MB202: FINANCIAL MANAGEMENT

UNIT 3

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FINANCING DECISION

The Financing Decision is a crucial decision that is to be made by the financial manager, the decision is about the financing-mix of an organization. Financing Decision is focused on the borrowing and allocation of funds required for the investment decisions of the firm. We will learn in detail about these various financing decisions in the upcoming section. The financing decision comes from two sources from where the funds can be raised – first is from the company's own money, such as the share capital, retained earnings. Second is from borrowing funds from the outside the corporate in the form debenture, loan, bond, etc. The objective of the financial decision is to balance an optimum capital structure.

Basic Financial Decisions

Basic Financial Decisions that financial managers need to take:

- **Investment Decision:** Also known as the Capital Budgeting Decisions. A company's assets and resources are very rare and thus must be put to use with much analysis. A firm should pick those investments where he can gain the highest conceivable returns. Investment decision involves careful selection of the assets where funds will be invested by the corporates.
- **Financing Decision:** Financial decision is the utmost important decision which is to be made by business individuals. These are wise decisions indeed that are to be chalked out with proper analysis. He decides when, where and how should the business acquire the fund. An organization's increase in share is not only a sign of development for the firm but also to boost the investor's wealth.
- **Dividend Decision:** Dividend decisions relate to the distribution of profit that are earned by the organization. The main criteria in this decision are whether to distribute to the shareholders or to retain the earnings. Dividend decisions are affected by the earnings of the business, dependency on earnings.

Importance of Financial Decision Making

- **Long-term Growth and Effect:** Financial decisions are concerned with the long-term use of assets. These assets are very helpful in the process of production. Profit is also earned by selling the goods that are produced. This can, therefore, be accurate decisions. The greater the growth of business in the long run, the more effective the decision needs to be. In addition to that, these affect the future prospect of the business.
- **Large Amount of Funds Involved:** Funds are the base of this business decision. Decisions regarding the fixed assets are included in the context of capital budgeting. Huge capital is invested in these assets. If these decisions turn out to be a flaw, then it will cause heavy loss of capital which is indeed a scarce resource.
- **Risk Involved:** Capital budgeting decisions come with risks. There are two reasons for the risk factor to be involved in it. First, these decisions are analysed for a long period, and thus the expected profits for several years are to be anticipated which even lead to fluctuations. These are human estimations which may turn out to be wrong. Secondly, as a heavy investment is involved, it is very difficult to change the decision once it has been taken.
- **Irreversible Decisions:** Nature of these decisions is irreversible, once taken it cannot be reformed. For instance, if soon after setting up a sugar mill, the owner thought of changing it, then the old machinery used for the purpose and other fixed assets will have to be sold at a loss. In doing this, the heavy loss will have to be incurred by the owner.

BUSINESS FINANCE

Business finance is the funds required to establish, operate business activities, and expand in the future. Funds are specifically required various purchase type of tangible assets such as furniture, machinery, buildings, offices, factories, or intangible assets like patents, technical expertise, and trademarks, etc.

Apart from the assets mentioned above, other things that require funding are the day-to-day operational activities of a business. This activity includes purchasing raw materials, paying salaries, bills, collecting money from clients, etc. It is essential to have sufficient amount of money to survive and grow the business.

Classification of Sources of Funds

Businesses can raise capital through various sources of funds which are classified into three categories.

1. Based on Period – The period basis is further divided into three dub-division.

- **Long Term Source of Finance –** This long term fund is utilized for more than five years. The fund is arranged through preference and *equity shares* and debentures etc. and is accumulated from the capital market.
- **Medium Term Source of Finance –** These are short term funds that last more than one year but less than five years. The source includes borrowings from a public deposit, commercial banks, *commercial paper,* loans from a financial institute, and lease financing, etc.
- **Short Term Source of Finance –** These are funds just required for a year. Working Capital Loans from Commercial bank and trade credit etc. are a few examples of these sources.

2. Based on Ownership – This sources of finance are divided into two categories.

- **Owner's Fund –** This fund is financed by the company owners, also known as owner's capital. The capital is raised by issuing *preference shares,* retained earnings, equity shares, etc. These are for long term capital funds which form a base for owners to obtain their right to control the firm's management and operations.
- **Burrowed Funds –** These are the funds accumulated with the help of borrowings or loans for a particular period of time. This source of fund is the most common and popular amongst the businesses. For example, loans from commercial banks and other financial institutions.

3. Based on Generation – This source of income is categorized into two divisions.

- **Internal Sources –** The owners generated the funds within the organization. The example for this reference includes selling off assets and retained earnings, etc.
- **External Source –** The fund is arranged from outside the business. For instance, issuance of equity shares to public, debentures, commercial banks loan, etc.

1. On the Basis of Period

- **Long Term Equity**
  - Equity shares
  - Retained earnings
  - Preference shares
  - Debentures
  - Loan from financial institutions
- **Medium Term**
  - Loan from banks
  - Public deposits
  - Loan from financial institutions
- **Short Term**
  - Trade credit
  - Factoring
  - Banks
  - Commercial paper

2. On the Basis of Ownership

- Owners Fund
  - Equity shares
  - Retained Earnings
- Borrowed Funds
  - Debentures
  - Loans from banks
  - Loans from financial institutions
  - Public deposits
  - Lease financing

3. On the Basis of Source of Generation

- Internal Sources
  - Equity share capital
  - Retained earnings
- External Sources
  - Financial institutions
  - Loan from banks
  - Preference shares
  - Public deposits
  - Debenture
  - Lease financing
  - Commercial papers
  - Trade credit
  - Factoring

CAPITAL STRUCTURE

The most crucial component of starting a business is capital. It acts as the foundation of the company. Debt and Equity are the two primary types of capital sources for a business. Capital structure is defined as the combination of equity and debt that is put into use by a company in order to finance the overall operations of the company and for its growth.

Types of Capital Structure

The meaning of Capital structure can be described as the arrangement of capital by using different sources of long term funds which consists of two broad types, equity and debt. The different types of funds that are raised by a firm include preference shares, equity shares, retained earnings, long-term loans etc. These funds are raised for running the business.

Equity Capital: Equity capital is the money owned by the shareholders or owners. It consists of two different types

- Retained earnings: Retained earnings are part of the profit that has been kept separately by the organisation and which will help in strengthening the business.
- Contributed Capital: Contributed capital is the amount of money which the company owners have invested at the time of opening the company or received from shareholders as a price for ownership of the company.

Debt Capital: Debt capital is referred to as the borrowed money that is utilised in business. There are different forms of debt capital.

- Long Term Bonds: These types of bonds are considered the safest of the debts as they have an extended repayment period, and only interest needs to be repaid while the principal needs to be paid at maturity.
- Short Term Commercial Paper: This is a type of short term debt instrument that is used by companies to raise capital for a short period of time

Optimal Capital Structure

Optimal capital structure is referred to as the perfect mix of debt and equity financing that helps in maximising the value of a company in the market while at the same time minimises its cost of capital. Capital structure varies across industries. For a company involved in mining or petroleum and oil extraction, a high debt ratio is not suitable, but some industries like insurance or banking have a high amount of debt as part of their capital structure.

Financial Leverage

Financial leverage is defined as the proportion of debt that is part of the total capital of the firm. It is also known as capital gearing. A firm having a high level of debt is called a highly levered firm while a firm having a lower ratio of debt is known as a low levered firm.

Importance of Capital Structure

- A firm having a sound capital structure has a higher chance of increasing the market price of the shares and securities that it possesses. It will lead to a higher valuation in the market.
- A good capital structure ensures that the available funds are used effectively. It prevents over or under capitalisation.
- It helps the company in increasing its profits in the form of higher returns to stakeholders.
- A proper capital structure helps in maximising shareholder's capital while minimising the overall cost of the capital.
- A good capital structure provides firms with the flexibility of increasing or decreasing the debt capital as per the situation.

Factors Determining Capital Structure

Following are the factors that play an important role in determining the capital structure:

- Costs of capital: It is the cost that is incurred in raising capital from different fund sources. A firm or a business should generate sufficient revenue so that the cost of capital can be met and growth can be financed.
- Degree of Control: The equity shareholders have more rights in a company than the preference shareholders or the debenture shareholders. The capital structure of a firm will be determined by the type of shareholders and the limit of their voting rights.
- Trading on Equity: For a firm which uses more equity as a source of finance to borrow new funds to increase returns. Trading on equity is said to occur when the rate of return on total capital is more than the rate of interest paid on debentures or rate of interest on the new debt borrowed.
- Government Policies: The capital structure is also impacted by the rules and policies set by the government. Changes in monetary and fiscal policies result in bringing about changes in capital structure decisions.

