

A STUDY ON NET INCOME APPROACHE FOR THE RAISING OF THE FUNDS
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ABSTRACT

Capital structure is not simply business proposition. It is not just a question of raising resources of funds for the development of the company. It provides a link between the Present and future. Today india is one of the fastest growing country raising the different source of money through equity debt bonds and different type of loans.

The economic scenario which emerged after globalization privatization and liberalization has thrown new challenge before the issuers. Now it has to be more competitive in order to meet the needs of the customers.

Keywords: debt, equity, bonds earning per share, profitability, overall cost of capital.

Introduction:

This topic explain the relationship between the firm value and cost of capital and its capital structure. capital structure of the firm also will affect the cost of capital.

The evaluation of the project requires we assuming that there is no corporate taxes and interest is allowed as a deduction for the tax purpose.

A corporate can finance its business mainly by 2 means, i.e., debts and equity. However, the proportion of each of these could vary from business to business.

A company can choose to have a structure with 50% each of debt and equity or more of one and less of another.

Capital structure is also referred to as financial leverage, which strictly means the proportion of debt or borrowed funds in the financing mix of a company.

The theory suggests increasing the firm's value by decreasing the overall cost of capital which is measured in terms of the Weighted Average Cost of Capital. This can be done by having a higher proportion of debt, which is a cheaper finance source than equity finance.

Weighted Average Cost of Capital (WACC) is the weighted average costs of equity and debts, where the weights are the amount of capital raised from each source.

The capital structure or financial leverage decision examined from the point of view on the value of the firm.

The firm finance its assets by equity and debt is called a levered firm

Need for the study:

Most of the companies raising the problem which source of finance will give the optimum returns to the firm. This net income approach

Will explain the cost of equity and cost debt and value of the firm. Now a days cost equity is most costlier than cost of debt because the rate return to the equity shareholders is every time fluctuated. But rate returns are fixed to the debt holders.

Net income approach will give the clarity what happened overall cost of capital will be decrease.

Not only net income approach will explain overall cost of capital but also explained by net operating income and modigliani miller approach also.

Every capital structure theory will have explained cost of funds regarding cost of equity and cost of debt and cost retained earnings

Objective of the study:

The following are the objective of the study:

- To know the value of the firm
- To know the overall cost of capital
- To know why overall cost of capital will decrease
- To know the earning per share of the firm(EPS)
- To know the market value of the firm

Hypothesis of the study:

In this study the following hypothesis has been framed.

There is a significant difference among overall cost of capital for the raising of the funds from equity resources and debt resource. Interest and dividend paid will effect the overall cost of capital.

Research methodology:

By carrying out the analytical study of the corporate companies for the raising of the funds through equity and debt.

Sample study of the net income approach:

Ex: Annual operating income 100000, cost of equity 10% and 5% debt ,300000 and 5% debt another case 900000

	Situation 1	situation 2	situation 3
Particular	Zero debt	5% 300000 debt	5% 900000
Net operating income	100000	100000	100000
Interest	0	15000	45000
Earning after tax	100000	85000	55000
Market value of the equity	1000000	850000	550000
Market value of the debt	0	300000	900000
Market value of the firm	1000000	1150000	1450000
Overall cost of capital	0.1	0.087	0.081

Overall cost of capital situation 1: net operating /value of the firm

$$100000/1000000 = 0.1$$

$$\text{Situation 2 : } 100000/1150000 = 0.087$$

$$\text{Situation 3 : } 100000/1450000 = 0.081$$

Assumption: There is no corporate taxes

The Net Income Approach makes certain assumptions which are as follows.

- The increase in debt will not affect the confidence levels of the investors.
- There are only two sources of finance; debt and equity. There are no sources of finance like Preference Share Capital and Retained Earnings.
- All companies have a uniform dividend payout ratio; it is 1.
- There is no flotation cost, no transaction cost, and corporate dividend tax.

- The capital market is perfect; it means information about all companies is available to all investors, and there are no chances of overpricing or under pricing of security. Further, it means that all investors are rational. So, all investors want to maximize their return by minimizing risk.
- All sources of finance are for infinity. There are no redeemable sources of finance.

In first case there is no debt is involved overall cost of capital 0.1

Second Case introducing debt capital 300000 overall cost of capital 0.087 that is decreased

Third case debt capital increased 900000 still overall cost of capital decreased 0.081

Ex: Annual operating income 200000, cost of equity 10% and 5% Debt 500000 and 5% debt another case 1000000

	Situation 1	situation 2	situation 3
Particular	Zero debt	5% 500000 debt	5% 1000000
Net operating income	200000	200000	200000
Interest	0	25000	50000
Earning after tax	100000	175000	150000
Market value of the equity	2000000	850000	1500000
Market value of the debt	0	500000	1000000
Market value of the firm	2000000	1350000	2500000
Overall cost of capital	0.1	0.14	0.08

By analysing situation 2 and 3 we are increasing the debt capital overall cost of capital will decrease

Consider a fictitious company with the below figures—all figures in USD.

