Subject code:16CCCCM13

FINANCIAL MANAGEMENT

(THEORY)

SECTION-A

1. **Define finance?**
   Finance may be defined as the provision of adequate amount of money when it is required.

2. **Define financial management**?
   According to Archer and Ambrosia, financial management is the application of the planning and control functions to the finance functions.

3. **Mention the objectives of Financial Management.**
   It is concerned with the raising of funds and the effective utilisation.

4. **What is meant by risk?**
   Risk refers to the degree of variability of actual return from the expected return.

5. **Types of Risk.**
   - Capital risk
   - Income risk
   - Liquidity risk
   - Default risk

6. **Cost of capital**
   It is defined as the cost of obtaining funds.

7. **Historical Cost**
   It is the cost incurred in the past in procuring funds for the firm.

8. **Redeemable Preference Shares**
   Preference Shares which are to be redeemed after the expiry of the stipulated period are known as Redeemable Preference Shares

9. **Net Operating Income Approach**
   The capital Structure does not affect the overall cost of Capital and the value of the firm. Whatever is the mix of debt and equity.

10. **Traditional Approach**
    It is a compromise between the Net Income Approach and Net Operating Income Approach.

11. **Leverage**
    It refers to the influence of one financial variable over some other related financial variable.

12. **Types of Leverage**
    - Operative Leverage
    - Financial Leverage
    - Composite Leverage

13. **Financial Leverage**
The use of Long term debt and preference share capital along with the owners equity in the capital structure is called financial leverage

14. **Zero Coupon Bonds**
It is also known as deep discount bonds. The interest rate is not specified.

15. **Debentures**
Debentures or bonds are financial securities issued by compaies to raise long term loans from the public.

16. **Dividend**
It refers to that part of the earnings of a company which is distributed to share holders.

17. **Forms of Dividend**
    - Cash Dividend
    - Bond Dividend
    - Property Dividend
    - Stock Dividend

18. **Bonus Share**
It is a shares issued free of cost to existing share holders.

19. **Right issue**
It is the offer of new shares of the company to the existing share holder.

20. **Working Capital**
Capital required for purchase of raw materials and for meeting the day to day expenditure is called working capital.

21. **Types of Working Capital**
    - Fixed Working Capital
    - Variable Working Capital

22. **Net Working capital**
It is the excess of current asset over current liabilities.

23. **Factors determining working capital**
    i. Nature of Business
    ii. Size of Business
    iii. Terms of sales
    iv. Terms of Purchase

24. **Meaning of Cash**
It includes coins, currencies, notes, cheques, draft, cash at bank.

25. **Motives of Holding Cash**
    - Transaction motive
    - Precautionary motive
    - Speculatory motive

26. Objectives of cash management.

a. To keep cash at the minimum level
b. To invest the surplus cash if any in profitable opportunities

27. Cash Budget

It is summary statement of firms expected cash inflows and outflows over a projected period.

28. Lock Box System

It is a another method of reducing, mailing, processing and collecting time.

29. Baumol Model

Optimum cash level is that level where the carrying cost and transaction cost are minimum.

30. Receivables

The term receivables refer to debt owned to the firm by the customers arising from sale of goods or services in the ordinary course of business.

31. Factoring

It is a financial institution which offers services relating to management and financing of debt arising from credit sales.

32. Average collection period.

It indicate the speed with which debtors receivables are collected.

33. Inventories

It is a stock of goods kept in business and either for sale or for consumption in the production process.

34. Re-order Level

This is the level at which a new order for materials is to be placed by the storekeeper.

35. Economic Order Quantity

It is an ideal quantity of materials which can be purchased at Minimum cost at a time.

SECTION-B-(5 MARKS)

1. Explain the types of financial decisions

It concern with the financial matters of a firms. These financial decisions are grouped in to three categories

a. Investment Decisions
b. Financing Decisions
c. Dividend Decisions

a. Investment Decisions

The investment decisions are two types

i) Long-term Investment decisions

It includes the evaluation of various capital expenditure proposals in terms of their cost, revenue, profit and risk.

ii) Short-term Investment decisions.

It is concerned with the management of working capital. It is also known as Liquidity decisions.

b. Financing Decisions

The finance manager has to decide the sources of finance for financing the investment .Debt and equity are two major source of long –term finance.

c. Dividend Decisions

i) It is concerned with deciding the quantum of profits to be distributed to shareholders

ii) The finance manager has to decide whether the firm should distribute all the profit, retain the balance.

2. Explain the functions of financial management

a) Estimating financial Needs

The finance manager is to provide adequate and timely finance. A firm may need money for purchase of fixed assets or investment in current assets.

b) Identification of Sources of funds:-

The sources of long term as well as short term finance, their casts and other terms have to be ascertained. Many sources are available for raising funds, Equity shares, Preference Shares, loans etc

c) Developing an optimum Capital Structure:-

it involves deciding the proportion of debt and equity as the source of finance.

d) Capital Budgeting:-

This decision relate to effective utilisation of capital

e) Working Capital Management:-

It refers to the funds required for financing the day today operations.

3. ABC Analysis (Always Better Control)

- It is a system of inventory control
- It exercise varied degree of care and control for different categories of materials, according to their value
- It is known as selective value approach
- It is based on the principle of management by exception

- Under ABC analysis, the materials are classified into three categories on the basis of their value.
  Catagory A - High Value Materials
  Catogory B - Medium Value Materials
  Category C – Low Value Materials

4. What are the factors determining capital structure

The capital structure of a firm dependson a number of factors

a. **Financial Leverage**
   - The use of long term debt and preference capital in the capital structure is called financial leverage.
   - It analysis the relationship between EBIT and EPS under different methods of financing

b. **Cost of Capital**
   - The capital structure should be designed to minimise the overall cost of capital
   - It is the minimum return expected by its suppliers

c. **Flotation Cost**
   This cost are incurred for the issue of shares, bond, debentures etc

d. **Cash flow Ability**
   If a company is not able to generate cash to meet this obligation, the company may have to face insolvency.

e. **Legal requirements**
   A company has to comply with legal requirements and government guidelines in planning the capital structure.

5. Factors determining Working Capital Needs

a. Nature of Business
b. Size of Business
c. Seasonal Fluctuations
d. Speed of Turnover
e. Terms of sales
f. Terms of purchase
g. Price level changes
h. Dividend policy

6. Objectives of receivables management.

a) It is the process of making decisions relating to investment in trade debtors
b) Certain investment in receivables is necessary to increase the sales and profit
c) Increase in receivables also increase the risk of bad debts.
d) The objectives of receivables management is to take a sound decision as regards investment in debtors
e) Additional funds are therefore, required to meet the working capital needs of a business which require extra cost in terms of interest

7. Concept of time value of money

a) According to this concept, the same amount of cash receivables during different time periods has different values.

b) The value of money received today is greater than the value of the same amount receivable after 5 or 10 years.

c)The time value of money is to be recognised in making financial decisions
d)The money may be needed to meet urgent current needs therefore people prefer to receive money as early as possible.

8. Doubling period

a)often investors and financial decision makers are interested in knowing the doubling periodthat is the time taken for doubling of an investment.

b)when interest rates rules high in the nineties, investment in Indira Vikas Patra doubled in 5 years

c)An investment of Rs.1000 became 2000 in 5 years.

d)The doubling period can be found approximately by following the rules of thumb method popularly known as Rule of 72 and 69.

9. Salient Features of Bonds

1.Bonds are Long term debt instruments. They are generally redeemable, after 7 years or 10 years.

2.Bonds may be issued at par, at a premium or at a Discount

3.Interest rate is fixed and known to the Investors. It is paid on the face value.

4.Interest rate also known as Coupon Rate.

5.The expected cash inflows to a bond holder consists of annual interest payments and repayment of principle.

6.Payment of Interest at the specified rate and reoayment of principle on the due date is promised.

10.Modigliani-Miller Approach - Assumptions

It is based on the following assumptions

1. There is a perfect market
2. There are no corporate taxes
3. There are no transaction cost
4. The payment is 100%
5. Firms can be grouped into homogeneous risk classes
6. Risk to investors depends on the random variations of expected net operating income

11.Features of the sound capital structure.

a. **Profitability**
   - The capital structure should be beneficiary to the share holders
   - Debts is generally a cheaper source of finance

b. **Flexibility**
   - Business conditions are dynamic
   - It should be possible for the company to adopt its capital structure to meet the changing condition.

c. **Conservatism**
   It is necessary to maintain the borrowings at a reasonable level

d. **Solvency**
   Excessive debt is a threat to the solvency of the company

e. **Control**
   The risk of loss of control should be minimum. When raising debt the company must avoid severe restrictions by the lenders.

12.Lock Box System

1. It is another method of reducing, mailing, processing and collecting time. This system quite popular in USA.
2. The customers are required to remit payments to the lock box directly
3. The bank pickup the cheques and after processing they are deposited in the firms bank account
4. The bank performs the clerical task of handling the remittances even prior to deposit with them at a low cost.
5. It cut down mailing and processing time and thus reduces the cash requirement of the firm.

