

## STUDY MATERIAL:-

### FINANCIAL MANAGEMENT

#### VERY SHORT QUESTIONS ( 1 MARK)

**1 Define Financial Management.**

Ans financial management is that specialized activity which is responsible for obtaining and affectively utilizing the funds for the efficient functioning of the business and, therefore, it includes financial planning, financial administration and financial control.

**2 State the primary objective of Financial management.**

Ans. To maximize the shareholders wealth.

**3 State the decisions involved in Financial management.**

Ans.. a) Investment decision b) Financing decision c) Dividend decision

**4 What is meant by Financial Planning?**

Ans.. Financial planning means deciding in advance, the financial activities to be carried on to achieve the basic objective of the firm. The basic objective of the firm is to get maximum profits out of minimum efforts.

**5 What are the objectives of financial planning?**

Ans.. a) to ensure availability of fund whenever required.  
b) to see that the firm does not raise funds unnecessarily.

**6 What is Working Capital ?**

Ans.. The capital required for day to day operations of the business is called Working capital.

**7 State the difference between gross working capital and net working capital.**

Ans.. Gross working capital is the sum/ aggregate of the current assets, whereas

Net working capital = Current assets – current liabilities.

**8 What is meant by capital budgeting decision?**

Ans.. A long term Investment decision is called capital budgeting decision.

**9. When is financial leverage considered favorable?**

Ans) Financial leverage is considered favorable when return on investment is higher than the cost of debt.

**10. How does production cycle effect working capital?**

Ans) working capital requirement is higher with longer production cycle.

**11. What do you mean by floatation cost?**

Ans) Cost incurred for raising funds.

**12. What is capital structure of a company?**

Ans.. Capital structure is the relative proportion of different sources of long term finance. In other words Capital structure of a company refers to the make up of its capitalization

**SHORT ANSWER QUESTIONS (3 / 4 MKS)**

**1. Are the share holders of a company likely to gain with a debt component in the capital employed ? Explain with the help of an example?**

Ans) The shareholders of a company are very likely to gain with debt component in the capital employed by way of trading On equity as it increases the earning per share(EPS) of the share holders.

**2 Define current assets and Give four examples.**

Ans. Current assets also called as floating assets or fluctuating assets are short term assets whose value fluctuates in the short period. These assets are required to pay off the current liabilities. For e.g. cash in hand/Bank, Inventory, Debtors. Bills receivable, Marketable securities etc.

**3 “To avoid the problem of shortage and surplus of funds, what is required in Financial management? Name the concept and explain four points of importance.**

Ans. Financial Planning is required to avoid shortage or surplus of finance.

Importance of financial planning is:

- a) By planning utilization of finance, it reduces waste ,duplication of efforts and gaps in the planning.
- b) It helps in coordinating the various business activities such as sales, purchases, production, finance etc.
- c) It is a technique of control. It helps in setting up standard and compare with the actual performance. The deviations, if any are then analysed. Causes found out and corrective measures are taken.
- (d)It helps in avoiding shocks and surprises as proper provision regarding Shortage or surplus is made in advance by anticipating future receipts and Payments.

**4 Explain the role of ‘Operational efficiency’ in the determination of working capital requirement.**

Ans. The firm with a better operational efficiency has to invest less in working capital because-

- a) they convert raw materials quickly into finished goods, and sell them at their earliest. i.e. converts stock into sales quickly.
- b) Promptly collects debts from debtors and bills receivable.

**5 Discuss how Working capital affects both the liquidity and profitability of a business.**

Ans. Short term Investment decisions are concerned with the decisions about the level of cash, inventory and debtors etc. (working capital)

Efficient cash management, Inventory management and receivable management are essential ingredients of sound working capital management.

The working capital should be neither more or less than required. Both the situations are harmful. If the amount of working capital is more than required, it will no doubt increase the liquidity but decrease the profitability. Similarly if there is a shortage of working capital, it will face the problem of meeting day to day requirements.

