The objective of this course is to give an overview of the problems facing by the financial manager in the commercial world. It will introduce you to the concepts and theories of corporate finance that underlie the techniques that are offered as aids for the understanding, evaluation and resolution of financial manager’s problem.

<table>
<thead>
<tr>
<th>S. No.</th>
<th>Topic</th>
<th>No. of classes required</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td><strong>UNIT I: The Finance Function:</strong></td>
<td></td>
</tr>
<tr>
<td>1</td>
<td>Definition, Nature and Scope</td>
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<tr>
<td>2</td>
<td>Evolution of Finance Function, It’s New role in the Contemporary Scenario</td>
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<td>3</td>
<td>Goals of Finance Function, Maximisation Vs Satisfying, Profit Vs Wealth Vs Welfare</td>
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<tr>
<td>4</td>
<td>The agency relationship and costs</td>
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<td>5</td>
<td>Risk return trade off</td>
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<td>6</td>
<td>Concept of time Value of Money- Future Value and Present Value</td>
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<td>7</td>
<td>Basic Valuation Model</td>
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<td></td>
<td><strong>UNIT II: The Investment Decisions:</strong></td>
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<tr>
<td>1</td>
<td>Investment Decision Process-Project Generation, Evaluation, Selection and Implementation</td>
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<tr>
<td>2</td>
<td>Developing Cash Flow, Data for New Projects</td>
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<td>3</td>
<td>Traditional Methods</td>
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<td>4</td>
<td>DCF Methods</td>
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<td>5</td>
<td>The NPV VS IRR Debate, Approaches for Reconciliation</td>
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<td>6</td>
<td>Capital Budgeting decisions under conditions of Risk and Uncertainty</td>
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<td>Debt Vs Equity, Cost of Equity, preference shares, Cost of Retained earnings</td>
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<td>III</td>
<td>Capital Structure Decisions:</td>
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<tr>
<td>1</td>
<td>Capital structure vs Financial structure-Capitalisation</td>
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<tr>
<td>2</td>
<td>Financial Leverage</td>
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<td>3</td>
<td>Operating Leverage, Combined Leverage</td>
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<td>4</td>
<td>EBIT-EPS analysis</td>
<td>3</td>
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<td>5</td>
<td>Indifference Point/ BEA of financial leverage</td>
<td>2</td>
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<td>Capital structure theories:</td>
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<td>6</td>
<td>The Modigliani Miller Theory, NI Approach</td>
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<td>7</td>
<td>NOI Approach and Traditional Theory</td>
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<td>8</td>
<td>A critical appraisal</td>
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<td>IV</td>
<td>Dividend Decisions:</td>
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<td>1</td>
<td>Dividends and Value of the firm- Relevance</td>
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<tr>
<td>2</td>
<td>Factors determining dividend policy</td>
<td>1</td>
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<td>3</td>
<td>Dividends and Valuation of the firm- Basic models</td>
<td>2</td>
</tr>
<tr>
<td>4</td>
<td>Declaration and Payment of Dividends</td>
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<tr>
<td></td>
<td>Major theories of Dividends:</td>
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<tr>
<td>5</td>
<td>MM Model, Gardon Model</td>
<td>2</td>
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<td>6</td>
<td>Walter Model, Litner model</td>
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<td>7</td>
<td>Dividend Policies of Indian Companies</td>
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<td>2</td>
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<td>3</td>
<td>Determinants of Working capital need</td>
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<tr>
<td>4</td>
<td>Operating cycle, planning of working capital</td>
<td>1</td>
</tr>
<tr>
<td>5</td>
<td>Financing of working capital through bank finance and trade credit</td>
<td>1</td>
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<td>Management of current assets:</td>
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<td>6</td>
<td>Management of cash, Basic strategies for cash management</td>
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<td>7</td>
<td>Cash budget</td>
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<tr>
<td>8</td>
<td>Cash management techniques/ processes</td>
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</tr>
<tr>
<td>9</td>
<td>Marketable securities: Characteristics, selection criterion</td>
<td>1</td>
</tr>
<tr>
<td>10</td>
<td>Marketable security alternatives</td>
<td>1</td>
</tr>
<tr>
<td>11</td>
<td>Management of receivables</td>
<td>2</td>
</tr>
<tr>
<td>12</td>
<td>Management of inventory</td>
<td>2</td>
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<td></td>
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<td></td>
<td>Total classes needed for the subject</td>
<td>70</td>
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</table>

References:
1. Financial Management- I. M. Pandey
2. Financial Management- M Y Khan and P K Jain
3. All financial management books for additional information.

Case References:
All cases from Financial Management- I. M. Pandey

Short Questions:

UNIT I:
1. Financial Management
2. Maximizations Vs. Satisfying
3. Satisfying Vs. Profit Vs. Wealth
4. Goals of Finance function
5. Agency Costs
6. Risk –Return Trade off
7. Time value of Money
8. Basic Valuation Models

UNIT II:
1. Investment Decision
2. Project Generation
3. Project Evaluation
4. Project selection
5. Project implementation
6. Capital budgeting techniques
7. Traditional methods (Individual or All)
8. DCF methods (Individual or All)
9. Capital Budgeting decisions under conditions of Risk and Uncertainty
10. Cost of capital
11. Cost of equity
12. Debt VS Equity
13. Marginal Cost of Capital
14. Weighted average cost of capital

UNIT III:
1. Capital structure
2. Financial leverage
3. Operating leverage
4. Composite leverage
5. EBIT-EPS analysis
6. Indifference point
7. Capital structure theories (all or Individual)

UNIT IV:
1. Value of the firm
2. Relevance of the dividends
3. Factors determining dividend policy
4. Valuation of the firm
5. Declaration and payment of dividends
6. Bonus shares
7. Rights issues
8. Shares splits
9. Forms of Dividends
10. Theories of Dividends (all or individual)

Unit V:
1. Net working capital
2. Gross working capital
3. Working capital
4. Components of working capital
5. Determinants of working capital
6. Operating cycle
7. Planning of working capital
8. Trade credit
9. Management of cash
10. Cash budget
11. Cash management techniques
12. Marketable securities
13. Receivables management
14. Inventory management
Essay Questions:

UNIT I:
1. Describe the scope of financial management. Explain the role of financial manager to play in a modern enterprise.
2. Illustrate that the profit maximization is not an operationally feasible criterion.
3. Discuss the financial manager’s goal when the conflict arises between shareholders’ and managers’
4. Explain ‘An individual’s time preference for money may be expressed as a rate’.
5. Explain the mechanics of calculating the present value cash flows.
6. Illustrate that what happens to the present value of an annuity when the interest rate rises.

UNIT II:
1. Explain under what circumstances the net present value and internal rate of return methods differ.
2. Examine the capital budgeting methods that do not consider the time value of money to lead to wrong capital budgeting decisions.
3. Explain the various concepts of cost of capital should be distinguished in financial managemenr.
4. Explain the significance of cost of capital in financial decision-making.
5. Problems of Cost of Capital
6. Problem on Capital budgeting decision techniques

UNIT III:
1. Explain the concept of financial leverage and its impact on the earnings per share.
2. Illustrate EBIT-EPS analysis and its merits and demerits.
3. Problems on Financial Leverage, Operating Leverage
4. Problems on EBIT-EPS analysis

UNIT IV:
1. Explain the nature of the factors which influence the dividend policy of a firm
2. Since the rights issue allows the ordinary shareholders to purchase the shares at a price much lower than the current market price, why does not shareholders’ wealth increase? Illustrate your answer.
3. Problem on Gordon Model
4. Problems on Walter Model.
UNIT V:
1. Briefly explain factors that determine the working capital needs of a firm
2. Explain the costs of liquidity and illiquidity. What is the impact of these costs on the level of current assets?
3. What methods do you suggest for estimating working capital needs? Illustrate your answer.
4. Is the credit policy that maximizes expected operating profit an optimum credit policy? Explain.
5. Explain pros and cons of various methods of receivables.
6. Explain the steps involved in analysing investment in inventories? Illustrate with an example.
7. Problems on working capital
8. Problems on EOQ, ABC, LIFO, FIFO etc.

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2 Explain the scope and functions of Financial Management.

2 ABC Ltd is considering the purchase of Machines. Two machines X and Y each costing Rs. 50,000 are available. Earnings after taxes are expected to be as under.