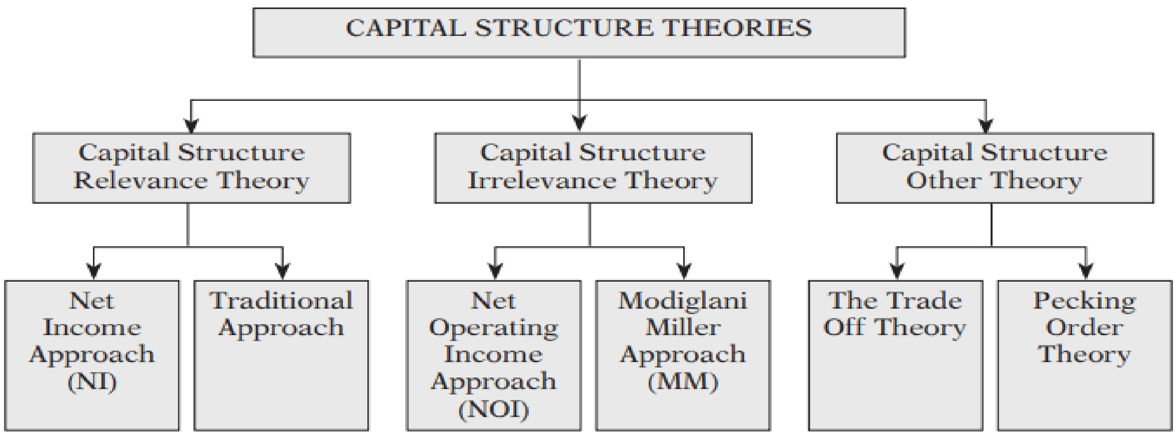
Factors affecting the Capital Structure

Several factors affect a company's capital structure, and it also determines the composition of debt and equity portions within this structure. Some of these factors are as follows:

- Business Size – The size and scale of a business affect its ability to raise finance. Small-sized companies face difficulty in raising long-term borrowings. Creditors are hesitant to give them loans because of the scale of their business operations. Even if they do get these loans, they have to accept high-interest rates and stringent repayment conditions. It limits their ability to grow their business.
- Earnings – Firms with relatively stable revenues can afford a more significant amount of debt in their capital structure. Since debt repayment is periodical with fixed interest rates, businesses with higher income prospects can bear these fixed financial charges. On the other hand, companies that face higher fluctuations in their sales, like consumer goods, rely more on equity shares to finance their operations.
- Competition: If a company operates in a business environment with more competition, it should have more equity shares in its capital structure. Their earnings are prone to more fluctuation compared to businesses facing lesser competition.
- Stage of the life cycle: A business in the early stage of its life cycle is more susceptible to failure. In that case, they should use a more significant proportion of ordinary share capital to finance their operations. Debt comes with a fixed interest rate, and it is more suitable for companies with stable growth prospects.
- Creditworthiness: Any company that has a reputation for paying back its loans on time will be able to raise funds on less stringent terms and at lower interest rates. It allows them to pay back their loans on time. The opposite is true for firms that don't have a good credit standing in the market.
- Risk Aptitude of the Management: The attitude of a company's management also affects the proportion of debt and equity in the capital structure. Some managers prefer to follow a low-risk strategy and opt for equity shares to raise finances. Other managers are confident of the company's ability to repay big loans, and they prefer to undertake a higher proportion of long term debt instruments.
- Control: A management that wants outside interference in its operations may not raise funds through equity shares. Equity shareholders have the right to appoint directors, and they also dilute the stake of owners in the company. Some companies may prefer debt instruments to raise funds. If the creditors get their instalments on loans and

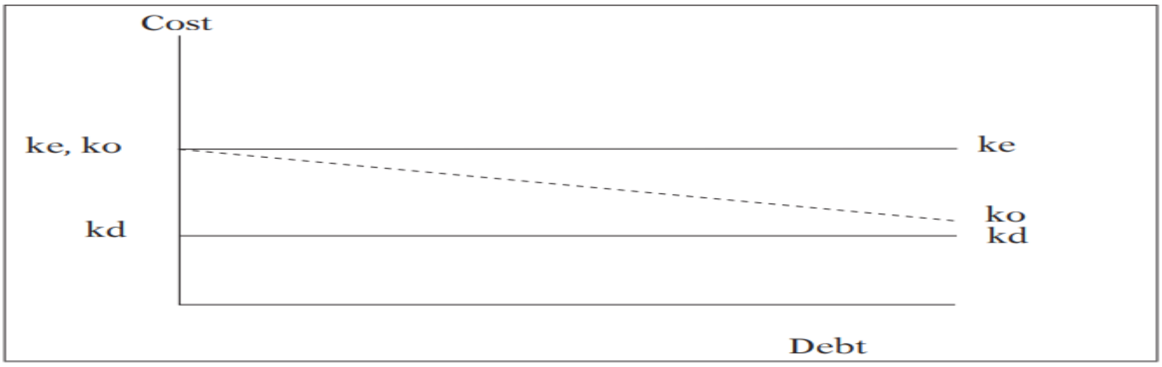
- interest on time, they will not be able to interfere in the workings of the business. But if the company defaults on their credit, the creditors can remove the present management and take control of the business.
- State of Capital Market: The tendencies of investors and creditors determine whether a company uses more debt or equity to finance their operations. Sometimes a company wants to issue ordinary shares, but no one is willing to invest due to the high-risk nature of their business. In that case, the management has to raise funds from other sources like debt markets.
- Taxation Policy: The government's monetary policies in terms of taxation on debt and equity instruments are also crucial. If a government levies more tax on gains from investing in the share market, investors may move out of equities. Similarly, if the interest rate on bonds and other long-term instruments is affected due to the government's policy, it will also influence companies' decisions.
- Cost of Capital: The cost of raising funds depends on the expected rate of return for the suppliers. This rate depends on the risk borne by investors. Ordinary shareholders face the maximum risk as they don't get a fixed rate of dividend. They get paid after preference shareholders receive their dividends. The company has to pay interest on debentures under all circumstances. It attracts more investors to opt for debentures and bonds.

