

FINANCIAL MANAGEMENT

STUDY NOTES

- **Introduction:** Money required for carrying out business activities is called business finance. Finance is the life blood of a business.
 - Finance is needed to establish a business, to run it, to modernize it, to expand or diversify it.
- **Financial management** is the activity concerned with the planning, raising, controlling and administering of funds used in the business.
- **Objectives of Financial Management**
 - Wealth Maximisation
 - To ensure effective utilisation of funds
 - To attain optimum capital structure
 - To procure sufficient funds for the organisation
 - To ensure safety of funds
- **Financial Decisions**
 - Investment Decision
 - Financing Decision
 - Dividend Decision
- **Investment Decision:** It relates to how the firm's funds are invested in different assets. Investment decisions can be long-term or short-term.
 - Capital budgeting decision – A long term investment decision
 - Working capital decisions – short term investment decisions
- **Factors affecting Investment Decisions / Capital Budgeting decisions**
 - Cash flows of the project
 - Rate of Return
 - Investment Criteria Involved.
- **Financing Decision:** It relates to the amount of finance to be raised from various long term sources.
- **Factors Affecting Financing Decision**
 - Cost of raising funds
 - Risk associated with different sources is different
 - Flotation Cost, Higher the flotation cost, less attractive is the source of finance.
 - Cash flow position of the business
 - Control Considerations
 - State of Capital Markets
 - Period of Finance
- **Dividend Decision:** Dividend refers to that part of the profit which is distributed to shareholders. A company is required to decide how much of the profit earned by it should be distributed among shareholders and how much should be retained.
- **Factors affecting Dividend Decision:**
 - Earnings over a period of time
 - Growth Prospects in future
 - Preference of Shareholders
 - Issue of bonus shares
 - Stability of Dividends in spite of fluctuations in earnings
 - Cash Flow Positions in terms of strong or weak
 - Taxation Policy related to payment of dividend
 - Legal constraints about payment of dividends
- **Financial Planning:** The process of estimating the fund requirement of a business and specifying the sources of funds is called financial planning. It ensures that enough funds are available at the right time so that a firm could honour its commitments and carry out its plans.

- **Importance of Financial Planning**
 - To ensure availability of adequate funds at the right time.
 - To see that the firm does not raise funds unnecessarily.
 - It provides policies and procedures for the sound administration of finance functions.
 - It results in preparation of plans for the future. Thus new projects can be undertaken smoothly.
 - It attempts to achieve a balance between inflow and outflow of funds. Adequate liquidity is ensured throughout the year.
 - It serves as the basis of financial control. The management attempts to ensure utilization of funds in tune with the financial plans.
- **Capital Structure:** It refers to the mix between owner's funds and borrowed funds. It will be said to be optimal when the proportion of debt and equity is such that it results in an increase in the value of the equity share.
- **Factors affecting Capital Structure**
 - Trading on Equity
 - Cash flow position
 - Interest Coverage Ratio to assess burden of paying interest in relation to profit
 - Return on Investment to assess profitability on investment
 - Floatation Cost involved in raising funds
 - Control consideration in management of the organization
 - Tax Rate on profit
 - Flexibility in raising funds from different sources
 - Capital market conditions
- **Fixed Capital:** It refers to investment in long-term assets. Investment in fixed assets is for longer duration and they must be financed through long-term sources of capital.
- **Factors affecting requirement of Fixed capital**
 - Nature of Business affecting requirements of fixed assets
 - Scale of Operations in terms of high or low
 - Choice of Technique in terms of capital intensive or labour intensive
 - Technology upgradation in terms of frequency- is it frequent or occasional
 - Growth Prospects in terms of high or low
 - Diversification
 - Distribution Channels
 - Collaboration between two or more parties
- **Working Capital:** refers to the capital required for day to day working of an organisation. Apart from the investment in fixed assets every business organisation needs to invest in current assets, which can be converted into cash or cash equivalents within a period of one year.
- **Factors affecting working capital requirements of an organisation:**
 - Nature of Business in terms of length of operating cycle
 - Scale of operations in terms of high or low
 - Business Cycle in terms of boom or depression
 - Seasonal Factors involving production/sales in few months of the year only
 - Credit allowed to buyers
 - Credit availed from sellers/raw material suppliers
 - Inflation in terms of high or low
 - Turnover of working capital