Thus optimum amount of current assets and current liabilities should be determined so that the profitability of the business remains intact and there is no fall in the liquidity.

**6 How does 'Interest coverage ratio' affects the capital structure.**

Ans. The interest coverage ratio refers to the number of times earnings before interest and taxes of a company covers the interest obligations.

Interest coverage ratio =  $\text{EBIT} / \text{Interest}$

Higher the ratio, better is the position of the firm to pay its interest obligations, so

it should issue debt. On the other hand if it is low, the firm should avoid using debt as

interest is to be paid irrespective of profits.

**7 Why Capital budgeting decisions are more important?.**

Ans. The long term Investment decision is called capital budgeting. It is more important due to the following reasons-

- a) Long term growth and affects : As capital budgeting decisions involve investment in long term fixed assets, it affects the long term growth.
- b) Large amount of funds involved : As huge amount of fund is blocked for a long period, the decision should be taken rationally.
- c) Risk involved : As such a decision affects the returns of the firm as a whole, it involves more risk.
- d) Irreversible decisions : These long term decisions taken once cannot be reversed back, without incurring heavy losses. It will lead to waste of fund, if reversed.

Thus capital budgeting decisions should be taken after careful study and deep analysis.

**8 What is Financial risk? How does it arise?**

Ans. It refers to the risk of the company not being able to cover its fixed financial cost. Fixed financial cost includes payment of interest that is to be paid irrespective of profit.

The higher level of risk are attached to higher degrees of financial leverage. If EBIT(Earnings before interest and tax) decreases, financial risk increases as the firm is not in a position to pay its interest obligations. Thus the risk of default is

called Financial risk. The firm should overcome the situation accordingly or will be forced towards liquidation.

### **LONG QUESTIONS ( 5/6 MKS)**

#### **1.What are the determinant of capital structure of a company?**

**OR**

**‘Determination of capital structure of a company is influenced by a number of factors’ explain six such factors.**

Ans. Capital structure refers to the relative proportion of different sources of long term finance. Following factors are to be considered before determining capital structure.

- a) Cash flow position: The cash available with the company should be enough to meet the fixed interest liabilities. Interest on debt is to paid irrespective of profits. A company has to meet working capital requirements, invest in fixed assets and also pay the interest and principal amount of debt after a particular stipulated period. If cash position is sound, debt van be raised, and if not sound debt should be avoided.
- b) Interest coverage ratio : it is the ratio that expresses the number of times the Net profit before interest and tax covers the interest liabilities. Higher the ratio, better is the position of the firm to raise debt.
- c) Control : Issue of Equity shares dilutes the control of the existing shareholders , whereas issue of debt does not as the debenture holders do not participate in the management decisions as they are not the owners of the fir. Thus if control is to be retained, equity should be avoided.
- d) Stock market conditions : If the stock market is bullish, the investors are adventurous and are ready to invest in risky securities, equity can be issued even at a premium whereas in the Bearish phase, when the investors become cautious, debt should be issued as there is a demand for fixed cost security.
- e) Regulatory framework : Before determining the capital structure of a company , the guidelines of SEBI and concerned regulatory authority is to be considered. For e.g companies Act, Banking regulation Act etc are to considered.
- f) Tax rate : As interest on debt is treated as an expense, it is tax deductible. Dividend on equity is the distribution of profit so is not tax deductible. Thus if the tax rates are high, issue of debt is an attractive means as it is economical in nature.

#### **2. Explain briefly five factors determining the amount of fixed capital.**

Ans. Fixed capital refers to the capital which is used for the purchase of fixed assets, such as land, building, machinery etc.

Following factors are to be considered before determining its requirement.

- a) Nature of Business: If a firm is a manufacturing fir, it requires to purchase fixed assets for the production process. It needs investment in fixed assets, so require more fixed capital. Similarly if it is a Trading firm where the finished goods are only traded i.e purchased and sold, it needs less fixed capital.
- b) Scale of operations larger the size and scale of operations larger is the requirement of the fixed capital and vice versa.