CAPITAL STRUCTURE THEORIES



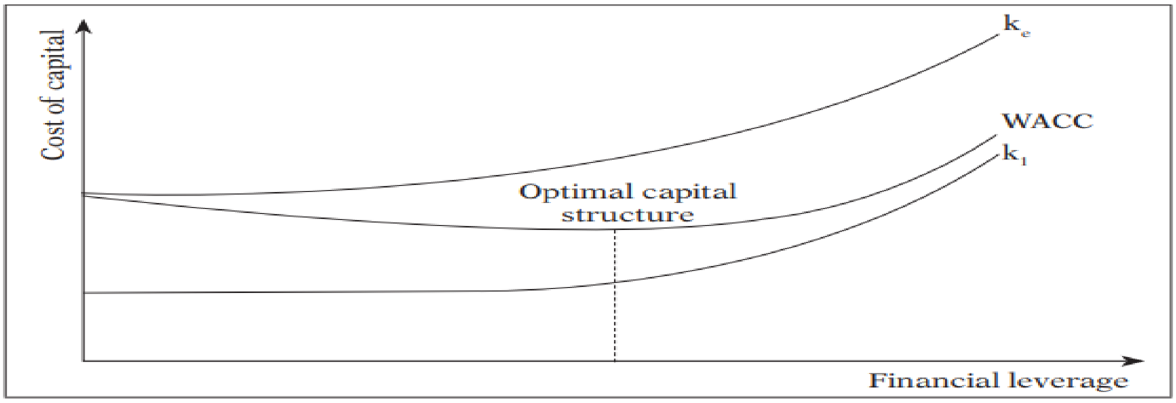
1. Net Income Approach (NI)

This theory was postulated by David Durand, who put forward the idea of increasing the proportion of debt in the overall capital structure. According to him, debt is a fund source because it has a lower interest rate, eliminating the risk factor and playing a significant role in deducting expenses for income tax. This theory is also called the "Fixed 'Ke' theory." According to this approach, capital structure decision is relevant to the value of the firm. An increase in financial leverage (Debt Proportion) will lead to decline in the weighted average cost of capital (WACC), while the value of the firm as well as market price of ordinary share will increase.



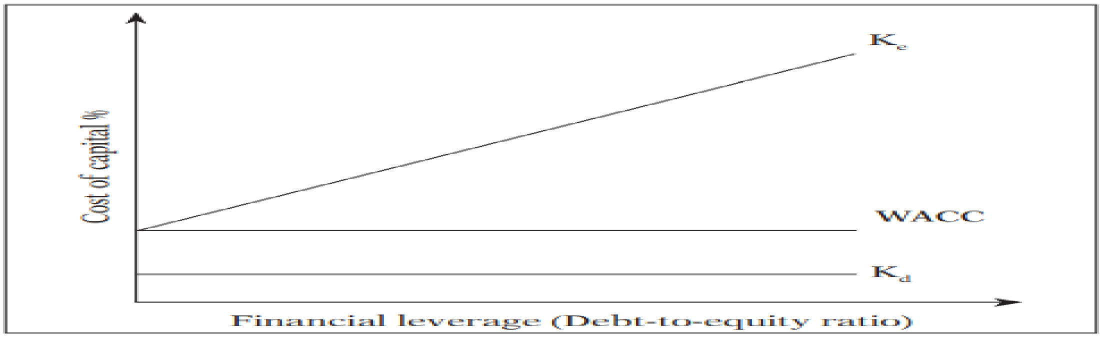
2. Traditional Approach

The traditional theory was postulated by Ezra Solomon. The assumptions of this approach are quite related to the net income theory. The main principle behind this theory was to increase the proportion of debt to a certain limit in the capital structure. This approach favours that as a result of financial leverage up to some point, cost of capital comes down and value of firm increases. However, beyond that point, reverse trends emerge.



