividends. This is because their income is below the tax-free dividend limit.

Whereas on the other side, dividends should not be distributed if the large proportion of shareholders are taxed. In this scenario, profits should be reinvested.

3. Cash Reserves.

Companies which have a huge cash pile are vulnerable to a takeover. If the company has a huge cash pile, and no other investment opportunities then they should distribute dividends.

4. Growth

Companies in high-growth industries have huge capital requirements and instead of borrowing it is better to reinvest the profits. Due to this prefer to pay low or no dividend.

As investors who invest in high-growth companies don't expect a dividend, paying dividend can be a sign that the company does not have growth opportunities

5. Stability

The dividend policy of any company should be stable and consistent. ~~S~~ As companies who pay dividends and who do not pay or pay low dividends attract a specific set of investors. Any change in the dividend policy will ~~b~~ have an adverse effect on the market ~~result~~ as the investors will switch to companies which fit their criteria.

Q.4.] The major type of business entities are as follows:-

1) Sole proprietorship.
2) Partnership
3) Limited Companies.
4) Limited Liability partnership.

Ownership

1] Sole proprietorship is a form of business which is owned, managed and controlled by a single individual.

2] Partnership is a form of business which is owned by one or more person.

3] Limited Company is a form of business which has a legal identity separate from the owners. The shareholders are the owners of the company.

4] Limited liability partnership is a form of a business where two or more members. There are no shareholders.

Liability.

1] The sole proprietor has unlimited liability i.e if the business's ~~t~~ assets are not sufficient to cover its liabilities, then the sole trader's personal property can be sold to meet the liabilities.

2] Partners of a Partnership firm have unlimited liability.

3] The shareholders i.e owners of the limited company have limited liability.

4] The members of a limited liability partnership have a limited liability i.e their liability is limited to the capital invested by them.

Legal Status

1] Sole proprietorship does not have a separate legal identity.

2] Partnership firm does not have a separate legal identity from the partners.

3] A limited company has a separate legal identity.

4] A limited liability partnership is a separate legal identity.

Q.5] 1] Sole trader / Sole proprietorship is a bussiness form which is owned, managed and controlled by an individual who bears all the risk and enjoys the profits.

A limited company is a separate legal identity from its owner.

2] A Sole trader pays a normal income tax. There is no separate tax on business profit.

A limited company has to pay a corporate tax on their profits. However, the employees have to pay income taxes on their salaries and shareholders pay taxes on dividends.

Corporate taxes are higher than personal income tax. Moreover, after taking a salary, the ~~sta~~ employee or CEO of the company has to pay a personal tax.

Therefore, by keeping only the minimizing the tax amount in mind Sole proprietorship is the idle choice.

Q.6] Modigliani and Miller's irrelevance properties.

1) Capital Structure Irrelevance Theory.

Capital Structure does not affect the market value of the Company, the market value of the company is affected by the Investment decision that the Finance Manager would take

2) Modigliani and Miller's second irrelevance proposition is:- The expected rate of return on the common stock of a leveraged firm increases in proportion to the debt-equity ratio, expressed in market values.

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Q.7] Working Capital

1) Working Capital is Calculated by Subtracting Current liabilities from Current assets.

2) Working Capital is the Capital required ~~to~~ for the day-to-day functioning of the business.

3) A certain level of liquidity is required by a business to survive which is provided by the working Capital.

2) Fixed Capital

1) Fixed Capital includes the long-term capital structure and are assets like properties, equipment etc that a business needs to operate.

2) Fixed Capital is the value of Capital assets which are available for production purposes.

Q.8] Economies of Scale.

1) Economies of scale are said to be achieved, when more units of goods or services can be produced on a large scale, with a (on average) fewer input costs.

2) It refers to the cost advantage experienced by a firm when it increases its level of output.

3) The advantage arises because higher the quantity of output produced, the lower will be the per-unit fixed cost.

4) These cost advantages are experienced by the firm when the production process become efficient.

5) These economies of scale can be both internal and external. Internal economies of scale are caused by factors within a single company while external factors affect the entire industry.

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Q.11] Possible costs of holding buffer inventory / stock of goods.

~~It~~ is - An optimum stock of goods should be maintained to ensure smooth functioning of the business.

However, there are some costs to holding buffer inventory / stock of goods.

1) Having a buffer stock i.e excess stock means that much cash trapped in inventory and may affect the liquidity position of the company / business.

2) Moreover, the business incurs additional expense on storage of these goods as well as on their insurance. ~~[illegible]~~

3) The buffer stock may ~~be damag~~ get damaged, stolen or obsolete. Therefore, the business bears the risk of that as well.