- c) Choice of technique: The Manufacturing firm using the modern, latest technology machines has to invest more funds in the fixed assets, so they require more fixed capital. On the other hand, firms using the traditional method of production where the task is performed manually by the labourers, it requires less fixed capital.
- d) Diversification : There are few firms and organizations who deal in a single product. These investment in fixed assets is low, whereas the firms dealing in number of products ( Diversification) requires more investment in purchasing different fixed assets, it requires more fixed capital.
- e) Financing alternatives: If the manufacturing firm actually buys the assets and blocks huge funds in the fixed assets, it requires more fixed capital. The companies who acquire the fixed asset and use them by obtaining leasing facilities, it requires less fixed capital. Leasing is suitable in high risk lines of business where huge funds should not be blocked in the fixed assets.

**3. What is meant by Working capital? How is it calculated? Explain the determinants of working capital requirements.**

Ans. Working capital is the capital required for meeting day to day requirements/operations of the business.

Net working capital= current assets – current liabilities.

Following factors are to be considered before determining the requirement of working capital.

- a) Scale of operations: There is a direct link between the scale of business and working capital. Larger business needs more working capital as compared to the small organizations.
- b) Nature of Business: The manufacturing organizations are required to purchase raw materials, convert them into finished goods, maintain the stock of raw materials, semi finished goods and finished goods before they are offered for sale. They have to block their capital for labour cost, material cost etc, so they need more working capital. In the trading firm processing is not performed. Sales are affected immediately after receiving goods for sale. Thus they do not block their capital and so needs less working capital.
- c) Credit allowed: If the inventory is sold only for cash, it requires less working capital as money is not blocked in debtors and bills receivable. But due to increased competition, credit is usually allowed. A liberal credit policy results in higher amount of debtors, so needs more working capital.
- d) Credit availed: If goods are purchased only for cash, it requires more working capital. Similarly if credit is received from the creditors, the requirement of working capital decreases.
- e) Availability of Raw materials: If the raw materials are easily available in the market and there is no shortage, huge amount need not be blocked in inventories, so it needs less working capital. But if there is shortage of materials, huge inventory is to be maintained leading to larger amount of working capital. Similarly if the lead time is higher, higher amount of working capital is required.

**4. ‘Every Manager has to take three major decisions while performing the finance function’ briefly explain them.**

Ans. The three important decisions taken by the finance manager are as follows –

1) Investment decision: It refers to the selection of the assets in which investment is to be made by the company. Investment can be made in Long term fixed assets and short term current assets. Thus Investment decision is divided in two parts :

(a) Long term Investment decisions: Such decisions are also called Capital Budgeting decisions. It relates to the investment in long term fixed assets. As such decisions affects the growth of the firm, it involves huge fund to be blocked for a long period, and such decisions are irreversible in nature, they should be taken carefully after making a comparative study of various alternatives available.

(b) Short term Investment decision (Working capital decision): It refers to investment in short term assets such as cash, inventory, debtors etc. Finance manager has to ensure that enough working capital is available to meet the day to day requirements. It should also ensure that unnecessarily high reserve of working capital should not be retains as it decreases the profitability. Thus profitability and Liquidity are to be compared and appropriate amount kept as working capital.

2. Financing decision: There are various sources of obtaining long term finance such as Equity shares, preference shares, term loans, Debentures etc. For taking financing decision and deciding the capital structure various factors are to be considered and an analysis of cost and benefit is made.

3. Dividend decision: It refers to the decision related to the distribution of profit. The finance manager has to decide as to how much amount of profit is to be distributed as Dividend and how much to be retained in the business. If too much retained earnings are maintained, it dissatisfies the shareholders as they receive less dividend. Similarly if a liberal dividend policy is followed, though the shareholders are satisfies, but the firm does not have enough reserve for future growth, expansion, meeting contingency etc.

##### **5. What is meant by ‘Financial management’ Explain its importance..**

Ans. Financial management refers to that part of the management which is concerned with the efficient planning and controlling the financial affairs of the enterprise. Financial management plays the following role.-

a) Determination of fixed assets : Fixed assets have an important contribution in increasing the earning capacity of the business. Long term investment decisions also called capital budgeting decision raise the size of fixed assets..

b) Determination of current assets : Current assets are needed to meet the day to day transactions of the business. The total investment in current assets is to be determined and the split up into its elements is required. For e.g. if it is decided to maintain current assets of Rs 10 lakh, further decision is to be made as to how much cash is required, how much amount to be invested in debtors, stock etc.

c) Determination of long term and short term finance: Under this a Finance manager has to maintain a proper ratio of short term and long term sources of finance after estimating its requirement.

- d) Determination of Capital Structure: A balanced decision related to capital structure is to be made . The proportion of debt and equity is to be determined.
- e) Determination of various items in the Profit and loss account-The financial decisions affect the various items to appear in the profit and loss account. For e.g depreciation on fixed assets, interest on debt etc.

**STUDY MATERIAL:-**

**CASH FLOW STATEMENT**

**Qus:1 Why is the cash flow statement not a suitable judge of profitability ?**

Ans: Cash Flow statement is prepared on cash basis of accounting but profit is calculated on accrual basis. So cash flow statement is not a judge of profitability.

**Qus:2 Under which accounting standard , cash flow statement is prepared ?**

Ans: Under accounting standard-3(Revised).

**Qus:3 Why do we add back non cash items to net profit while calculating cash flow from operating activities.**

Ans: Non cash items reduce the net profit without reducing the cash balance.

**Qus:4 How will you classify loans given by HDFC while preparing cash flow statement.**

Ans: As Operating Activities.

**Qus:5 How will you classify deposits by customers in SBI while preparing cash flow statement.**

Ans: Operating Activities

**Qus:6 Where will you show purchase of furniture in cash flow statement ?**

Ans: As Outflow under Investing Activities.

**Qus:7 Give examples of non cash transactions.**

Ans: Give any two examples-

- (i) Acquisition of fixed asset by issue of debentures or shares.
- (ii) Conversion of debentures into shares.

**Qus:8 A company receives a dividend of Rs. 5 Lakhs on its investment in other company's share will it be Cash inflow from operating or investing activities in case of a.**

- (i) Finance Company.
- (ii) Non-Finance Company.



Ans: It will be operating activities in case of a finance company and investing activities in case of non-Financing Company.

**Qus:9 Give four example of movement between cash and cash equivalents.**

Ans: Cash deposited into bank, Cash withdrawn from bank for office use, purchase of short term marketable securities, , sale of short term marketable securities

**Qus:10 How are various activities classified as per AS-3 (Revised) ?**

Ans: (i) Operating Activities.  
(ii) Investing Activities.  
(iii) Financing Activities.

**Qus:11 Give one example each of an extra ordinary item under operating, investing and financing activity.**

Ans: Examples of extraordinary items under:-

- (a) Operating activity – claim received from insurance company against loss of stock.
- (b) Investing activity – amount of compensation received against acquisition of land belonging to the enterprise.
- (c) Financing activity – payment for buy-back of equity shares of the company.

**Qus:11 Cash flow from operating Activities + Cash flow from Investing Activities + Cash flow from Financing**

Activities =.....

Ans: ...= Net Increase /Decrease in cash and Cash Equivalents.

**Qus:12 What are the two methods which can be employed to calculate net cash flow from operating activities ?**

Ans: Direct Method and Indirect Method.

**Qus:13 Modern Toys Ltd. Purchased a machinery of Rs.20,00,000 for manufacturing toys. State giving reason**

**Whether the cash flow due to the purchase of machinery will be cash flow from operating activities,**

**Investing activities or Financing activities ?**

Ans: Investing Activities Because .....