3. Net Operating Income Approach (NOI)

Also known as the irrelevant theory, it was also postulated by David Durand. It depicts that the company's market value is not affected by changes in the capital structure. The overall cost of equity can remain fixed no matter the proportion of debt. According to this approach, capital structure decisions of the firm are irrelevant. Any change in the leverage will not lead to any change in the total value of the firm and the market price of shares, as the overall cost of capital is independent of the degree of leverage.

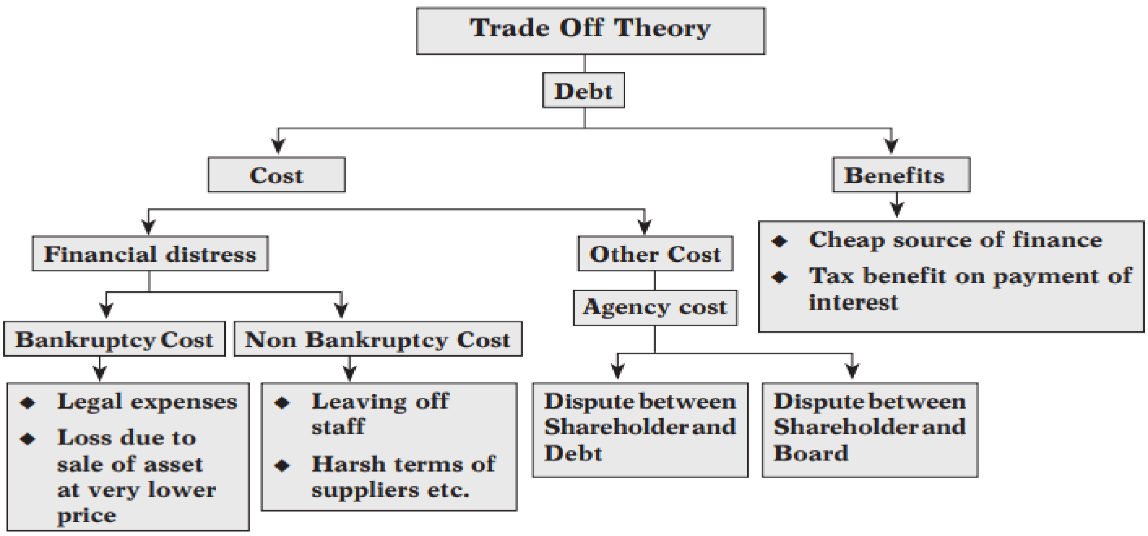


4. Modigliani-Miller Approach (MM)

This theory came into existence by correlating the ideas of two co-members, Franco Modigliani and Merton Miller. This theory had two further assumptions.

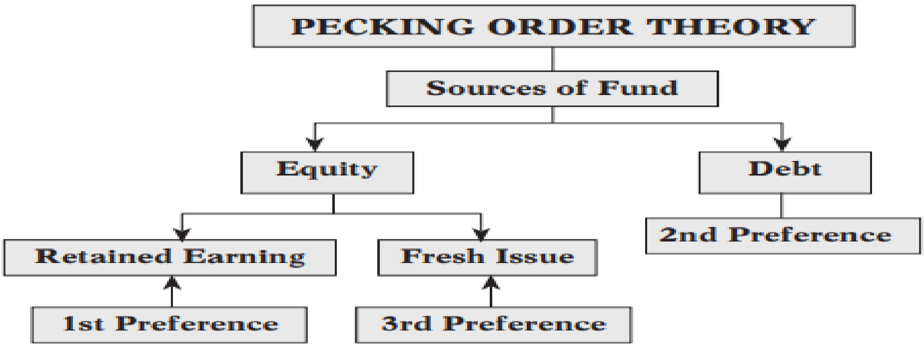
- **Absence of Corporate taxes**: According to Modigliani-Miller's theory, in the absence of the corporate tax, the value of the creditworthy firm will be equal to that of the amount of equity compromised.
- **Presence of corporate taxes**: In the case where taxes are applied, the value of the creditworthy firm is equal to the value of the indebted firm summed up with the product of the tax rate and the value of debt.

5. The Trade Off Theory



6. Pecking Order Theory

The pecking order theory focuses on asymmetrical information costs. This approach assumes that companies prioritize their financing strategy based on the path of least resistance. Internal financing is the first preferred method, followed by debt and external equity financing as a last resort.



