Biyani's Think Tank

Concept based notes

Financial Management

(BCom II Year)

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Preface

I am glad to present this book, especially designed to serve the needs of the students. The book has been written keeping in mind the general weakness in understanding the fundamental concepts of the topics. The book is self-explanatory and adopts the "Teach Yourself" style. It is based on question-answer pattern. The language of book is quite easy and understandable based on scientific approach.

Any further improvement in the contents of the book by making corrections, omission and inclusion is keen to be achieved based on suggestions from the readers for which the author shall be obliged.

I acknowledge special thanks to Mr. Rajeev Biyani, *Chairman* & Dr. Sanjay Biyani, *Director* (*Acad.*) Biyani Group of Colleges, who are the backbones and main concept provider and also have been constant source of motivation throughout this Endeavour. They played an active role in coordinating the various stages of this Endeavour and spearheaded the publishing work.

I look forward to receiving valuable suggestions from professors of various educational institutions, other faculty members and students for improvement of the quality of the book. The reader may feel free to send in their comments and suggestions to the under mentioned address.

Author

Ankita Nyati

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Section –A

Meaning, scope, importance and limitation of financial Management Tasks and responsibilities of a Modern Finance manager.

Q1. What do you understand by financial management? Discuss its role or key areas of finance in brief.

Ans. Introduction: Financial management is has emerged as an interesting and exciting area for academic studies as well as for the practical finance managers. Financial management covers all decisions, taken by an individual or a business firm, which have financial implications. In our simple understanding finance perceives as Money. But in actual terms finance is study of money and its flow.

Meaning:

The world "Financial Management" is the composition of two words i.e. *'Finance'* and *'Management'*.

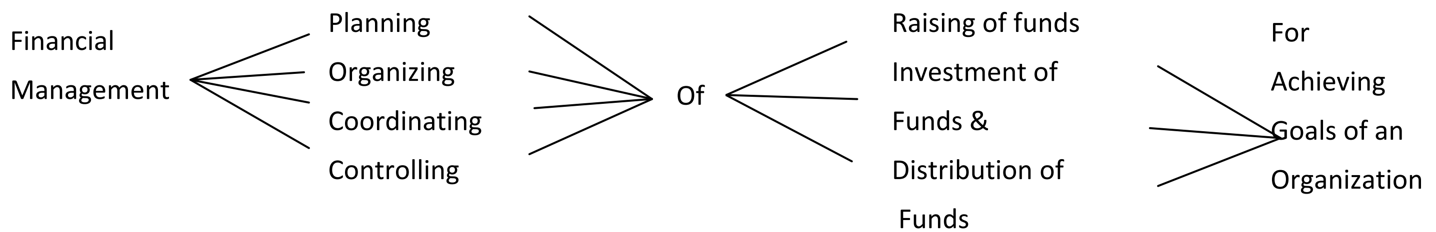
- *Finance* means the science or study of money and its supply. It is the procuring or raising of money supply (funds) and allocating (using) those resources (funds) on the basis of monetary requirements of the business. Finance is called science of money. It is not only act of making money

available, but its administration and control so that it could be properly utilized.

- The word *'Management'* means planning, organizing, coordinating and controlling human activities with reference to finance function for achieving goals/objectives of organization. Thus financial management is defined as the overall administration and management of money and its flow.

Definition of Financial management: ***Financial Management means planning, organizing, directing and controlling the financial activities such as procurement and utilization of funds of the enterprise. It means applying general management principles to financial resources of the enterprise.***

Diagrammatic Explanation of Financial Management



Explanation of the key areas of finance:

I – Raising of funds – Based on the total requirements of capital/funds for use in fixed assets, current assets as well as intangible assets like goodwill, patent, trade mark, brand etc. crucial decision are:

- When to raise (time)

- Sources from which to raise

- How much (quantum of money)

- In which form (debt or equity)

- Cost of raising funds

II – Investment of funds – Funds raised need to be allocated/ invested in:

- **Fixed assets** – also known as capital assets or capital budgeting decision. These decisions are based upon cost and return analysis through various techniques
- **Current assets** – also known as working capital management. These are assets for day today running the business like cash, receivables, inventory, short form investments etc. Decision about investment of funds is taken keeping in view two important aspects i.e. Profitability and Liquidity.

III - Distribution of funds - Profit earned need to be distributed in the form of dividend. Higher the rates of dividend, higher world are the price of shares in market. Another crucial decision under it would be the quantum of profit to be retained. The retained profit is cost free money to the organization.

