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M.C.O.-7

Financial Management

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Sample Preview of the Solved Sample Question Papers

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QUESTION PAPER

June – 2023

(Solved)

FINANCIAL MANAGEMENT

M.C.O.-7

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

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

Q. 1. ***(a)*** **What do you understand by 'Financial Management'? Discuss why is wealth maximisation better objective than profit maximisation.**

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

(b) **Explain the concept of 'risk' and 'return'.**

Ans. Ref.: See Chapter-4, Page No. 37, Q. No. 1, Q. No. 2.

Q. 2. 'XYZ' Limited is considering to purchase a machine, out of two machines 'A' and machine 'B'. The cost of each machine is ₹ 6,00,000. Earnings after tax and depreciation during the 5 years life time of machine are expected to be as given below:

Year	**Earnings after tax and depreciation**	
	Machine A (₹)	**Machine B (₹)**
1	**1,50,000**	**10,000**
2	**50,000**	**20,000**
3	**40,000**	**30,000**
4	**20,000**	**1,20,000**
5	**10,000**	**50,000**

Depreciation has been provided on straight line basis. Find out the payback period of each machine and suggest which machine is more profitable.

Ans.

Year	**Machine A**		**Machine B**	
	Cash Flow	**Com. Cash Flow**	**Cash Flow**	**Com. Cash Flow**
C_0	–6,00,000	–6,00,000	–6,00,000	–6,00,000
C_1	2,70,000	–3,30,000	1,30,000	–4,70,000
C_2	1,70,000	–1,60,000	1,40,000	–3,30,000
C_3	1,60,000	-	1,50,000	–1,80,000
C_4	1,40,000	1,40,000	2,40,000	60,000
C_5	1,30,000	2,70,000	1,70,000	2,30,000

Annual Deperciation = 600000/5= 1,20,000

To derive the cash flows the depereciation is added back to earnings after tax and depereciation.

Payback Period for Machine A is 2nd year and for Machine B is 3 years + (1,80,000/2,40,000) × 12

3 years & 9 months

accordingly Machine A is more profitable.

Q. 3. ***(a)*** **Define cost of capital and discuss its significance.**

Ans. Ref.: See Chapter-5, Page No. 40, 'Meaning and Importance'.

(b) **What do you understand by capital structure of a firm? What is an optimal capital structure? Explain.**

Ans. Ref.: See Chapter-14, Page No. 182, Q. No. 1, Page No. 174, 'Concept of Optimal Capital Structure'.

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Q. 4. ***(a)*** **What is meant by leverage? What are the various types of leverages? Explain with examples. How are they calculated?**

Ans. Ref.: See Chapter-13, Page No. 168, Q. No. 1, Q. No. 2, Page No. 159, 'Financial Leverage' and Page No. 168, Q. No. 3.

(b) **Given below is the information of a firm :**

	₹
Equity share capital (shares of ₹ 10 each)	**50,00,000**
Debentures (14%)	**25,00,000**
Earnings before interest and tax (EBIT)	**15,00,000**

Calculate financial leverage of the company.

Ans.

$$\text{Financial Leverage} = \frac{\text{EBIT}}{\text{EBT}}\ \frac{15,00,000}{11,50,000} = 1.30$$

Earning before interest and tax (EBIT)	15,00,000
Debentures (14%)	25,00,000
Interest on Debentures	3,50,000
EBT= EBIT – Interest	(15,00,000 – 3,50,000)
	11,50,000

Q. 5. Explain the various approaches that are used in valuation of equity shares giving suitable examples.

Ans. Ref.: See Chapter-3, Page No. 19, 'Valuation of Equity Shares'.

Q. 6. What are the different sources of Long-term Finance? Explain each one of them in brief.

Ans. Ref.: See Chapter-8, Page No. 90, 'Introduction', 'Retained Earning', Page No. 91, 'Equity Capital', Page No. 92, 'Preference Capital', Page No. 99, Q. No. 5, Page No. 95, 'Term Loans', Page No. 96, 'Venture Capital'.

Q. 7. ***(a)*** **What is lease financing? What are its different forms? Explain.**

Ans. Ref.: See Chapter-10, Page No. 120, 'Concept of Lease Financing', Page No. 121, 'Forms of Lease Finance'.

(b) **Discuss various marketable securities in which surplus cash can be invested.**

Ans. Ref.: See Chapter-17, Page No. 220, 'Investment of Surplus Cash in Marketable Securities'.