FINANCIAL STRUCTURE

Financial Structure includes both long-term and short-term financial instruments to raise capital for the organisation. All the items present in the Liabilities side of the Balance Sheet are a part of the Financial Structure.

Key components of a financial structure

1. Equity financing

Equity financing refers to raising capital for a business by selling shares to investors. Investors gain proportionate ownership of the company's assets and are entitled to a share of its earnings. Equity financing includes selling various equity instruments, such as,

- Common and preferred Stock: Common stock comes with voting rights, whereas preferred stock does not. However, preferred stockholders have priority while receiving dividends. An internal source of generating equity for your business is using the
- Retained earnings: It represents a company's accumulated profits after paying its costs, income taxes, and dividends to shareholders. The retained earnings can be utilized to fund business operations. Equity can be raised from diverse sources such as
- Venture capital and angel investors: Venture capitalists and angel investors provide capital or initial seed money in exchange for equity stakes in start-ups or high-growth companies.
- Initial public offerings (IPOs): Private companies become publicly traded by offering their shares to the public for the first time. IPOs raise substantial equity capital. Equity financing offers businesses a means to raise funds without incurring debt.

2. Debt financing

Debt financing involves raising capital for a business by borrowing funds and repaying it with interest. Let's discuss the various instruments of debt financing.

- Bank loans and lines of credit: Financial institutions act as lenders. Companies repay the principal amount with interest over a specified period.
- Corporate bonds: Companies issue corporate bonds to investors to raise capital. Investors are paid interest periodically and are repaid the principal amount at maturity.
- Debentures: Debentures are marketable debt security that companies issue to obtain financing. They are backed by the company's creditworthiness rather than specific assets.
- Lease financing: It involves obtaining capital by entering into lease agreements for equipment or real estate. This allows businesses to use assets without ownership. The diverse debt financing instruments allow companies to raise capital by leveraging existing assets and future cash flows.

3. Working capital management

Working capital management is a business strategy to monitor a company's operational liquidity and short-term financial activities to ensure efficient day-to-day operations.

Cash management strategies: Efficient cash management is necessary to maintain liquidity. Strategies include

- Optimizing cash flow through effective billing and collection processes
- Managing payment schedules
- Investing excess cash to generate returns

Inventory and accounts receivable management

- Managing inventory levels is essential to prevent overstocking or stock outs. Efficient supply chain management is employed to optimize inventory.
- Accounts receivable management involves balancing credit terms to receive timely customer payments, reducing the cash conversion cycle.

Short-term investments

Cash investments in short-term instruments, such as money market funds or treasury bills, help companies to earn returns while ensuring liquidity. Understanding the components of financial structure highlights the criticality of capital structure decisions.

Difference between Capital Structure and Financial Structure

The main differences between Capital and Financial Structure are as follows:

Capital Structure	Financial Structure
Definition	
Capital Structure is a combination of different types of long-term sources of funds.	Financial Structure is a combination of different types of long-term as well as short-term sources of funds.
Balance Sheet	
The Capital Structure is a part of the Liabilities section of the Balance Sheet.	The Financial Structure includes all the items in the Liabilities section of the Balance Sheet.
Scope	
Capital Structure has a narrower scope compared to Financial Structure.	Financial Structure has a broader scope compared to Capital Structure.
Financial Instruments	
The instruments under Capital Structure include the following: Equity Shares Preference Shares Debentures Long-term Borrowings Retained Earnings	The instruments under Financial Structure include the following: Equity Shares Preference Shares Debentures Long-term Borrowings Retained Earnings Account Payable Short-term Borrowings

LEVERAGE

Leverage refers to borrowing funds for a particular purpose with an obligation to repay these funds, with interest, at an agreed-to schedule. The idea behind leverage is to help borrowers achieve a higher return with a smaller investment.

Two ways to borrow capital are to issue bonds (equity financing) or borrow directly from lenders (debt financing).

Equity financing involves selling your equity in exchange for funding. One of the biggest benefits of equity financing is that it doesn’t lead to the company having to make interest payments or any principal repayment. Some of the most common examples of equity financing are initial public offerings (IPOs) and crowdfunding.

Debt financing involves a company borrowing money to fund working capital requirements. When a company borrows money, it needs to make interest payments as well as repay the principal. Taking a loan is a common debt financing example.

The 3 main types of leverage

There are three main types of leverage:

1. Financial leverage

Financial leverage refers to the amount of debt a business has acquired. On a balance sheet, financial leverage is represented by the liabilities listed on the right-hand side of the sheet. Financial leverage lets your business continue to make investments even if you're short on cash. It's usually preferred to equity financing, as it lets you raise funds without diluting your ownership.