<table>
<thead>
<tr>
<th>Year</th>
<th>Machine X Rs.</th>
<th>Machine Y Rs.</th>
<th>Discount factor at 10%</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>15,000</td>
<td>5,000</td>
<td>• 9091</td>
</tr>
<tr>
<td>2</td>
<td>20,000</td>
<td>15,000</td>
<td>• 8624</td>
</tr>
<tr>
<td>3</td>
<td>25,000</td>
<td>20,000</td>
<td>• 7513</td>
</tr>
<tr>
<td>4</td>
<td>15,000</td>
<td>30,000</td>
<td>• 6830</td>
</tr>
<tr>
<td>5</td>
<td>10,000</td>
<td>20,000</td>
<td>• 6209</td>
</tr>
</tbody>
</table>

Evaluate the two alternatives according to NPV method (a discount of 10% is to be used. Which machine should be selected and why?

3 Explain the problems faced in determining cost of capital. How is the cost of capital relevant in capital budgeting decisions?

3 Explain the significance of operating and financial leverage analysis for a financial executive in corporate profit and financial structure planning.
3. The X Ltd. company’s shareholders funds for the year ending 31st March, 2007 are as follows:

<table>
<thead>
<tr>
<th>Shareholders Funds</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>12% preference share capital</td>
<td>Rs. 1,00,000</td>
</tr>
<tr>
<td>Equity share capital</td>
<td>4,00,000</td>
</tr>
<tr>
<td>Share premium</td>
<td>40,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>3,00,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>8,40,000</strong></td>
</tr>
</tbody>
</table>

The earnings available for equity shareholders from this period’s operations are Rs. 1,50,000. Which have been included as part of the Rs.3,00,000 retained earnings. You are required to:

6. Calculate the maximum dividend per share (DPS) that the company can pay.

7. If the company has Rs. 60,000 in cash, what is the largest DPS it can pay without borrowing?

8. Indicate what accounts, if any will be affected if the firm pays the dividends indicated in (b) above.

6. Briefly explain the factors which determine the working capital needs of a large scale manufacturing company.

7. Discuss the utility of the cash budget as a tool of the cash management. What are the steps involved in the construction of a cash budget?

8. The following details are available in respect of a firm.
   i) Inventory requirement per year 6,000 units
   ii) Cost per unit (other than carrying and ordering costs) Rs. 5
   iii) Carrying costs per item for one year Rs.1
   iv) Cost of placing each order Rs. 60
   v) Alternative order sizes:
      (Units) 6,000; 3000; 2000; 1200; 1000; 600 and 200
      Determine the Economic order Quantity.
finance functions?

2 Time value of money is helpful in capital budget, explain?

2 Define cost of capital. Discuss in detail the steps involved in computation of WACC.

2 Briefly discuss the techniques of capital budgeting with merits and demerits.

2 What is a flexible capital structure? Is a flexible capital structure more costly?

2 From the following information estimate working capital required for the level of activity 78000 units. You may assume that production is carried on evenly throughout the year & wages & over head expenses accrue similarly, and a time period of four weeks is equivalent to a month.

<table>
<thead>
<tr>
<th></th>
<th>Cost per unit(Rs)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Raw material</td>
<td>45</td>
</tr>
<tr>
<td>Direct labour</td>
<td>20</td>
</tr>
<tr>
<td>Over heads</td>
<td>37.5</td>
</tr>
<tr>
<td>Total cost</td>
<td>102.5</td>
</tr>
<tr>
<td>Profit</td>
<td>22.5</td>
</tr>
<tr>
<td>Selling price</td>
<td>125</td>
</tr>
</tbody>
</table>

Additional information: raw material in stock: two weeks; material in process: one week; finished goods in stock: two weeks; Credit allowed by suppliers: half month; Credit allowed to customers: four weeks; over heads: two weeks; cash at bank is expected to be Rs. 30000. 80% of sales are credit sales.

3 Discuss in detail the factors that determine the cash needs of a firm. Five examples to necessary factors.

Discuss in detail the Gordon’s dividend policy.