Q. 8. ***(a)*** **What do you understand by 'factoring'? What are its functions?**

Ans. Ref.: See Chapter-19, Page No. 238, 'Factoring'.

(b) **Explain Walter's relevance theory of dividend.**

Ans. Ref.: See Chapter-15, Page No. 190, 'Walter's Model'.

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

(a) **Time value of money.**

Ans. Ref.: See Chapter-2, Page No. 14, Q. No. 1.

(b) **Capital asset pricing model.**

Ans. Ref.: See Chapter-4, Page No. 34, 'Capital Asset Pricing Model (CAPM)', 'Assumption of CAPM'.

(c) **Project financing.**

Ans. Ref.: See Chapter-11, Page No. 131, 'What is Project Financing'.

(d) **Inventory management.**

Ans. Ref.: See Chapter-18, Page No. 229, 'Introduction', 'Objective of Inventory Management'.

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Sample Preview of The Chapter

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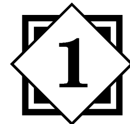
FINANCIAL MANAGEMENT

FOUNDATION OF FINANCE

Financial Management: An Overview



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INTRODUCTION

Financial management is that managerial activity which is concerned with the planning and controlling of the firm's financial resources. It deals with the management of finance/funds. The subject of financial management is an immense interest to both academicians and practicing managers. Financial decisions are vital for business firm for its growth and development, as the firm is derived by its financial policies. Among the most crucial decisions of the firm are those while relate to finance, and an understanding of the theory of financial management provides, a conceptual and analytical insights to make those decisions skilfully. On the contrary any wrong decisions may affect the solvency of the firm.

Under this chapter we will understand the meaning of financial management, nature and organisation of finance function, evolution and goals of financial management and key activities and the challenges faced by the financial managers.

CHAPTER AT A GLANCE

NATURE OF FINANCE FUNCTION

It is said that the finance is the life blood of business. 'Money begets money' and 'money makes the mare go', are the famous proverbs that highlight that finance actually matters to everybody. It is difficult to separate the finance function from production, marketing and other functions, but the function themselves can be readily identified.

The functions of raising funds, investing them in assets and distributing returns earned from assets to shareholders are respectively known as financing decision, investment decisions and dividend decision. Thus, it makes clear that finance functions call for skilful planning, control and execution of a firm's activities.

1. Investment Decision: A firm's investment decisions involve capital expenditures which may be invested in any project. The financial management provides a framework to make investment wisely. It relates to

(*a*) Management of working capital
(*b*) Capital budgeting decision
(*c*) Management of mergers, reorganisation and disinvestment
(*d*) Buy or lease decisions
(*e*) Securities analysis and portfolio management

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Investment decision includes the decisions primarily relating to assets composition—fixed as well as current assets.

2. Financing Decision: Financing decision is the second important function to be performed by the financial manager. Broadly one must decide when, where from and how to acquire funds to meet the firm's investment needs. The central issue is to determine the appropriate proportion of equity and debt, leading to the **optimum capital structure.** The firm's capital structure is considered optimum when the market value of shares is maximised. Once the financial manager is able to determine the best combination of debt and equity, he/she, must raise the appropriate amount through the best available sources, which can be both from internal and external funds. The employment of these sources in various combinations is called 'financial leverage.' Different types of analysis are required for this decision e.g., leverage analysis, EBIT-EPS analysis.

3. Dividend Decision: Dividend decision is the third major financial decision. The financial manager must decide whether the firm should distribute all profits, or retain them, or distribute a portion and retain the balance. The proportion of profits distributed as dividends is called the **dividend-payout ratio** and the retained portion of profits is known as the **retention ratio,** like the debt policy, the dividend policy should be determined in terms of its impact on the shareholders value. The **optimum dividend policy** is one that maximises the market value of the firm's shares. Retention of earnings depends upon reinvestment opportunities available and the opportunity to generate. Dividends may be paid in cash or in the form of bonus shares.

EVOLUTION OF FINANCIAL MANAGEMENT

Finance management emerged as a separate field from accounting in 1900. The enterprises became dynamic with complex decision based on the requirement of funds, in almost all business activities for growth in technological innovations and creation of new industries. This further has lead to the promotion of the study of finance to emphasis on investment, liquidity and financing of the firms.