**Qus:14 M/s.Lakshmi Electrical Appliances furnish the following information -**

Calculate net cash flow from financing activities:-

Particulars	31.12.2007	31.12.2008
Equity share capital	2,00,000	4,50,000
10% debentures	1,00,000	-
6% preference shares	-	3,00,000

Additional information –

- (a) Interest paid on debentures Rs.5,000/-.
- (b) Dividend paid on equity shares Rs.40,000/-.
- (c) Bonus shares were issued to existing shareholders in the ratio of 4:1 during the year.

**Ans.:** CALCULATION OF NET CASH FLOW FROM FINANCING ACTIVITIES

Particulars	Rs.
Cash proceeds from issue of Pref. Shares + equity shares	3,00,000
Redemption of 10% debentures	(1,00,000)
Interest paid	(5,000)
Dividend paid on equity shares	(40,000)
Net cash flow from financing activity	4,05,000

**Qus:15** A company had the following balance -

Particulars	Rs.
Investment at the beginning of the period	3,40,000
Investment at the end of the period	2,80,000

During the year, the company sold 40% of investments at the beginning at a profit of 84,000. Calculate cash fro, investing activities –

Particulars	Rs.
Inflow from sale of investment	
Cost of investment Gold	2,20,000

(40% of Rs.340000) = 136000	
Add profit on sale = <u>84000</u>	
Out flow on purchase of investment	(76,000)
Net cash flow from investing activities	1,44,000

Investment A/c.

To balance b/d.	3,40,000	By Cash sale of investment	2,20,000
To profit on sale	84,000		
To bank a/c. (purchase)	76,000	By balance c/d.	2,80,000
	5,00,000		5,00,000

**Practice numerical:**

**Qus:16 From the following profit or loss account find out the flow of cash from operating activities of Mohan Ltd.**

**Profit and Loss Account**

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Particulars		Amount	Particulars		Amount
		(Rs)			(Rs)
To Rent Paid	14,000		By Gross Profit		1,82,000
Less: Prepaid	<u>2,000</u>	12,000	By Profit on Sale of Machine		12,000
To Salaries		25,000	By Tax Refund		3,800
To Depreciation		15,000	By Rent received	4,000	
To Loss on sale of Furniture		10,000	Add: Rent accrued	<u>1,000</u>	5,000
To Goodwill written Off		8,000			
To Bad Debts		3,000			
To Office Expenses		18,000			
To Discount allowed		7,000			
To Proposed Dividend		30,000			
To Provision for Tax		22,000			
To Net Profit		52,800			
		<u>2,02,800</u>			<u>2,02,800</u>

**Note:** There was increase in Closing stock by Rs. 25,000.

Ans: Cash from Operating Activities Rs.1,03,800.

**Qus:17 Prepare Cash flow Statement from the following information of LOYD PVT. LTD. For the year ended March 31,2004.**

**BALANCE SHEETS OF LOYD PVT. LTD. AS ON MARCH 31,2004**

<b>Liabilities</b>	<b>2003</b>	<b>2004</b>	<b>Assets</b>	<b>2003</b>	<b>2004</b>
	(Rs)	(Rs)		(Rs)	(Rs)
Share capital	3,00,000	4,00,000	Goodwill	70,000	30,000
Profit & Loss	1,20,000	2,60,000	Machinery	3,00,000	3,20,000
Account General	60,000	95,000	12%	1,50,000	3,00,000
Reserve	70,000	80,000	Investments	35,000	1,85,000
Tax Provision	50,000	90,000	Stock	50,000	70,000
Creditors	30,000	10,000	Debtors	30,000	40,000
Bill Payables	25,000	40,000	Cash at Bank	20,000	30,000
Depreciation Provision	6,55,000	9,75,000	Short term Investment	6,55,000	9,75,000

**Additional Information :**

1. Investment costing Rs.50,000 were sold for Rs. 48,000 during the year.
2. Tax paid during the year Rs.70,000.
3. Interest received on Investment Rs. 12,000.

Ans: (i) Cash Inflow From Operating Activities Rs.80, 000.  
(ii)Cash Outflow on Investing Activities Rs.1, 60,000.  
(iii) Cash Inflow from Financing Activities Rs. 1, 00,000.