QUESTION BANK

MULTIPLE CHOICE QUESTIONS

- This decision determines the overall cost of capital and the financial risk of the enterprise,
 - Financial decision
 - Capital budgeting decision
 - Working capital decision
 - Financing decision
- Under which of the following circumstances a company is not likely to declare a higher dividend?
 - When the earnings of the company are high
 - When a company has a lucrative forthcoming business opportunity
 - When the cash flow position of the company is strong
 - All of the above
- Which of the following is not an objective of financial planning?
 - Ensuring enough funds are available at the right time
 - Ensuring 100% utilization of working hours.
 - Ensuring smooth business operations
 - All of the above
- Arrange the following steps involved in the process of financial planning in the correct sequence.
 - Estimation of expected profit, Preparation of a sales forecast, Preparation of financial statements
 - Preparation of financial statements, Estimation of expected profit, Preparation of a sales forecast
 - Preparation of a sales forecast, Estimation of expected profit, Preparation of financial statements
 - Preparation of a sales forecast, Preparation of financial statements, Estimation of expected profit
- Under which of the following situations a company should not issue debt capital?
 - When the rate of tax is low.
 - When the cash flow condition of the company is strong.
 - When the return on investment is high.
 - When the interest coverage ratio is high.
- Under which of the following conditions the fixed capital requirements of a business is not likely to below?
 - When the raw material is easily available
 - When the labour-intensive production technique is used
 - When the growth prospects of the firm are low
 - When the level of collaboration is low
- Working capital requirements are low when an organisation has
 - High technology
 - High creditors
 - High debtors
 - High investors
- Capital structure shows:
 - Debt- equity ratio
 - Debtor creditor ratio
 - Fixed assets-current assets ratio
 - Interest cover ratio
- Wealth maximization depends on
 - Market cost per share
 - Market price per share
 - Cost of dividend
 - Cost of interest coverage ratio
- If the dividend portion of total earnings is high., portion of retained earnings will be:
 - Low
 - Moderate
 - High
 - Equal
- Financial Management aims at _____ of funds procured, keeping the risk under control and achieving effective deployment of such funds.
 - Reducing the cost
 - Increasing the cost
 - Same cost
 - None of above

12. Objective of financial management is to maximise the _____ of equity shares of the company or to maximise the wealth of owners of the company, that is, the shareholders.
- (a) Current price (b) Constant price
(c) Same price (d) None of the above
13. These decisions are concerned with the decisions about the levels of cash, inventory and receivables. These decisions affect the day-to-day working of a business. These affect the liquidity as well as profitability of a business.
- (a) Long -term investment decisions (b) Short-term investment decisions
(c) Financial decision (d) None of the above
14. This decision normally has the capacity to severely damage the financial fortune of a business.
- (a) Bad capital budgeting (b) Working capital decision
(c) Financial decision (d) None of the above
15. The decision to invest in a particular project involves a number of calculations regarding the amount of investment, interest rate, cash flows and rate of return. There are different techniques to evaluate investment proposals which are known as _____. These techniques are applied to each proposal before selecting a particular project.
- (a) Short-term investment decisions (b) Capital budgeting techniques
(c) Both (a) and (b) (d) None of the above
16. This type of decision involve, how much of the profit earned by company (after paying tax) is to be distributed to the shareholders and how much of it should be retained in the business.
- (a) Investment decision (b) Dividend decision
(c) Financial decision (d) None of the above
17. The choice between the payment of dividend and retaining the earnings is, to some extent, affected by the difference in the tax treatment of dividends and this gain. If tax on dividends is higher, it is better to pay less by way of dividends. As compared to this, higher dividends may be declared if tax rates are relatively lower. This gain is:
- (a) Capital gains, (b) Revenue gain
(c) Both (a) and (b) (d) None of the above
18. The decision is affected by the tax treatment of dividends and capital gains. For a company, It is better to pay less by dividends when the tax rate on the dividend is higher and pay more as dividends when the tax rate is lower. This is because dividends are tax-free in the hands of shareholders, dividends distribution tax is levied on the company. Payment of tax on the dividend is an:
- (a) Added expense for the company to be paid apart from the dividends that are distributed.
(b) Subtracted expense for the company to be paid apart from the dividends that are distributed
(c) Both (a) and (b)
(d) None of the above
19. Financial planning helps in determining the objectives, policies, procedures, programmes and budgets to deal with the:
- (a) Financial activities of an enterprise (b) Operating activities of an enterprise
(c) Both (a) and (b) (d) None of the above
20. Rahul is a successful businessman in the paper industry. During his recent visit to his friend's place in Mysore, he was fascinated by the exclusive variety of incense sticks available there. His friend tells him that Mysore region is known as a pioneer in the activity of Agarbathi manufacturing because it has a natural reserve of forest products especially Sandalwood to provide for the base material used in production. Moreover, the suppliers of other types of raw material needed for production follow a liberal credit policy and the time required to manufacture incense sticks is relatively less. Considering the various factors, Arun decides to venture into this line of business by setting up a manufacturing unit in Mysore. In context of the above case, identify which decision is taken by Rahul:
- (a) Financial decision (b) Investment decision
(c) Financing decision (d) None of the above

21. 'Rani' is a company enjoying market leadership in the food brands segment. Its portfolio includes three categories in the Foods business namely Snack Foods, Juices and Confectionery. Keeping in the with the growing demand for packaged food it now plans to introduce ready-To-Eat Foods. Therefore, the company has planned to undertake investments of nearly ₹450 crores for its new line of business. As per the current financial report, the interest coverage ratio of the company and return on investment is higher. Moreover, the corporate tax rate is high. In context of the above case: As a financial manager of the company, which source of finance will you opt for debt or equity, to raise the required amount of capital?
- (a) Interest coverage ratio (b) Tax rate
(c) Both (a) and (b) (d) None of the above
22. Sohan Ltd. is manufacturing steel at its plant at Noida. Due to economic growth, the demand for steel is also growing. The company is planning to set up a new steel plant at Gurgaon. It needs ₹800 crore to start the new plant. It decides to raise ₹300 crore through debentures, ₹200 crore through long-term loan from banks and ₹200 crore by issue of equity share to the public. It decided to finance the remaining amount by utilizing its reserves and surplus. Identify the importance of financial planning for this company:
- (a) Financial planning will help the company in avoiding business shocks and surprises. It will reduce waste and duplication of efforts.
(b) Financing decision
(c) Company have growth opportunities of setting up a new steel plant at Gurgaon, it retains ₹100 crore out of profits to finance the required investment.
(d) All of the above
23. Shrey inherited a very large area of agricultural land in Haryana after the death of his grandfather. He plans to sell this piece of land and use the money to set up a small scale paper factory to manufacture all kinds of stationary items from recycled paper. Being an amateur in business, he decides to consult his friend Subhash who works in a financial consultancy firm. Subhash helps him to prepare a blue print of his future business operations on the basis of sales forecast in next five years. Based on these estimates, he helps Shrey to assess the fixed and working capital requirements of business. In context of the above case, identify the type of financial service that Subhash has offered to Shery:
- (a) Financial planning (b) Annual planning
(c) Monthly planning (d) None of the above
24. Yovu Ltd. is a company engaged in production of organic foods. Presently, it sells its products through indirect channels of distribution. But, considering the sudden surge in the demand for organic products, the company is now inclined to start its online portal for direct marketing. The financial managers of the company area planning to use debt in order to take advantage of trading on equity. In order to finance its expansion plans, it is planning to raise a debt capital of ₹40 lakhs through a loan @ 10% from an industrial bank. The present capital base of the company comprises of ₹9 lakh equity shares of ₹10 each. The rate of tax is 30%. Which of the following conditions necessary for taking advantage of trading on equity:
- (a) The rate of return on investment should be more than the rate of interest.
(b) The amount of interest paid should be tax deductible.
(c) Both (a) and (b)
(d) None of the above
25. From the set of facts given in column I and corresponding relevant fact given in column II, choose the correct pair of statement: Identify the option which is showing correct pairing:

Column I		Column II	
I.	Shareholders wealth	A.	Represents the excess of current assets over current liabilities
II.	Keeping equity low to maximise returns on equity shares	B.	Require to invest more in working capital
III.	Rate of inflation is high	C.	Trading on equity
IV.	Net working capital	D.	Product of number of shares and market price per share

- (a) I – D, II – C, III – B, IV – A (b) I – B, II – C, III – A, IV – D
(c) I – A, II – C, III – B, IV – D (d) I – C, II – D, III – A, IV – B

26. From the set of facts given in column I and corresponding relevant fact given in column II, choose the correct pair of statement:

Column I		Column II	
I.	Proportion between owners fund and borrowed fund	A.	Difference of current assets and current liabilities
II.	Objective of shareholders wealth	B.	Diversification
III.	Rate of inflation is high	C.	Capital structure
IV.	Net working capital	D.	Maximisation of shareholders wealth

- (a) I – B, II – C, III – A, IV – D
 (b) I – C, II – D, III – B, IV – A
 (c) I – A, II – C, III – D, IV – B
 (d) I – A, II – B, III – C, IV – D

27. From the set of facts given in column I and corresponding relevant fact given in column II, choose the correct pair of statement:

Column I		Column II	
I.	Debenture holder of a company	A.	retained earnings
II.	Routine maintenance expenses	B.	Fixed capital
III.	Long term assets	C.	Working capital
IV.	Cheapest source of finance	D.	Creditor

- (a) I – D, II – C, III – B, IV – A
 (b) I – C, II – D, III – B, IV – A
 (c) I – A, II – B, III – C, IV – D
 (d) I – B, II – D, III – A, IV – C

28. From the set of facts given in column I and corresponding relevant fact given in column II, choose the correct pair of statement:

Column I		Column II	
I.	Low rate of dividend	A.	Capital structure
II.	Mixture of fixed capital	B.	Over capitalisation
III.	Example of owners fund	C.	Within one year
IV.	Current assets can be converted in cash	D.	Preference share

- (a) I – D, II – C, III – B, IV – A
 (b) I – C, II – D, III – B, IV – A
 (c) I – A, II – B, III – C, IV – D
 (d) I – B, II – D, III – A, IV – C

29. From the set of facts given in column I and corresponding relevant fact given in column II, choose the correct pair of statement:

Column I		Column II	
I.	Time span between acquisition of goods for sale/processing and realisation of sales proceeds of the concerned goods.	A.	Floatation cost
II.	Represents the excess of current assets over current liabilities	B.	Total capitalisation
III.	These are the costs that are incurred by a company when issuing new securities. The costs can be various expenses including, but not limited to, underwriting, legal, registration, and audit fees. Floatation expenses are expressed as a percentage of the issue price.	C.	Operating cycle
IV.	Debt + Equity	(d)	Net working capital

- (a) I – D, II – C, III – B, IV – A
 (b) I – C, II – D, III – B, IV – A
 (c) I – A, II – B, III – C, IV – D
 (d) I – B, II – D, III – A, IV – C