Financial management is important in all types of business as well as for profit organisations like hospitals and schools. Thus a sound financial management comprising of planning, organising, directing and controlling of financial activities is essential for the survival and growths of an enterprise. With the advent of various financial instrument in 1990's replacing hard cash as a transfer of funds and financial management emerged as a distinct management discipline and is linked to changes in business and socio-economic scenario, brought about by the advancements in information technology, multi- division corporation and increasing global competition. The 21st century has brought globalisation through merger of firm access to international market, increased competition and the need for the quality products.

KEY ACTIVITIES OF FINANCIAL MANAGER

Who is a financial manager? What is his or her role? In a business firm the financial manager occupies a very important position. He is one of the dynamic members of corporate managerial team who is responsible in a significant way, to carry out the finance functions. It should be noted that, in a modern enterprise, the financial manager occupies a key position whose job is not that of an accountant to record and prepare financial statement. Whereas he or she is expected to manage the funds in such a manner, to ensure their optimum utilisation and their procurement in order to maintain a balance between risk, cost and control considerations.

They occupy a key position and is one of the members of the top management. The finance manager is now responsible for shaping the fortunes of the enterprise, and is involved in the most vital decision of the allocation of capital. He or she must realise that his or her actions have far-reaching consequences for the firm as they influence the size, profitability, growth, risk and survival of the firm, and as a consequence, affect the overall value of the firm. The responsibilities and duties of financial manager are indeed the organisation-wide.

GOALS OF FINANCIAL MANAGEMENT

The firm's investment and financing decisions are unavoidable and continuous. In order to make them rationally, the firm must have a goal. A good goal must be clear, timely measurable and consistent. A firm may have different goals e.g. production goals, sales goal and financial management goal. In order to achieve the main goal of financial management one must be

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directed to focus on the ultimate goal of a firm, which broadly deals with the maximising the shareholders' wealth.

Shareholders wealth maximisation, as reflected in the market value of the firm's shares comprises of the following:

(i) Maximisation of profit
(ii) Maximisation of Return on capital employed
(iii) Growth in earning per share or market value of a share or dividends
(iv) Optimum level of leverage
(v) Minimisation of costs of capital

Maximisation of Shareholders' Wealth

Maximising shareholders' wealth means maximising the net present value of a course of action to shareholders. The economic value of the shareholder's wealth is the market price of the share which is the present value of all future dividends and benefits expected from the firm.

The objective behind this brings a responsibility on management to promote the welfare of equity shareholders as they provide risk (venture) capital for starting a company. It is an appropriate and operationally feasible criterion to choose among the alternative financial actions. Shareholders wealth maximisation provides an unambiguous measure of what financial management should seek to maximise in making investment and financing decisions on behalf of shareholders. Thus, wealth maximisation of shareholders is the main objective, though profit maximisation can be considered as a part of wealth maximisation objective.

RISK AND RETURN TRADE OFF AS A GUIDING FACTOR IN DECSION-MAKING

Financial decisions incur different degree of risk. Your decision to invest your money in government bond has less risk as interest rate is known and the **risk of default** is very less. On the other hand, you would incur more risk if you decide to invest your money in shares, as return is not certain. However, you can expect a lower return from government bond and higher from shares. Risk and expected return move in tandem; the greater the risk, the greater the expected return.

Risk is defined as the 'variability of expected returns from an investment' less the variability, less is the risk and vice versa.

Returns is defined as the "gain (or loss) expected over a given period of time by the decision-maker". Financial decisions of the firm are guided by the **risk-returns trade-off.**

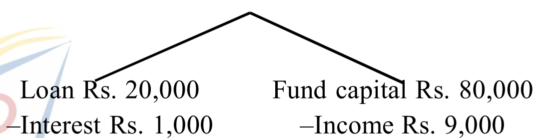
For elaborating this let us assume:

(*a*) That the expected earning is equal to expected cash flows,
(*b*) That there are no taxes.

Assume that you have Rs.1,00,000/- you have borrowed Rs. 20,000/- in it @ 5% and you want to open a grossery shop. The total operating cost per year is Rs.1,00,000/-, sales made is Rs 1,10,000/-.

