ASSIGNMENT

Course Code	**:**	**MMPF - 002**
Course Title	**:**	**Capital Investment and Financing Decisions**
Assignment Code	**:**	**MMPF - 002/TMA/JULY/2026**
Coverage	**:**	**All Blocks**

Note: Attempt all the questions and submit this assignment to the Coordinator of your study centre. Last date of submission for July 2026 Semester is 31st October 2026 and for January 2027 Semester is 30th April 2027.

1. Explain the concept of 'Cost of Capital'? Discuss and describes how the cost of capital is calculated for each individual component of capital. Discuss the factors influencing the pattern of capital structure.

2. A company is considering the following investment alternatives, which have the following cash flows:

Cash flows				
Project	T_0	T_1	T_2	T_3
X_1	-20,000	+20,000	--	--
B_1	-20,000	+35,000	+15,000	--
B_2	-20,000	+24000	+8,000	+24,000
B_3	-20,000	+20,000	+6,000	+26,000

   Rank the projects according to each of the following methods (a) Payback (b) ARR (c) IRR and (d) NPV. Assume a discount rate of 10% for each of the alternative.

3. What is Project Risk? Discuss the various methods used to measure project risk under uncertainty.

4. Describe the various Non traditional sources of Long Term Financing.

5. What is Financial Engineering? Discuss the factors for growth of financial engineering applications in designing financial products.

1. Explain the concept of ‘Cost of Capital’? Discuss and describes how the cost of capital is calculated for each individual component of capital. Discuss the factors influencing the pattern of capital structure.

Answer

Cost of capital is the minimum rate of return that a firm must earn on its investments so that the market value of the firm is not reduced. From the viewpoint of investors, it is the return they expect for providing funds. From the viewpoint of the company, it is the cost of using those funds. It therefore acts as a link between investment decisions and financing decisions. A project should normally earn at least the required cost of capital, after allowing for its risk, before it can add to shareholders' wealth.

A company normally uses more than one source of long-term finance. Debt, preference shares, equity shares and retained earnings have different costs because the claims, risk and tax treatment attached to them are different. The cost of each source is first calculated separately. These specific costs can later be combined, according to their weights in the capital structure, to obtain the weighted average cost of capital.

Cost of long-term debt

Debt may be in the form of term loans, debentures or bonds. Its explicit cost is the interest payable to lenders. Since interest is generally deductible while computing taxable income, the relevant cost to the firm is usually the after-tax cost of debt.

For irredeemable debt, the approximate after-tax cost is:

$$K_d = I(1 - T) / NP$$

where I is annual interest, T is the corporate tax rate and NP is the net proceeds received by the company. If a redeemable debenture is issued at a premium or discount and is repayable after a fixed period, the redemption gain or loss is also included. A commonly used approximation is:

$$K_d = [I(1 - T) + (RV - NP)/n] / [(RV + NP)/2]$$

where RV is redemption value and n is the number of years to redemption. The tax shield makes debt cheaper than an otherwise similar source carrying no tax-deductible payment, but excessive debt also increases financial risk.

Cost of preference capital

Preference shareholders receive a fixed dividend, but preference dividend is paid out of profit after tax. Hence there is no interest-type tax shield. For an irredeemable preference share, the cost is: