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FUNDAMENTALS OF FINANCIAL MANAGEMENT

B.C.O.E.-143

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Sample Preview of the Solved Sample Question Papers

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QUESTION PAPER

June – 2023

(Solved)

FUNDAMENTALS OF FINANCIAL MANAGEMENT

B.C.O.E.-143

Time: 3 Hours] *[Maximum Marks : 100*

Note: *Answer any* ***five*** *questions. All questions carry* ***equal*** *marks.*

Q. 1. ***(a)*** **Discuss the meaning and scope of financial management.**

Ans. Ref.: See Chapter-1, Page No. 4, Q. No. 2 and Page No. 1, 'Nature of Financial Management'.

(b) **What are the responsibilities of the Financial Manager in a Modern Business Organization?**

Ans. Ref.: See Chapter-2, Page No. 5, Q. No. 6.

Q. 2. ***(a)*** **Discuss the different types of risk.**

Ans. Ref.: See Chapter-4, Page No. 28, 'Types of Risk'.

(b) **Differentiate between Capital Asset Pricing Model (CAPM) and Arbitrage Pricing Theory (APT).**

Ans. Ref.: See Chapter-4, Page No. 30, 'The Capital Asset Pricing Model (CAPM)' and Page No. 31, 'Arbitrage Pricing Theory (APT)'.

Q. 3. ***(a)*** **Write a brief note on Net Present Value (NPV)** ***vs.*** **Internal Rate of Return (IRR).**

Ans. Ref.: See Chapter-7, Page No. 54, 'Net Present Value' and Page No. 55, 'Internal Rate of Return'.

(b) **A project requires an investment of Rs. 5,00,000 and has scrap value of Rs. 20,000 after five years. It is expected to yield profits after depreciation and taxes during the five years amounting to Rs. 40,000; Rs. 60,000; Rs. 70,000; Rs. 50,000 and Rs. 20,000. Calculate the average rate of return on the investment.**

Ans. The Average Rate of Return (ARR) on an investment is calculated by dividing the average annual profit by the initial investment and then expressing the result as a percentage.

ARR = (Average Annual Profit/Initial Investment) × 100

Average Annual Profit = Total Profits over 5 years/5

Average Annual Profit = (40,000 + 60,000 + 70,000 + 50,000 + 20,000)/5 = 48,000

So,

ARR = (48,000/5,00,000) × 100 = 9.6%

Therefore, the average rate of return on the investment is 9.6%.

Q. 4. ***(a)*** **What is Cost of Capital? Discuss the significance of the cost of capital.**

Ans. Ref.: See Chapter-9, Page No. 74, 'Meaning' and 'Significance of Cost of Capital'.

(b) **A company has sales of Rs. 5,00,000; variable costs of Rs. 3,00,000, fixed costs of Rs. 1,00,000 and long-term loans of Rs. 4,00,000 at 10% rate of interest. Calculate the Composite Leverage.**

Ans. Composite Leverage = Percentage Change in EBIT/Percentage Change in Sales

EBIT = Sales − Variable Costs − Fixed Costs

EBIT = 5,00,000 − 3,00,000 − 1,00,000

EBIT = 1,00,000

Assume a 10% increase in EBIT:

New EBIT = 1.1×Old EBIT

New EBIT = 1.1×1,00,000

New EBIT = 1,10,000

Assume a 5% increase in Sales:

New Sales = 1.05×Old Sales

New Sales = 1.05×5,00,000

New Sales = 5,25,000

Using the values into the Composite Leverage formula:

Composite Leverage = 10%/5%

Composite Leverage = 2

Therefore, the Composite Leverage is 2. This means that for a 10% increase in EBIT, there is a 5% increase in Sales, resulting in a Composite Leverage of 2.

Q. 5. ***(a)*** **Define Capital Structure. What should generally be the features of an appropriate capital structure?**

Ans. Ref.: See Chapter-11, Page No. 101, Q. No. 1 and Page No. 102, Q. No. 3.

(b) **Discuss the importance of Adequate Working Capital.**

Ans. Ref.: See Chapter-17, Page No. 157, 'Importance of Adequate Working Capital'.

Q. 6. ***(a)*** **Give a critical appraisal of the traditional approach and the Modigliani-Miller's approach to the problem of capital structure.**

Ans. Ref.: See Chapter-11, Page No. 101, 'Traditional Approach' and 'Modigliani-Miller Approach'.

***(b)* Discuss the types of Dividend.**

Ans. Ref.: See Chapter-13, Page No. 117, 'Types of Dividends'.