The position is as follows:

I. Financing – Risk and Return



II. Operating – Risk and Return

At the end of the year you have Rs.1,10,000/- of which you reinvested Rs.1,00,000/- in the business and remaining Rs.10,000/- you pay interest of Rs.1,000/- and keep with you Rs. 9,000/-. This return is product of two factors: (*i*) you earned Rs.10,000/-, (*ii*) Rs.10,000/- were divided between the creditor and you (the owner), while affected the owners return. Based on the return on total assets you earned 10% (10,000/1,00,000), but earned a rate of return of 11.25% for the owner 9,000/ $80{,}000 \times 100$, which is the result of operating and financing activities.

ORGANISATION OF FINANCE FUNCTIONS

The vital importance of the financial decisions to a firm makes it imperative, to setup a sound and efficient organisation for the finance functions. The exact organisation structure for financial management will differ across firms. It will depend on factors such as the size of the firm, nature of the business, financing operations, capabilities of the firm's financial officials and most importantly, on the financial philosophy of the firm. An organisation on functional basis could be followed as under:

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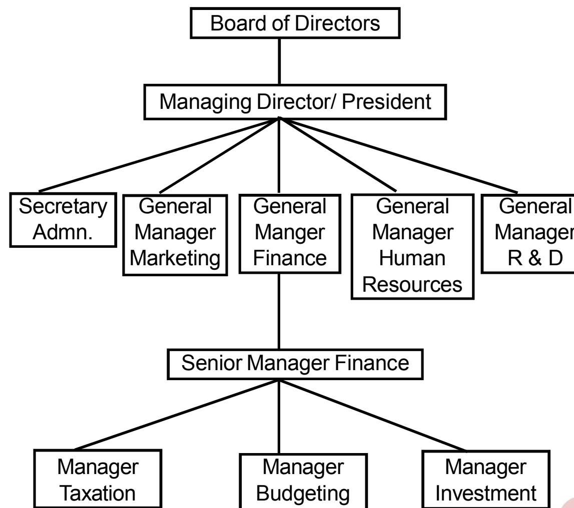

Under above type of organisation each major function is organised as a separate department. Its emphasis is on specialization. Due to this reason finance manager's job is that of an expert. Along with supervising finance department he also coordinates activities with other departments, by planning, organising, controlling and administering funds used in the business.

CHALLANGES FOR FINANCIAL MANAGER

The changing trend in the business environment, particularly economic and financial, calls upon the challenges for financial manager.

The First most important challenge is shareholders value creation: This is done by not only concentrating on earning per share but also on market capitalization. This holds is true as the investors are satisfied not only with increasing sales or decreasing cost; but want growing total shareholders return.

Second, challenge come from individual and institutional inventions. In addition to the traditional skills of financial manager, a good understanding of the psychology of invention has emerged as the prime, skills for them.

Thirdly, dealing with continuous increasing risks in the marked constitute to another challenge before the financial manager. Financial manager is expected to continually generate appropriate measures of performance for managerial performance evaluation with the company and reporting to the extend shareholders etc. Therefore, rapid technological advancement, complied with large scale investment made by MNC's merger movements and wide-spread diversifications of products have made his job demanding.

CHECK YOUR PROGRESS

Q. 1. What is financial management?

Ans. Financial management is also called managerial finance or corporate finance.

"Financial management is concerned with efficient use of an important economic resource namely: capital funds. It is true study of the problems involved in the use and acquisition of funds".

"It can be broadly defined as the activity concerned with planning, raising, controlling and administering of funds used in the business." H.Guttmann and H.Dongall: Corporate financial Policy (Engleword Clifers) N.Y. Prentice Hall 1980.

Financial management is nothing but managerial decision making on asset mix, capital mix and profit allocation. It has no unique body of knowledge of its own, and draws heavily on economics for its technical concepts even today. Financial management was a branch of economics till 1890, and as a separate discipline, it is of recent origin.

Q. 2. List the functions of financial management.

Ans. "The function of financial management is to review and control decision to commit and recommit funds to new and on going uses. In addition to raising funds, financial management is directly concerned with production, marketing and other functions within an enterprise whatever decisions are made about the acquisition or distribution of assets."

This makes it clear that finance functions call for skilful planning, control and execution of a firm's activities, and not only restrict to raising of funds.

Finance functions include:

(*i*) Long-term asset-mix or investment decision.
(*ii*) Capital-mix or financing decision.
(*iii*) Profit allocation or dividend decision.

Q. 3. Differentiate between financing decision and investment decision.

Ans. *Financing* is the decision of which resources or funds are to be brought into the business from external investors and creditors in order to be invested in profitable projects. The first external source of finance is *debt*, which includes *loans* from banks and

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