The formula to calculate the degree of financial Leverage is

DFL = % Change in EPS / % Change in EBIT

Or

DFL = EBIT/ EBT

2. Operating leverage

Operating leverage accounts for the fixed operating costs and variable costs of providing goods and services. As fixed assets don't change with the level of output produced, their costs are constant and must be paid regardless of whether your business is making a profit or experiencing losses. On the other hand, variable costs change depending on the output produced.

The formula to compute the degree of operating leverage is

DOL = % Change in EBIT / %Change in Sales

Or

DOL = Contribution / EBIT

3. Combined leverage

Combined leverage accounts for your organization's total business risks. As the name suggests, combined leverage aggregates the effects of operating and financial leverages to present a complete picture of your company's financial health.

Combined leverage can be used by capital-intensive businesses with expansion potential but insufficient levels of cash or equity. To effectively use combined leverage though, be sure of your business's future expenses and the market conditions. High levels of combined risk can make returns susceptible to inputs, such as sales volumes.

DCL = DOL*DFL

EBIT-EPS Analysis

EBIT-EPS (earnings before interest and taxes - earnings per share) analysis is a valuable tool for understanding how different financing decisions can affect a company's profitability for shareholders. It is used in financial planning to evaluate different financing options and their impact on a company's earnings per share (EPS). EBIT-EPS analysis gives a scientific basis for comparison among various financial plans and shows ways to maximize EPS. Hence EBIT-EPS analysis may be defined as ‘a tool of financial planning that evaluates various alternatives of financing a project under varying levels of EBIT and suggests the best alternative having highest EPS and determines the most profitable level of EBIT’.

Concept of EBIT-EPS Analysis:

The EBIT-EBT analysis is the method that studies the leverage, i.e. comparing alternative methods of financing at different levels of EBIT. Simply put, EBIT-EPS analysis examines the effect of financial leverage on the EPS with varying levels of EBIT or under alternative financial plans. It examines the effect of financial leverage on the behavior of EPS under different financing alternatives and with varying levels of EBIT. EBIT-EPS analysis is used for making the choice of the combination and of the various sources. It helps select the alternative that yields the highest EPS. We know that a firm can finance its investment from various sources such as borrowed capital or equity capital. The proportion of various sources may also be different under various financial plans. In every financing plan the firm’s objectives lie in maximizing EPS.

Advantages of EBIT-EPS Analysis

EBIT-EPS analysis serves as a strategic roadmap to financial growth and offers several potential benefits for businesses and investors, including -

- It allows you to identify and mitigate potential financial landmines associated with various funding strategies.
- You can strike the ideal balance between debt and equity to maximise EPS.
- It allows businesses to foster trust and transparency by clearly communicating the financial implications of funding decisions.
- Businesses can compare the financial landscapes of different funding options to select the most advantageous route.

- EBIT-EPS analysis aids in predicting the long-term impact of financial choices on profitability and growth.

Limitations of EBIT-EPS Analysis

- EBIT-EPS analysis primarily emphasises maximising EPS, potentially overlooking other critical financial factors like stability, liquidity, and risk management.
- It doesn't account for the increased risk associated with higher debt levels, which can be problematic during economic downturns.
- EBIT-EPS analysis does not consider external economic factors like interest rates and economic cycles.
- It doesn't address the risk of overcapitalisation, which means that adding more debt or equity may not generate enough profits to justify their expenses.

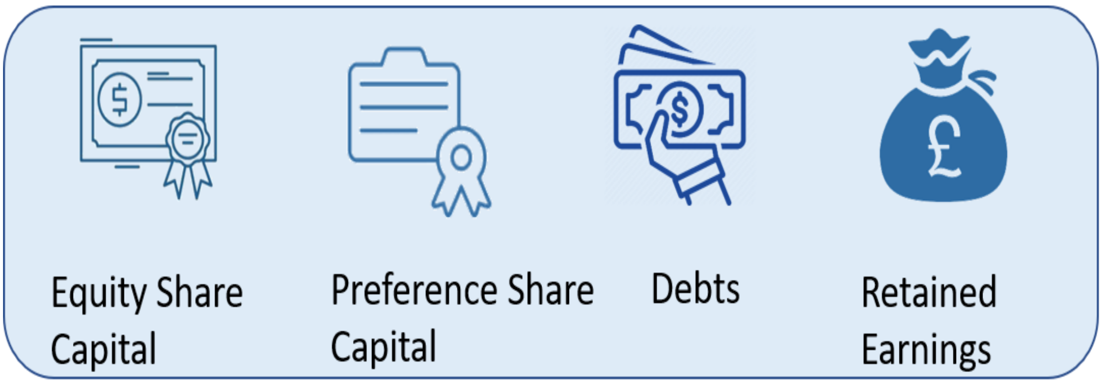
COST OF CAPITAL

Cost of Capital is the rate of return the firm expects to earn from its investment in order to increase the value of the firm in the market place. In other words, it is the rate of return that the suppliers of capital require as compensation for their contribution of capital.