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SHORT NOTES

1. What do you mean by investment?
2. Distinguish between even cash flow and uneven cash flows
3. A project requires a cash outlay of Rs.20,000 and generates cash inflow of Rs. 8000, 4000, 7000 & 5000; during the next 4 years. What is the project payback period.
4. What is break even analysis?
5. Working capital concept

ESSAY QUESTIONS

11. a. Explains the functions of financial manager.

(OR)

b. Explain the nature and scope of financial management.

12. a. Explain the importance and techniques of capital budgeting decisions.

(OR)

b. One of the projects of a company is doing poorly and is being considered for replacement. The projects (A, B & C) are expected to require Rs 200,000 each, have an estimated life of 5 years, 4 years & 3 years respectively and have no salvage value. The required rate of return is 10%. The anticipated cash flows after taxes for the three projects is as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>CFAT’s(Rs)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>A</td>
</tr>
<tr>
<td>1</td>
<td>50,000</td>
</tr>
<tr>
<td>2</td>
<td>50,000</td>
</tr>
<tr>
<td>3</td>
<td>50,000</td>
</tr>
<tr>
<td>4</td>
<td>50,000</td>
</tr>
<tr>
<td>5</td>
<td>190,000</td>
</tr>
</tbody>
</table>

a. Rank each project applying the methods of pay back, ARR, NPV, IRR & PI.
b. Explain why the 5 capital budgeting systems yield conflicting answers.
c. Recommend the projects to be accepted and give reasons.
13. a. Calculate the operating leverage, financial leverage and combined leverage from the following data under situation i&ii and financial plans A & B.

- Installed capacity: 4000 units.
- Actual production and sales: 75% of the capacity.
- Selling price: Rs 30 per unit.
- Variable cost: Rs 15 per unit.
- Fixed Cost situation:
  - Situation i: 15,000
  - Situation ii: 20,000

Capital structure:

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Financial plan A</th>
<th>Financial plan B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity</td>
<td>10,000</td>
<td>15,000</td>
</tr>
<tr>
<td>Debt(0.2 interest)</td>
<td>10,000</td>
<td>5,000</td>
</tr>
<tr>
<td></td>
<td><strong>20,000</strong></td>
<td><strong>20,000</strong></td>
</tr>
</tbody>
</table>

(OR)

b. Explain the importance and significance of operating and financial leverage analysis for a financial executive in a corporate profit and financial structure planning.

14. a. Explain the MM hypothesis theory and Walter's approach to dividends.

(OR)

b. The asbestos company belongs to a risk class of which the appropriate capitalization rate is 10%. It currently has 100,000 shares selling at Rs. 100 each. The firm is contemplating the declaration of a Rs. 6/- dividend at the end of the current fiscal year, which has just began. Answer the following questions based on the MM model and the assumption of no taxes:

a. what will be the price of the shares at the end of the year if dividends are not declared and if dividends are declared.

15. a. From the following forecast of income and expenditure prepare a cash budget for the months of Jan to April.

<table>
<thead>
<tr>
<th>Months/expenses</th>
<th>Sales (credit)</th>
<th>Purchases (credit)</th>
<th>wages</th>
<th>Mfg expenses</th>
<th>Admin expenses</th>
<th>Selling Expenses</th>
</tr>
</thead>
<tbody>
<tr>
<td>November</td>
<td>30,000</td>
<td>15,000</td>
<td>3000</td>
<td>1150</td>
<td>1060</td>
<td>500</td>
</tr>
<tr>
<td>December</td>
<td>35,000</td>
<td>20,000</td>
<td>3200</td>
<td>1225</td>
<td>1040</td>
<td>550</td>
</tr>
<tr>
<td>January</td>
<td>25,000</td>
<td>15,000</td>
<td>2500</td>
<td>990</td>
<td>1100</td>
<td>600</td>
</tr>
<tr>
<td>February</td>
<td>30,000</td>
<td>20,000</td>
<td>3000</td>
<td>1050</td>
<td>1150</td>
<td>620</td>
</tr>
<tr>
<td>March</td>
<td>35,000</td>
<td>22,500</td>
<td>2400</td>
<td>1100</td>
<td>1220</td>
<td>570</td>
</tr>
</tbody>
</table>
b. Explain Cash Management Models.

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
1. Are the shareholders 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 = EBIT/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 firm, 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) require 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.

1. ‘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, expression, 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.

d) 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. 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.