13.Aims of Finance Function

a. **Procurement of funds**
   The main aim of the finance function is the provision of adequate finance to meet the requirements of the business
   Finance must be provided in time at a reasonable cost

b. **Efficient utilisation of funds**
   It is the fundamental requirement for the success of the financial function
   The firms must generate the return higher than the cost of funds, so as to magnify the earnings of the share holders

c. **Increasing profitability**
   Finance function should aim at increasing the profitability of the business
   All financial decision influence the profit.

d. **Maximizing firms value**
   Finance function plays the key role in maximizing the firms value
   To a considerable extent the value of the firms depends on its profitability.

14.Reasons for Time preference for money

People prefer to receive money, earlier that later. The reasons are

1. **Uncertainty**
   Future is uncertain. there is a chance of not getting the money at all. Hence people like to receive the money today itself rather than waiting for the future.

2. **Preference for consumption**
   The money may be needed to meet the urgent current needs. Therefore people prefer to receive money as early as possible.

3. **Investment opportunity**
   Money has time value. If Mr.Ram receives 20,000 he can invest the amount and turn interests. Suppose he gets an interest of 10% he will have Rs.22,000 at the end of one year. Therefore it is good to receive RS.20,000 now as it will grow into Rs.22, 000 after one year.

15.Significance of Financial Management

It largely depends on the efficiency of financial management

1. **Acquisition of funds**
   Funds for starting the business have to be acquired at the minimum possible cost.

2. **Proper use of funds**
   To achieve the objective the funds are to be used efficiently in projects which genenrate higher returns

3. **Financial control**
   It provides tools of control such as budgeting, ration analysis, cash flow and fund flow

4. **Efficiency of the company**
   It ensures the efficiency of business function, purchase, production, marketing etc

5. **Mobilisation of savings**
   It mobilises the savings of billions of small investors and channelizes them into productive purpose.

SECTION – C

1. Objectives of Financial Management

Financial management is concerned with the raising of funds and their effective utilisation. In order to make these financial decisions rationally, the firm should have a clear objectives.

Two important objectives

- Profit Maximization
- Wealth Maximizaion

Profit Maximization:

It refers to the maximization of income or earnings of a firm

a) Natural Goal
Profit is the aim of any business, mainly it relate to profit maximization.

b) Measures of Efficiency
Profit is a measure of efficiency

c) Internal Generation of funds
Profit lead to internal generation of funds

d) Fulfilment of Social obligation
Profits are essential for fulfilling social obligations of the business

Wealth Maximization

- It refers to the maximisation of the wealth of the shareholders.
- It involves maximization of the net present value of the investment
- Net present value of an investment is the difference between present value of its inflows and out flows
- The wealth created by a company is represented by the market price of its share
- Wealth maximisation implies maximization of market value of shares.

2. Objectives of Inventory Management

- To avoid over stocking and under stocking of inventories
- To avoid wastage like theft, pilferage, spoilage etc
- To maintain inventories at the optimum level keeping in view the operational requirements.
- To purchase raw materials in bulk to avail quantity discount and to take advantage of favourable market conditions.
- To ensure supply of raw materials at a reasonable price without sacrificing the quality
- To have optimum investment in inventories, thus ensuring efficient use of capital
- To promote manufacturing efficiency
- It ensure better service to customers.

3. Valuation of Preference Shares

Preference shares have the features of both equity and debt. Hence they are known as hybrid securities.

Features of Preference Shares:

- Preference shares are given preference over equity shares in respect of payment of dividend and redemption.
- Preference shares carry a fixed rate of dividend
- The rate of dividend is indicated by the prefix say 9% preference share or 10% preference shares
- The preference dividend is payable out of profits
- It is payable after paying interest on debt but before paying dividend on equity shares
- Preference shares may be redeemable or irredeemable
- Redeemable preference share are redeemed after a certain period, say 7 or 10 years
- Irredeemable preference shares have no maturity period. They are known as perpetual preference shares.

4. Types of Risk

Risk refers to the degree of variability of actual return from the expected return.

Types of Risk

a) **Capital risk**

The risk of incurring a Capital loss due to the fall in the price of a security is known as Capital risk

b) **Income risk**

It is the risk of variation in return available from a security.

c) **Default risk**

The chance of default by the company in the payment of interest or the repayment of principal is called default risk.

d) **Liquidity risk**

- It is associated with the secondary market
- A security which can be bought or sold easily, without significant price.
- The greater the uncertainty about the time and price of selling, the greater is the liquidity risk.

5. VED Analysis

Vital, Essential and Desirable Analysis (VED Analysis) is used primarily for control of spare parts. The spare parts can be divided into three categories Vital Parts, Essential Parts and Desirable Parts in view of the importance to production

Vital parts are very important parts. Non availability of these parts at the required time may lead to stoppage of production. Hence vital parts are kept in stock in sufficient quantity to ensure uninterrupted production.

Essential parts are essential for effective functioning of the operating system. Care has to be taken to ensure that they are always in stock.

Desirable spare parts are those parts which are needed but their absence for a short time will not lead to stoppage or production.

6. Inventory Turnover ratio

It is one of the techniques of inventory control. It express the relationship between the cost of material consumed and the average stock held. It indicate the number of times the inventory is consumed and replenished

Objectives of inventory turnover ration

a) Fast moving stock (i.e) stock in high demand
b) Slow moving stock (i.e) stock in slow demand
c) Dormant stock (i.e) stock having no demand at present
d) Obsolete stock (i.e) stock no longer in demand

$$\text{Inventory turnover ratio} = \frac{\text{Cost of material consumed}}{\text{Cost of Average stock}}$$

$$\text{Average Stock} = \frac{\text{Opening Stock} + \text{Closing Stock}}{2}$$

$$\text{Inventory turnover in days} = \frac{\text{Days during the period}}{\text{Inventory turnover ratio}}$$

7. Kinds of Inventories

Inventories are stock of goods kept in business and meant either for sale or for consumption in the production. It includes:

a)Raw Materials:- Raw materials are the basic inputs they are converted in to finished products through the manufacturing process.

b)Work- in-progress:- These inventories are semi-finished goods .The raw materials enter the process of manufacturing but they are yet to atain a final shape of finished goods.

c)Finished Goods:- Finished goods are completed products which are ready for sale The levels of three kinds of inventories of a firm depend on the nature of its business .A manufacturing firm will have high levels of all the three kinds of inventories.

8. Benefits of Holding Inventories:-

Maintaining inventories involves blocking of firms fund and incurrence of storage and handling costs. The benefits of holding inventories are as follows:-

a) Avoiding Loss of Sales:-

If a firm maintains adequate stock of finished goods, it can avoid loss of sales due to non supply of goods in time.

b) Availing Quantity Discount:-

Maintaining of large inventories in selected product lines enables the firm to obtain quantity discount through bulk purchases.

c) Reducing Ordering Cost:-

The variable cost associated with individual orders .E.g. typing, checking, approving and mailing the order etc. can reduced if a firm places large order than numerous small ones.

d) Smooth Running of business:-

If a firm maintains adequate stock of raw material it facilitates uninterrupted production and smooth running of business.

9. Methods of Evaluating Capital Expenditure Proposals

Different firms may use different methods for evaluating the project proposals. while evaluating two basic principles are kept in view namely, the bigger benefits are always better than the deferred ones.

The following methods are usually followed for evaluation.

1.Pay back period Method

It is popularly known as pay off or pay out method. It is defined as the number of years required to recover the initial cash outlay invested in a project.

$$\text{Pay back period} = \frac{\text{Initial Investment}}{\text{Annual Cash Inflow}}$$

2. Accounting Rate of Return Method

It takes in to account, the accounting concept of profit (i.e(profit after depreciation and tax)and not the cash inflows .The project which yields the highest rate of return is selectd.

$$\text{ARR} = \frac{\text{Average Annual Profit}}{\text{Original Investment}} \times 100$$

3.Discounted Cash flow Method

It is an improvement on the pay back method. It takes in to an account both the profitability and the time value of money. This method is based on the fact that future value of money will not be equal to the present value of money. Discount cash flow methods for evaluating capital investment proposal are of three types.

a)Net Present Value Method

b)Excess present value Index

c)Internal Rate of Return.

10.Theories of Capital structure.

The four major theories which explain the relationship between capital structure ,cost of capital and valuation of firm are

1.**Net Income Approach**

2.Net operating Income approach

3.Traditional Approach

4.Modigilani-Miller approach

1,Net Income Approach:-

According to NI approach, a firm can minimise the overall cost of capital (WACC)by maximising the use of debt in its capital structure.

Assumptions

*The cost of debt is less than the cost of equity

*There are no corporate taxes

*The use of debt does not alter the risk perceptions of investors.

2.Net Operating Income Approach(NOI) Approach

NOI approach is diametrically opposite to net income approach .According to this theory, capital structure does not affect the overall cost of capital and the value of the firm. That is overall cost of capital remains the same whatever is the mix of debt and equity

Assumptions

*The market capitalises the firm as a whole. Therefore, net operating income is capitalised with the over all cost of capital.

*Business risk is the same for different levels of debts in the capital structure. Hence, overall cost of capital is constant.

*There are no corporate Taxes.

3. Traditional Approach:-

It is also called Intermediate approach. It is a compromise between the net income approach and net operating income approach..It can help to reduce the overall cost of capital and increase the value of the firm. After this point ,debt increases the financial risk of share holders.

4. Modigilani-Miller approach:-

It explains the relationship between capital structure, cost of capital and value of the firm under two conditions. When there are no corporate taxes.