Q. 7. *(a)* What is Debenture? Discuss the types of Debenture.

Ans. Ref.: See Chapter-3, Page No. 18, 'Debentures' and Page No. 21, Q. No. 6.

***(b)* Write down the format of statement of working capital requirements.**

Ans. A statement of working capital requirements provides an overview of a company's short-term financial needs and resources. It typically includes various components related to working capital, such as current assets and current liabilities. While there is no standardized format for a working capital statement, it generally includes the following sections:

1. Heading
- Name of the Company
- **Title:** Statement of Working Capital Requirements
- Date of the statement

2. Introduction
- Brief overview of the purpose of the statement
- Explanation of working capital and its importance in the company's operations

3. Current Assets
- Breakdown of individual current assets such as:
- Cash and Cash Equivalents
- Accounts Receivable
- Inventory
- Short-term Investments

4. Current Liabilities
- Breakdown of individual current liabilities such as:
- Accounts Payable
- Short-term Loans
- Accrued Expenses

5. Working Capital Calculation
- Calculate the Net Working Capital using the formula:
- Net Working Capital = Current Assets − Current Liabilities
- Net Working Capital = Current Assets − Current Liabilities

6. Analysis of Working Capital Components

Discuss changes in each component of working capital compared to the previous period.

Identify reasons for any significant increases or decreases.

7. Working Capital Ratios
- Calculate and present key working capital ratios, such as:
- Current Ratio
- Current Assets
- Current Liabilities
- Current Liabilities
- Working Capital Turnover

8. Seasonal Factors or Trends

Discuss any seasonal factors or trends that may impact working capital requirements.

9. Conclusion
- Summarize the overall working capital position.
- Provide recommendations or insights into managing working capital effectively.

Appendix (if necessary)
- Include detailed schedules or supporting information, especially for large or complex organizations.

Q. 8. *(a)* Discuss the cash management models.

Ans. Ref.: See Chapter-18, Page No. 169, Q. No. 5.

***(b)* The following information is given about materials:**

Annual usage Rs. 2,00,000

Cost of placing and receiving one order Rs. 80

Annual carrying cost: 10% of Inventory value.

Find the Economic Order Quantity (EOQ).

Ans. EOQ = Square root of 2DS/H

Here

D (Annual Usage) = Rs. 2,00,000

S (Ordering Cost per Order) = Rs. 80

H (Carrying Cost as a percentage of Inventory Value) = 10%

Carrying Cost per Unit = (H/100) × 1/2 × D

Carrying Cost per Unit = (10/100) × 1/2 × 2,00,000 = 10,000

So,

EOQ = Square root of (2 × 2,00,000 × 80)/10,000 = 17.89 or 18

Therefore, the Economic Order Quantity (EOQ) is approximately 18 units.

Q. 9. Write explanatory notes on any *two* of the following:

***(a)* Various aspects or dimensions of Receivable Management**

Ans. Ref.: See Chapter-19, Page No. 178, Q. No. 1.

***(b)* Cash Budget**

Ans. Ref.: See Chapter-18, Page No. 166, 'Cash Forecasting and Budget: Meaning and Importance'.

***(c)* Gross Working Capital *vs.* Net Working Capital**

Ans. Ref.: See Chapter-17, Page No. 156, 'On the Basis of Concept'.

***(d)* Dividend on theory of irrelevance**

Ans. Ref.: See Chapter-14, Page No. 131, Q. No. 1.

■■

Sample Preview of The Chapter

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FUNDAMENTALS OF FINANCIAL MANAGEMENT

Financial Management: An Overview 1

INTRODUCTION

The primary goal of every business entity, whether it operates in manufacturing or the service sector, is profit generation. Regardless of the type of business or activity, financial resources are consistently required. Effectively planning, directing, monitoring, organising, and controlling these financial resources is essential for their optimal utilisation. This is where the significance of a finance manager becomes evident. When financial resources are integrated with management functions, it gives rise to the field of financial management. In this chapter, we will explore the evolution of financial management, its characteristics, scope, objectives, the balance between risk and return, and the pivotal role played by a finance manager.

CHAPTER AT A GLANCE

EVOLUTION OF FINANCIAL MANAGEMENT

Money serves as a medium of exchange for various items, from assets and groceries to clothing. In contrast, finance refers to the strategic deployment of funds for investment, expecting returns. Financial management involves decision-making to manage money effectively. The evolution of financial management can be divided into three phases:

Traditional Phase (1900-1940): Primarily focused on procuring funds for an organisation, emphasising long-term sources and accounting aspects.

Transitional Phase (1940-1950): Shifted towards addressing day-to-day issues, planning, analysis, and control, with a growing emphasis on decision-making.

Modern Phase (1960 to present): Prioritises optimal utilisation of funds to maximise shareholders' wealth, involving rational decision-making by financial managers.

These phases have given rise to two approaches:

Traditional Approach: Concentrates on fund procurement.

Modern Approach: Incorporates fund procurement and its efficient utilisation.

NATURE OF FINANCIAL MANAGEMENT

Finance serves as the lifeblood of any business organisation, emphasising the critical need to efficiently procure and employ funds. The financial functions revolve around addressing the fundamental questions of why, what, where, how, and when with regards to finances. Key components of financial management encompass planning, resource allocation, resource management, and control.

Ezra Soloman defines it as the efficient utilisation of capital funds, focused on issues surrounding fund utilisation and acquisition.

Weston and Brigham describe it as an area of financial decision-making, harmonising individual motives with enterprise objectives.

Phillipatun offers a broader perspective, relating it to managerial decisions regarding credit acquisition and financing for organisations.

Financial management entails making decisions that result in fund procurement and their optimal use, consisting of investment, financing, and dividend decisions.

Investment decisions: Investment decisions involve selecting assets for long-term or short-term use, known as capital budgeting and working capital management, respectively.

Financing decisions: Financing decisions determine the financing mix or capital structure, considering the balance between internal and external, long-term and short-term funds.

Dividend decisions: Dividend decisions involve evaluating whether to retain or distribute profits to shareholders, guided by various factors.

FINANCE AND OTHER RELATED DISCIPLINES

Finance broadly divides into two categories: Public Finance and Private Finance.

Public Finance: Public Finance pertains to government entities, whether at the central, state, or institutional levels, focusing on funds raised through taxes. Its primary goal is to address social and economic objectives rather than profit generation.

Private Finance: Private Finance encompasses personal, business, and non-governmental institution finances.

Financial Management and Economics: Macroeconomics encompasses the broader national or global environment affecting industries, including factors like government policies and economic conditions. This relates to financial management through banking systems, capital markets, monetary and fiscal policies, and economic factors.

Microeconomics, on the other hand, delves into the controllable internal aspects of organisations, such as size, ownership, and liquidity. The connection between financial management and economics becomes evident when analysing these aspects.

Financial Management and Accounting: Traditional financial management heavily focused on accounting, evolving to encompass decision-making. Financial management picks up where accounting leaves off, as it involves interpreting and using accounting data for informed decisions. For example, a firm's sales and cost data can be analysed from both an accounting perspective (Profit & Loss Account) and a financial perspective (Cash Flow Statement), demonstrating their interdependence.

OBJECTIVES OF FINANCIAL MANAGEMENT

The objectives of financial management serve as a guiding framework for optimal decision-making. There are two primary objectives:

Profit Maximization: Initially a primary goal, profit maximization aimed to maximise a firm's income. It doesn't define profits, earnings per share, ROI, or tax considerations. It raises concerns about financial health and social responsibility.

Pros: Efficient resource use, performance measure, societal interest, economic efficiency.

Cons: Vague, neglects profit timing, risks, time value, quality, and social responsibility.

Wealth Maximisation: This approach, now universally accepted, overcomes profit maximisation's limitations. It aims to maximise shareholders' wealth through profit maximisation, return on capital employed, earnings per share growth, market value of shares, optimal leverage, and minimising the cost of capital. Wealth maximisation considers risk, appropriateness, and the time value of money. It focuses on the market price of shares and calculates the net present worth of the firm.

Wealth maximisation guides the three key functions of financial management: investment, financing, and dividend decisions. However, in cases of short time frames and negligible risk, profit maximisation and wealth maximisation align closely. Nonetheless, wealth maximisation is the ultimate objective in modern financial management, encompassing a comprehensive view of financial decision-making.

RISK AND RETURN TRADE-OFF

Two primary factors dictate the pricing of a security, namely:

(a) Risk

(b) Return

It is commonly asserted that the greater the risk, the higher the potential return, emphasising the close relationship between risk and return. In financial management, a profound understanding of this concept is of paramount importance, as it serves as a guiding principle for decision-making. Risk represents the degree of uncertainty and can be defined as the expected returns from an investment.

The rate of return from operations is typically determined by profit margins and turnover. Profit margins can be increased by *(a)* raising sales, which should surpass operating expenses, or *(b)* reducing operating expenses relative to sales. Turnover can be boosted by increasing sales more than operating assets or by reducing operating assets more than sales. Thus, a delicate balance must be maintained to maximise the owner's profit while considering the variability of returns.