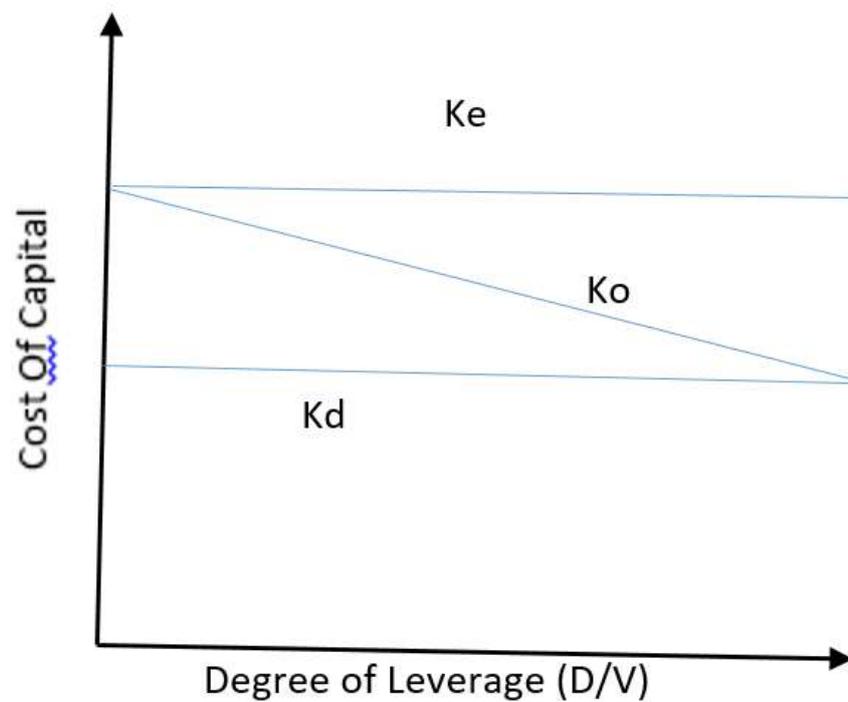
Earnings before Interest Tax (EBIT)	=	100,000
Bonds (Debt part)	=	300,000
Cost of Bonds issued (Debt)	=	10%
Cost of Equity	=	14%

Calculating the value of a company

EBIT	=	100,000
Less: Interest cost (10% of 300,000)	=	30,000
Earnings (since tax is assumed to be absent)	=	70,000
Shareholders' Earnings	=	70,000
Market value of Equity (70,000/14%)	=	500,000
Market value of Debt	=	300,000
Total Market value	=	800,000
Overall cost of capital	=	$\frac{\text{EBIT}}{\text{Total value of the firm}}$ $100,000/800,000$ 12.5%

Now, assume that the proportion of debt increases from 300,000 to 400,000, and everything else remains the same.

(EBIT)	=	100,000
Less: Interest cost (10% of 400,000)	=	40,000
Earnings (since tax is assumed to be absent)	=	60,000
Shareholders' Earnings	=	60,000
Market value of Equity (60,000/14%)	=	428,570 (approx)
Market value of Debt	=	400,000
Total Market value	=	828,570
Overall cost of capital	=	EBIT/(Total value of the firm)



Findings :

This net income approach will compare with various other approaches for the finding overall cost of capital. This are all always conflict to the modern approaches.

This approach is finding with net operating income approach. In net operating income approach overall cost of capital is constant. There is no difference between funds Can be raised from debt or equity capital.

But there is a difference in net income approach funds Can be raised from debt or equity.

Even we are are finding with modern approach and traditional approach also .

Equity capital is more costlier than debt capital their dividend rate is higher

Debt capital is cheaper than equity capital because their interest rate is fixed.

The investment in the debt capital are treated as outside persons in case of a liquidation time first priority is given to the debt holders compare with equity.

The liquidation time debt holders are the most benefited persons compare with preference shareholders and equity share holders

Suggestions:

The Net Income Approach suggests that the value of the firm can be increased by decreasing the overall cost of capital (WACC) through a higher debt proportion. There are various theories that propagate the 'ideal' capital mix/capital structure for a firm. Capital structure is the proportion of debt and equity in

which a corporate financeit's business. The capital structure of a company/firm plays a very important role in determining the value of a firm.

- In case the companies can follow net income approach the companies can maintain the continuous profits in every year
- Every year fixed interest paid to the debt holders
- For the maintaining of every year fixed payment the companies not depend on the single business they invest the money in different securites.
- In case the company follow portfolio income better returns available to the company
- At the same time every year overall cost capital is compare to the other approaches
- Maintain continuous profit is very relevant to the company
- Some modern approaches every time compare to the traditional approach
- Even in case of liquidation time the priority is given to the debt holders compare to equity share holders and preference share holders
- Funds can be raised from the debt is very cheaper compare to the other securites
- We maintain that interest not fluctuated that is better to the company

Conclusion:

Generally there are so many sources for the raising of the funds, equity funds and debt funds bonds and outside loans etc.

In case of net income approach raising the funds from the debt funds overall cost of capital will decrease but we maintain the continuous profits for the payment of the fixed charges

In case raising funds from the equity capital overall cost of capital will increase and value of the firm will decrease. But funds can be raised from the debt funds overall cost of capital decrease and value of the firm will increase