30. The working capital requirement of a business is not likely to be high when?
- (a) The nature of business is trading (b) Scale of operation of business is small
(c) It is difficult to procure raw material (d) The rate of inflation is low
31. Under which of the following circumstances the fixed capital requirement of a business is not likely to be high?
- (a) When the raw material is not easily available
(b) Capital intensive techniques of production are used
(c) The growth prospects of a company are high
(d) When the financial alternatives are easily available
32. If the rate of return on investment for a company is 16%, a situation of unfavorable financial leverage will be said to arise when the rate of interest payable on debt capital is
- (a) More than 16% (b) Less than 16%
(c) Equal to 16% (d) None of the above
33. The total of Uranium Private Limited is 50 lacs. The amount of debt is 20 lacs. The company has earned a profit of 10 lacs during the current financial year. Its return on investment (ROI) for the present year is:
- (a) 20% (b) 40%
(c) 10% (d) 80%
34. It is essentially the preparation of a financial blueprint of an organisation's future operations. Identify the related concept.
- (a) Financial management (b) Financial planning
(c) Capital budgeting decisions (d) Dividend decision
35. A company must adhere to the provisions of the Companies Act while taking the dividend decision. Identify the related factor of the dividend decision being mentioned in the above line.
- (a) Contractual constraints (b) Legal constraints
(c) Access to capital market (d) Preferences of shareholders
36. Arrange the following steps involved in the process of financial planning in the correct sequence.
- (a) Estimation of expected profit, Preparation of a sales forecast, Preparation of financial statements
(b) Preparation of a sales forecast, Preparation of financial statements, Estimation of expected profit
(c) Preparation of a sales forecast, Estimation of expected profit, Preparation of financial statements
(d) Preparation of financial statements, Estimation of expected profit, Preparation of a sales forecast
37. If in a particular situation, the earnings per share (EPS) falls with the increased use of debt, it indicates that
- (a) The rate of return on investment (ROI) is less than the cost of debt
(b) The rate of return on investment is more than the cost of debt
(c) The cost of debt is less than the rate of return on investment
(d) None of the above
38. Which of the following statements is not true with regard to the use of fixed capital?
- (a) It affects the long-term growth of the business
(b) A large number of funds are involved
(c) The business risk involved is low
(d) The investment decisions are irreversible
39. The working capital requirement of a business is not likely to be high when?
- (a) The nature of business is trading
(b) Scale of operation of a business is small
(c) It is difficult to procure raw material
(d) The rate of inflation is low

INPUT-TEXT BASED MCQs

Read the following text and answer the following questions (40 to 43) on the basis of the same:

Manya Ltd. is manufacturing cars at its manufacturing unit in Mumbai. The demand of its cars is high as the economic growth is about 5% to 7%. The company has estimated a 60% increase in the demand of its cars. It is planning to set up a new car manufacturing unit. For this the company will require approximately 12,000 crores as fixed capital and 200 crores as working capital. The company has already arranged for its fixed capital. State any three factors that the finance manager of the company should keep in mind while arranging its working capital.

40. Factors affecting the requirement of Working Capital
- (a) Nature of business (b) Scale of operation
(c) Business cycle (d) None of the above
41. Which of the following are owned sources of finance?
- (a) Equity share (b) Preference share
(c) Retained earnings (d) All of the above
42. Which of the following is borrowed sources:
- (a) Debentures (b) Bonds (c) Both (a) and (b) (d) None of the above
43. If the tax rate is high, the company is pay _____
- (a) Less dividend (b) High dividend (c) Both (a) and (b) (d) None of the above

Read the following text and answer the following questions (44 to 47) on the basis of the same:

Somnath Ltd. is engaged in the business of export of garments. In the past, the performance of the company had been upto the expectations. In line with the latest technology, the company decided to upgrade its machinery. For this, the Finance Manager, Dalmia estimated the amount of funds required and the timings. This will help the company in linking the investment and the financing decisions on a continuous basis. Dalmia therefore began with the preparation of a sales forecast for the next four years. He also collected the relevant data about the profit estimates in the coming years. By doing this, he wanted to be sure about the availability of funds from the internal sources of the business. For the remaining funds he is trying to find alternative sources from outside. Also state the objectives to be achieved by the use of financial concepts, so identified.

44. Identify the financial concept discussed in the above para.
- (a) Operational planning (b) Financial planning
(c) Both (a) and (b) (d) None of the above
45. Which objective is identified here in above para?
- (a) To ensure availability of funds when required
(b) To see that the firm does not raise resources unnecessarily.
(c) Both (a) and (b)
(d) None of the above
46. "A company has decided to issue equity but it is concerned about the control management will lose. So after a lot of brainstorming the board of directors decided to take a loan from a bank and debt from other sources." Identify the type of financial decision.
- (a) Dividend decision (b) Financing decision
(c) Financial decision (d) None of the above
47. A decision to acquire a new and modern plant to upgrade an old one is known as _____ decision.
- (a) Financing decision (b) Working capital decision
(c) Investment decision (d) Dividend decision

Read the following text and answer the following questions (48 to 51) on the basis of the same:

Indian equity markets are going through a phase of boom. There is a huge growth potential for innovative technologies. This has resulted in lots of new ventures lying for a market share and old enterprises trying to keep up with the pace

with which changes are taking place in the economy. This technological innovation has helped even smaller businesses to compete on a global scale.

48. Identify the factors affecting working capital requirements.
 (a) Business cycle (b) Growth prospects (c) Level of competition (d) All of the above

49. What is the meaning of working capital?
 (a) The capital of a business which is used in its day-to-day trading operations,
 (b) Calculated as the current assets minus the current liabilities.
 (c) Both (a) and (b)
 (d) None of the above

50. Technological changes are:
 (a) Internal factors (b) External factors (c) Both (a) and (b) (d) None of the above

51. Sundry Creditors. Bills Payable. Trade credit are the examples of:
 (a) Fixed capital (b) Working capital (c) Both (a) and (b) (d) None of the above

Read the following text and answer the following questions (52 to 55) on the basis of the same:

Sahni Ltd. is a company manufacturing furniture. It has a share capital of ₹60 lakhs. The earning per share in the previous year was ₹0.50. For diversification, the company requires an additional capital of ₹40 lakhs. The company raised funds by issuing 10% debentures for the same. During the current year, the company earned a profit of ₹8 lakhs on the capital employed. It paid tax @ 40%.

- (a) Let us presume that the share capital of ₹60 lakh is made up of ₹6 lakh equity shares assuming that the face value of each share is Rs.10.

Sources	Situation 1- (Amount (in Rs.))	Situation 2 (Amount (in Rs.))
Equity shares	60,00,000	60,00,000
10 % Debentures	NIL	40,00,000
Total Capital	60,00,000	1,00,00,000
EBIT	—	8,00,000
Less: Interest	—	— (4,00,000)
EBT	—	4,00,000
Less: Tax @ 40%	—	— (1,60,000)
EAT	*3,00,000	2,40,000
No. of shares of ₹10 each	6,00,000	6,00,000
EPS	0.50	2,40,000/6,00,000 = 0.40

- (b) $*0.50 \times 6,00,000 = 3,00,000$
 (c) Consequently EBT/EBIT in situation 1 = ₹5,00,000
52. On diversification, the earning per share fell down from _____ to _____
 (a) ₹0.50, ₹0.40 (b) ₹0.40, ₹0.50
 (c) ₹0.50, ₹0.20 (d) None of the above
53. factors that favour the issue of debentures by the company as part of its capital structure are:
 (a) Tax deductibility (b) Flotation cost
 (c) Control (d) All of the above

54. Which statement is true regarding Earning Per Share?
- (a) Earnings per share is calculated by dividing the company's total earnings by the total number of shares outstanding.
 - (b) $EPS = \text{Total Earnings} / \text{Outstanding Shares}$.
 - (c) Total earnings is the same as net income on the income statement.
 - (d) All of the above
55. Which statement is true regarding Earning before interest and taxes
- (a) EBIT is that profit of the business from which the payment of interest and tax remains to be deducted.
 - (b) It is also known as the operating profit of business
 - (c) It is an index of the profit earning capacity of the business
 - (d) All of the above

ANSWERS

Multiple Choice Questions

- | | | | | | | | | | |
|---------|---------|---------|---------|---------|---------|---------|---------|---------|---------|
| 1. (d) | 2. (b) | 3. (b) | 4. (d) | 5. (a) | 6. (d) | 7. (b) | 8. (a) | 9. (b) | 10. (a) |
| 11. (a) | 12. (a) | 13. (b) | 14. (a) | 15. (b) | 16. (b) | 17. (a) | 18. (a) | 19. (a) | 20. (b) |
| 21. (c) | 22. (d) | 23. (a) | 24. (c) | 25. (a) | 26. (b) | 27. (a) | 28. (d) | 29. (b) | 30. (c) |
| 31. (d) | 32. (a) | 33. (a) | 34. (b) | 35. (b) | 36. (b) | 37. (a) | 38. (c) | 39. (c) | |

Input-Text Based MCQs

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|---------|---------|---------|---------|---------|---------|---------|---------|---------|---------|
| 40. (d) | 41. (d) | 42. (c) | 43. (a) | 44. (b) | 45. (c) | 46. (c) | 47. (c) | 48. (d) | 49. (c) |
| 50. (c) | 51. (b) | 52. (a) | 53. (d) | 54. (d) | 55. (d) | | | | |