ROLE OF FINANCE MANAGER

A finance manager's role involves two key areas: Major functions (capital estimation, fund procurement, allocation, asset management, financial control) and other functions (inventory management, investment evaluation, financial negotiations, share price monitoring). They oversee financial decisions, budgets, liquidity, and risk assessment, aiming to meet funding needs. Challenges include adding shareholder value, understanding investor psychology, market risk management, and demonstrating interpersonal skills. These challenges intensify the demanding and multifaceted nature of the role.

CHECK YOUR PROGRESS

Q. 1. List the phases in evolution of financial management.

Ans. The phases in evolution of financial management are:

***(a)* The Traditional Phase (1900-1940):** During this era, finance primarily revolved around securing funds using various methods such as loans, shares, and debentures. The primary concern was meeting the organisation's financial needs. Emphasis rested on long-term financing sources and accounting practices. This phase persisted for approximately four decades but gradually lost relevance as it lacked decision-making elements, paving the way for the evolution of financial management.

***(b)* The Transitional Phase (1940-1950):** Similar to the traditional phase, this period still dealt with day-to-day financial issues but placed a greater emphasis on planning, analysis, and control. Slowly, decision-making processes started gaining importance during this phase, setting the stage for the modern phase.

***(c)* The Modern Phase (1960 to the present):** Extending the foundation laid by the traditional phase, this period centres on optimising the utilisation of acquired funds. It places a strong focus on maximising shareholders' wealth, introducing a logical and rational approach driven by financial managers' decision-making capabilities. This phase represents a significant shift towards a more strategic and comprehensive understanding of financial management.

Q. 2. What are the different kinds of finance functions?

Ans. Finance functions in an organisation encompass various activities that are crucial for managing its financial resources effectively. The different kinds of finance functions typically include:

Financial Planning: This involves setting financial objectives, estimating future financial needs, and creating a plan to meet those needs. It includes budgeting, forecasting, and developing financial strategies.

Cash Management: This function ensures that the organisation maintains adequate liquidity to meet its short-term financial obligations while optimising the use of cash resources to generate returns.

Working Capital Management: Working capital management involves managing the day-to-day operating liquidity, which includes managing inventory, accounts receivable, and accounts payable to ensure smooth operations.

Financial Reporting: Preparing accurate and timely financial reports for internal and external stakeholders is essential. It includes creating financial statements like the balance sheet, income statement, and cash flow statement.

Tax Planning and Management: Finance functions also encompass planning and managing taxes effectively to minimise tax liabilities while ensuring compliance with tax laws and regulations.

Cost Management: Managing costs efficiently is essential for profitability. Finance functions involve analysing and controlling costs across various aspects of the organisation's operations.

Financial Control: This involves establishing internal controls, policies, and procedures to safeguard assets, prevent fraud, and ensure compliance with financial regulations.

Dividend Policy: Deciding on the distribution of profits to shareholders in the form of dividends versus retaining earnings for reinvestment is an important finance function.

Corporate Finance: Corporate finance deals with the financing decisions of the organisation, including raising capital through debt or equity, managing capital structure, and making investment decisions.

Financial Strategy: Developing and implementing a financial strategy that aligns with the organisation's overall strategic goals and objectives.

Q. 3. How is Financial Management related to:
***(i)* Economics**
***(ii)* Accounting**

Ans. Financial Management is closely related to both Economics and Accounting, as these disciplines provide the foundation and framework for effective financial decision-making within an organisation.

***(i)* Relationship with Economics:** Financial Management and Economics share a deep connection, as they both address the allocation of scarce resources. Macroeconomics, which examines the broader economic environment at the national or global level, plays a crucial role in financial management. Factors like government policies, interest rates, inflation rates, and overall economic conditions directly impact financial decisions. Financial managers must consider these external economic factors when making investment, financing, and dividend decisions.

Microeconomics deals with the internal environment of an organisation. It focuses on factors within a company's control, such as production costs, pricing strategies, and market competition. Financial managers apply microeconomic principles when analysing investment opportunities, setting pricing strategies, and managing costs to maximise profitability.

***(ii)* Relationship with Accounting:** Accounting is the language of business, and financial management heavily relies on accounting information for decision-making. Accounting provides essential financial data, including income statements, balance sheets, and cash flow statements. Financial managers use this data to assess the financial health of the organisation. Financial managers analyse accounting information to evaluate performance, assess liquidity, profitability, and solvency, and make informed decisions based on these analyses. Financial management often begins with budgeting and forecasting, which involves using historical accounting data to predict future financial needs and plan accordingly. Accounting data helps financial managers make decisions regarding capital budgeting, financing, and dividend policies. It provides the basis for evaluating the financial implications of various choices.