The term cost of capital is a fundamental financial metric companies use to determine the minimum acceptable rate of return needed to warrant pursuing a capital budgeting project. These projects typically involve significant investments, such as purchasing land, buildings, machinery, equipment, and other tangible assets, all of which require large expenditures upfront.

Source of Cost of Capital

The source of capital employed by the firm is usually in the following form:



Components of Cost of Capital

There are three factors to the cost of capital explained below:

- **Zero Risk Return:** It talks about the expected rate of return when a project involves no financial or business risks.
- **Premium for the Business Risk:** Business risk is determined by the capital budgeting decisions that a firm takes for its investment proposals. So, if a firm selects a project that has more than normal risk, then it is obvious that the providers of capital would require or demand a higher rate of return than the normal rate. Thus the premium factor plays an important role here as it increases the Cost of Capital.
- **Premium for the Financial Risk:** Financial risk is associated with the capital structure pattern of the firm. Here, the premium finds its way to the picture depending on the volume of debts the firm owes. The higher the debt capital, the more is the risk compared to a firm that has relatively low debts.

Importance of Cost of Capital

Knowing the cost of capital can help businesses and investors in their financial journeys.

For businesses, it directly influences decisions related to capital budgeting, project investments, and capital structure. For investors, it's a key factor in assessing the attractiveness of an investment opportunity. Here's a further breakdown as to why it's so significant:

- **Strategic decision-making**: For businesses, the cost of capital is pivotal in strategic decision-making. It influences capital budgeting, project investments, and capital structure choices. By determining these costs, companies can make informed decisions that optimize their financial structure, minimize costs, and maximize profitability.
- **Investment assessment**: For investors, the cost of capital is a critical factor in assessing the attractiveness of an investment opportunity. Investors want to know whether the returns from an investment are expected to surpass the company's cost of capital. It helps them evaluate the risk and potential reward associated with an investment.
- **Capital structure optimization**: Understanding the cost of capital allows businesses to balance debt and equity financing. This optimization can lead to lower capital costs, increased financial stability, and improved creditworthiness.
- **Performance evaluation**: Cost of capital is also used to evaluate a company's financial performance. If a company consistently earns returns above its cost of capital, it indicates efficient capital utilization and value creation.

- **Market competitiveness**: In a competitive market, companies with a lower cost of capital may have a competitive advantage. They can potentially offer lower prices or invest in growth opportunities more aggressively.

Types of Cost of Capital

Explicit cost of capital: The explicit expenditure of each source can be represented as the discount rate which equates the current value of a company's obtained cash outflows to the present value.

The implicit cost of capital: Implicit costs can be described as the rate of return for the company and its owners that, if the undertaking's project under review is approved, will be forgiven for the best investment opportunity. When a company holds the revenue, the implicit loss would be the income, if the owners had allocated and spent the profits elsewhere.

The specific cost of capital: The costs of each capital component are known as the specific cost of capital. A company collects money from various sources including equity shares, preference shares, debenture, etc. Specific capital costs are the equivalent of equity capital, preference share capital, individual debenture costs, etc.

The weighted average cost of capital: The combined cost of each portion of the funds used by the company is the weighted average capital cost. Weight is the proportion of the worth of the overall capital of each part of the capital.

The marginal cost of capital: Marginal costs are described as costs to raise an additional capital rupee. The incremental or differential capital expenditure is often referred to as the marginal cost of capital. It applies to the adjustment in the total capital cost as a result of raising another fund rupee. This is defined in other words as the corresponding costs of the additional funds the organization has to collect.

Future cost and historical cost: The cost of funding for a given project is the estimated cost. When making financial decisions, they are very important. For example, a distinction should be made between the planned IRR and the expected funding expense of the same capital investment at the time financial decisions are taken, i.e. potential cost is the relevant costs.

Average Cost vs. Marginal Cost: The average cost is the sum of the total cost of goods or services divided by the total number of goods or services. And Marginal Cost increases are the cost of producing one more unit or additional unit of product or service. The average cost and marginal cost are vital concepts in accounting management, which is used widely in decision making and calculating revenue in different scenarios.