Section-A

1.

2 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. $K_e = \frac{P_0}{G}$

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

3 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.

3 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.

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

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

3 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 $P_0= \text{Current market Price,DIV}_1=\text{Expected dividend, } k=\text{cost of capital, } b=\text{retention ratio and } r=\text{ internal rate of return, }$ 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.

3 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.

3 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.

3 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.

3 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)

8 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.

8 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.

8 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.

10. 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.

11. 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:**

<table>
<thead>
<tr>
<th>Net Working Capital estimate of M/s D Rath &amp; Co</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>A. Current assets:</strong></td>
</tr>
<tr>
<td>i. Raw materials in stock, (1,04,000<em>Rs.80</em>4/52)</td>
</tr>
<tr>
<td>a. Raw material (1,04,000<em>Rs80</em>2/52)</td>
</tr>
<tr>
<td>b. Direct Labour(1,04,000<em>Rs 15</em>2/52)</td>
</tr>
<tr>
<td>c. Overheads (1,04,000<em>Rs.30</em>2/52)</td>
</tr>
<tr>
<td>ii. Finished goods stock: (1,04,000<em>Rs.170</em>4/52)</td>
</tr>
<tr>
<td>a. Debtors: (1,04,000<em>Rs170</em>8/52)</td>
</tr>
<tr>
<td>v. Cash at Bank</td>
</tr>
<tr>
<td>iii. Work-in- progress</td>
</tr>
<tr>
<td>Total Investment in Current assets</td>
</tr>
</tbody>
</table>
### B. Current Liabilities:

1. Creditors, average 4 weeks: \(1,04,000 \times Rs. 80 \times \frac{4}{52}\)
   - \(6,400,000\)

2. Lag in payment of wages \(1,04,000 \times Rs. 30 \times \frac{1.5}{52}\)
   - \(90,000\)

**Total current liabilities**

- \(7,300,000\)

### C. Net Working Capital: current assets – current liabilities

- \(45,150,000\)

Add: 10 per cent contingencies

- \(4,515,000\)

**Net Working Capital required**

- \(49,665,000\)

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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**

<table>
<thead>
<tr>
<th>Years</th>
<th>Cash Flows (Rs.'000)</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>-680</td>
</tr>
<tr>
<td>1</td>
<td>210</td>
</tr>
<tr>
<td>2</td>
<td>180</td>
</tr>
<tr>
<td>3</td>
<td>160</td>
</tr>
<tr>
<td>4</td>
<td>150</td>
</tr>
<tr>
<td>5</td>
<td>120</td>
</tr>
<tr>
<td>6</td>
<td>100</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Years</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Initial investment</td>
<td>-680</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2.</td>
<td>Before Tax Cash flows</td>
<td>210</td>
<td>180</td>
<td>160</td>
<td>150</td>
<td>120</td>
</tr>
<tr>
<td>3.</td>
<td>Less Depreciation</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>4.</td>
<td>Profit before Tax</td>
<td>110</td>
<td>80</td>
<td>60</td>
<td>50</td>
<td>20</td>
</tr>
<tr>
<td>5.</td>
<td>Tax</td>
<td>55</td>
<td>40</td>
<td>30</td>
<td>25</td>
<td>10</td>
</tr>
<tr>
<td>6.</td>
<td>Profit after Tax</td>
<td>55</td>
<td>40</td>
<td>30</td>
<td>25</td>
<td>10</td>
</tr>
<tr>
<td>7.</td>
<td>Net Cash Flow (PAT+Depreciation)</td>
<td>155</td>
<td>140</td>
<td>130</td>
<td>125</td>
<td>110</td>
</tr>
<tr>
<td>8.</td>
<td>PVF at 12%</td>
<td>1.0</td>
<td>0.893</td>
<td>0.797</td>
<td>0.712</td>
<td>0.636</td>
</tr>
<tr>
<td>9.</td>
<td>Present Value(7*8)</td>
<td>-680</td>
<td>138</td>
<td>112</td>
<td>93</td>
<td>80</td>
</tr>
<tr>
<td>10.</td>
<td>Sum of Present Values of Cash Inflow</td>
<td>576</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>11.</td>
<td>Net Present Value</td>
<td>-104</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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.