Q. 4. Mention the functions of a finance manager.

Ans. The functions of a finance manager can be categorised into two main areas:

(a) Major Functions
(b) Other Functions

Major Functions include	Other Functions encompass
• Estimation of capital requirements • Procurement of the necessary funds • Allocation of funds • Management of current assets • Financial control	• Maintaining an optimum level of Inventory and receivables • Evaluation of investments • Financial negotiations • Monitoring share prices

Q. 5. What is wealth maximisation?

Ans. Wealth maximisation surpasses the limitations of profit maximisation by aiming to enhance shareholders' wealth. It achieves this through various means, including maximising profits, optimising return on capital employed, fostering growth in earnings per share, increasing the market value of shares, optimising leverage, and minimising the cost of capital. Wealth maximisation takes into account factors such as risk, appropriateness, and the time value of money. It places a strong emphasis on the market price of shares and calculates the net present value of the firm. Wealth maximisation serves as a guiding principle for the three fundamental functions of financial management: investment decisions, financing decisions, and dividend decisions. While in situations involving short timeframes and minimal risk, profit maximisation and wealth maximisation may align closely, wealth maximisation remains the ultimate goal in contemporary financial management. It embodies a holistic approach to financial decision-making.

SELF-ASSESSMENT QUESTIONS

Q. 1. Distinguish between 'Money' and 'Finance'.

Ans. 'Money' and 'Finance' are two related but distinct concepts in the field of economics and finance. Money refers to the physical or digital medium of exchange that is widely accepted in transactions for goods and services. Money includes currency notes, coins, and digital representations of currency like bank deposits. Finance encompasses a broader concept that deals with the management of money, assets, liabilities, and investments. Finance involves the allocation, acquisition, and utilisation of funds to achieve financial goals and optimise resources. Money primarily serves as a medium of exchange, a unit of account, a store of value, and a standard of deferred payment. It facilitates transactions and serves as a common measure of value. Finance involves the strategic planning and management of funds. Finance includes activities such as budgeting, investing, borrowing, lending, and financial analysis to achieve various financial objectives.

Scope: Money is a subset of finance and is primarily concerned with the actual currency and liquid assets used in daily transactions. Finance encompasses a wider spectrum, including money but also covering capital markets, financial institutions, investment decisions, and risk management. Money is used for day-to-day transactions, payment of bills, and satisfying immediate financial needs. Finance is concerned with both short-term and long-term financial planning and decision-making, which can include investments, savings, and wealth management.

Examples of money include cash in hand. Examples of finance-related activities include investing in stocks, bonds, managing a company's budget, or securing a loan for a home purchase.

Q. 2. What is Financial Management?

Ans. Financial management is a vital aspect of business and personal financial planning that involves the strategic planning, control, and optimization of financial resources to achieve specific financial goals and objectives. It encompasses a wide range of activities and decisions related to the acquisition, allocation, and utilisation of funds and resources.

Key components of financial management include:

Financial Planning: This involves setting financial goals, developing a financial plan, and establishing a roadmap for achieving those goals. It includes forecasting financial needs and evaluating various options for meeting those needs.

Budgeting: Creating a budget is a fundamental aspect of financial management. It involves estimating income and expenses over a specified period, which helps in controlling spending, allocating resources efficiently, and ensuring financial stability.

Investment Management: Decisions related to investments in assets such as stocks, bonds, real estate, and other financial instruments are critical in financial management. This includes assessing risk tolerance and determining the best investment strategies to achieve financial objectives.

Risk Management: Identifying and managing financial risks is crucial. This may involve purchasing insurance, diversifying investments, or implementing strategies to mitigate risks associated with economic, market, or business factors.

Capital Structure Management: For businesses, determining the optimal mix of debt and equity to finance operations and growth is a key consideration in financial management. This decision affects the cost of capital and overall financial stability.

Cash Flow Management: Ensuring a healthy cash flow is essential for both individuals and businesses. Proper management of cash flow involves monitoring inflows and outflows of funds to ensure there is enough liquidity to cover expenses and meet financial obligations.

Financial Analysis and Reporting: Regularly assessing financial performance through financial statements and reports is a critical part of financial management. It helps in evaluating the success of financial strategies and making informed decisions.

Dividend Policy: For businesses, determining the distribution of profits to shareholders is an important financial decision. This involves deciding how much of the earnings will be retained for reinvestment and how much will be paid out as dividends.

Tax Planning: Efficient tax planning is essential to minimise tax liabilities while remaining compliant with tax laws. This includes taking advantage of available deductions and tax credits.

Financial Control: Establishing financial controls and internal procedures is crucial to prevent fraud, mismanagement, and financial irregularities. This