Model Answer
MBA II Semester Examination 2013
Financial Management
Section-A

1.

i. Long term investment decision or the capital budgeting decision refers to the commitment of current funds in long term assets in anticipation of receiving a series of cash flows in future.

ii. $K_e = \frac{DIV1.}{P0} + g$

Where K_e =Cost of equity capital,P_0 = Current market Price of the share and G = Growth rate of the company

iii. Net Operating income (NOI) approach to capital structure theories says that the value of the firm is independent of its capital structure. The value of the firm depends on its business risk class and operational efficiency rather than on how it is being financed.

iv. ARR stands for Accounting Rate of Return. It is a method to evaluate the attractiveness of investment proposals. It is calculated by dividing the average net operating profit [EBIT(1-T) by the average investment.

$$ARR = \frac{\text{Average Net Operating Profit after Tax}}{\text{Average Investment}}$$

v. The use of fixed-charges capital like debt in the capital structure is known as financial leverage.

vi. Gordon's model on dividend states that the value of the firm depends on the dividend decision Using the following equation:

P_0=DIV_1/k-rb, where P_0= Current market Price,DIV_1=Expected dividend, k=cost of capital, b=retention ratio and r= internal rate of return, Gordon states that for a growing firm, retention ratio should be high, for a declining firm retention ratio should be low and for a normal firm ,the dividend policy does not make any difference.

vii. Bonus shares are issued to capitalize reserves and surplus of a company. Bonus shares are issued to maintain the liquidity of the company. Bonus shares have psychological value and information content for shareholders.

viii. Spontaneous financing refers to the automatic financing sources of short –term funds arising in the normal course of business. Trade credit, outstanding expenses are examples of spontaneous financing.

ix. When the firm's actual bank balance is greater than the balance shown in firm's books, the difference is called disbursement or payment float. The difference between the total amount of cheque drawn on a bank account and the balance shown on the bank's books is caused by transit and processing delays.

x. These costs are associated inventory maintenance. Warehousing, handling, clerical and staff services, insurance and taxes are examples of carrying costs. Carrying cost vary with inventory holding. As order size increases, average inventory holding increases and therefore, the carrying cost increases. Ordering costs include requisition, placing of order, transportation, receiving, inspecting etc. Ordering costs are fixed per order and therefore, may decline as the order size increases.

Section – B
(Hints for long answer type questions)

2. Financial management basically means management of finances of the company. Management of finances includes various decisions taken by the finance manager. The student should describe the basic finance functions. The role of finance manager has changed over the time. The role of finance manager has changed from episodic financing to proper utilization of resources of the organization. Students should mention the routine functions of finance manager along with the basic finance functions.

3. IRR refers to the internal rate of return. Internal rate of return is defined as the discount rate which equates the present value of cash inflows to the present value of cash outflow. Discuss the merits and demerits of IRR. Merits: Time value of money, all cash flows, Intuitive appeal, Demerits: difficulty in calculation, multiple rates, ranking of projects etc.

4. Cost of capital may be defined as the minimum rate of return from projects that maintains the current market price of the share at its current level. Process of calculating overall cost of capital: Overall cost of capital is the weighted average cost of specific sources of funds. Hence, one has to calculate the cost of individual sources of funds, then, the weighted average cost of capital is found out by multiplying the

individual cost of capital with proportion of the specific source of fund in the total capital structure. Student has to specify how the cost of each source of fund is calculated.

5. Capital structure refers to the proportion of various long term sources of funds in an organization. Factors determining the capital structure: Assets, Growth opportunities, debt& non-debt tax –shields, financial flexibility and operating strategy, loan covenants, control, marketability and timing, capital market conditions, issue costs, capacity of raising funds, managers attitude towards debt etc.

6. Gross working capital refers to the total current assets of an organization. Net working capital is the difference between current assets and current liabilities of an organization. Factors determining the working capital need include: I. Nature of business, size of business, operating cycle, production policy, market and demand conditions, credit policy, operating efficiency, price level changes, availability of credit from suppliers etc.

Question No 7.

Solution:

Net Working Capital estimate of M/s D Rath & Co

A. Current assets:			
i.	Raw materials in stock, (1,04,000*Rs.80*4/52)	Rs.	6,40,000
ii.	Work-in- progress		
	a. Raw material (1,04,000*Rs80*2/52)		3,20,000
	b. Direct Labour(1,04,000*Rs 15*2/52)		60,000
	c. Overheads (1,04,000*Rs.30*2/52)		1,20,000
iii.	Finished goods stock: (1,04,000*Rs.170*4/52)		13,60,000
iv.	Debtors: (1,04,000*Rs170*8/52)		27,20,000
v.	Cash at Bank		25,000
Total Investment in Current assets			52,45,000
B. Current Liabilities:			
i.	Creditors, average 4 weeks: (1,04,000*Rs.80*4/52)		6,40,000
ii.	Lag in payment of wages (1,04,000*Rs.30*1.5/52)		90,000
Total current liabilities			7,30,000
C. Net Working Capital: current assets – current liabilities			45,15,000
Add: 10 per cent contingencies			4,51,500
Net Working Capital required			49,66,500

Note: A full unit of raw material is required at the beginning of the manufacturing process and, therefore, total cost of the material, that is, Rs.80 per unit has been taken into consideration, while in the case of expenses, viz. direct labor and overheads, the unit has been finished only to the extent of 50 per cent. Accordingly, Rs 15 and Rs. 30 have been charged for direct labour and overheads respectively in valuing work-in-process.

Question No8.

Solution:

i. Initial Investment: Cost of the machine = Rs.6,00,000

Add Increase in Working Capital =Rs. 80,000

Rs. 6,80,000

ii. Annual straight line depreciation= Rs. 6,00,000/6=Rs.1,00,000

NPV calculation

		Cash Flows (Rs.'000)						
	Years	0	1	2	3	4	5	6
1.	Initial investment	-680						
2.	Before Tax Cash flows		210	180	160	150	120	100
3.	Less Depreciation		100	100	100	100	100	100
4.	Profit beforeTax		110	80	60	50	20	0
5.	Tax		55	40	30	25	10	0
6.	Profit after Tax		55	40	30	25	10	0
7.	Net Cash Flow (PAT+Depreciation)		155	140	130	125	110	180*
8.	PVF at 12%	1.0	0.893	0.797	0.712	0.636	0.567	0.507
9.	Present Value(7*8)	-680	138	112	93	80	62	91
10.	Sum of Present Values of Cash Inflow 576							
11.	Net Present Value	-104						

Since the equipment has a negative NPV, the equipment should not be purchased.

*Includes Rs. 80,000 working capital released in the last year

9. (a) Trading on Equity: Trading on equity refers to use of fixed cost sources of funds in the capital structure of an organization. Based on the equity of the company, debt capital is raised i.e. the equity is traded upon. Students are expected to deal with the merits and demerits of trading on equity, its effect on risk and return

(b) Goals of Financial Management: Students are expected to write down various alternate goals of financial management i.e. profit maximization, wealth maximization and maximization of EPS. After discussing the merits and demerits of each in brief, the student should conclude that wealth maximization is the goal of financial management. They should also mention how specification of goals helps in decision making.

© Stable Dividend Policy: Students are expected to explain the concept of stable dividend policy. They should also mention the merits and demerits of stable dividend policies.

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