Q.2 What are the key objectives or goals of Financial Management?

Or

Why wealth maximization /value maximization is considered as better objective instead of profit maximization?

Ans There are two objectives of financial management viz

- *Profit maximization*
- *Share holders wealth maximization*

There are two schools of thought in this regard

1. Traditional and
2. Modern.

   While tradition approach favors profit maximization as key objective, the modern thinker's favors share holders wealth maximization as key objective of financial management. Traditional thinkers believe that profit is appropriate yardstick to measure operational efficiency of an enterprise. They are of the view that a firm should undertake only those activities that increase the profit.

Aspects of profit maximization:

(i) Profit is an ambiguous concept. Profit can be long term or short term, profit before Tax or after Tax, profit can be operating profit or gross profit etc. The economists concept of profit is different then accountants concept of profit.

(ii) Profit motto may lead to exploitation of customers, workers, employees and ignore ethical trade practices.

(iii) Profit motive also ignores social considerations or corporate social responsibility or general public welfare.

(iv) Profit always goes hand- to hand with risk. The owners of business will not like to earn more and more profit by accepting more risk.

(v) The profit maximization was taken as objective when business was self financed and self controlled.

Contradictory View: In view of above, modern thinkers consider wealth maximization as key objective of financial management. This is also known as value maximization or net present worth maximizations. This share holder's wealth maximization is evident from increase in the price of shares in the market. They are of the view that wealth maximization is supposed to be superior over profit maximization due to following reasons:

Aspects of wealth Maximization:

- This uses the concept of future expected cash flows rather than ambiguous term of profit.

- In takes in to accent time value of money.
- It also takes care of risk factors associated with project as the discount rate used for calculating present value is generally a risk adjusted discount rate.
- It is consistent with the objective of maximizing owner's welfare.

Conclusion:

Equity shares of a company are traded in stock market and stock market quotation of a share serves as an index of performance of the company. The wealth of equity share holders in maximized only when market value of equity share of the company is maximized. In this context, the term wealth maximization is redefined as value maximization.

At macro level, a firm has obligation to the society which is fulfilled by maximizing production of goods and services at least cost, thereby maximizing wealth of society.

Q.3 Discuss in brief the responsibilities of a financial manager in present scenario?

Or

Explain in brief key functions of a finance manager or chief finance officer of a large size industrial organization.

Ans. Financial manager is the one who performs the financial management in the company. A finance manager of a large organization has a very crucial responsibility to shoulder as he has to take all decision about raising & utilization of resources have been taken efficiently and at no time resources should remain idle. As the size of organization grows and volume of financial transactions increases, his role and functions assumes

greater importance. A financial manager is also known as CFO, i.e. Chief Financial Officer.

The key functions of a financial manger are as follows:

A) Management functions

- **Planning** - A CFO has to make financial planning in the form of short term and long term plans and frame policies relating to sources of finance, investment of funds including capital expenditure and distribution of profit.
- **Organizing**- creating and monitoring proper organizational structure of finance looking to the needs of organization.
- **Coordination** – A CFO has to coordinate with all other department so that no department suffers for want of funds.
- **Controlling** – A CFO has to fix/ set standards of performance, compare actual with standards fixed and exercise control on differences. He can apply techniques of budgetary control and for this; he has to develop a system of collecting/ processing/analyzing information.

B) Functions related to finance:

- **Financial Planning** – A CFO has to make financial planning in the form of short term and long term plans and frame policies relating to sources of finance, investment of funds including capital expenditure and distribution of profit.

- **Financial forecasting** – Creating and monitoring proper organizational structure of finance looking to the needs of organization.

- **Financial engineering** - A CFO has to keep himself abreast with new techniques of financial analysis and new financial instruments coming in

market. In financial engineering, a CFO has to work on finding out solutions to the problem through complex mathematical models and high speed computer solutions.

C) Basic Functions

6A's

- **Anticipating the needs of funds in the organization**
- **Acquisition of funds**
- **Allocation of funds**
- **Administration of finds**
- **Analyzing the performance of funds**
- **Accounting and recording the transactions.**
-

The six A's of Finance can be précised in the following three broad headings:

- **Anticipating and Acquisition of funds** – A Financial manager has to ensure adequate quantum of funds from right source, right cost, right time, and right form and at minimum cost. He is responsible for acquiring the funds with the best possible and minimum cost.

- **Allocation and Administration of funds** – How much amount of funds are to be invested in current capital as well as in fixed assets (long term assets), this is to be considered by the finance manager while keeping in view liquidity & profitability. He also ensures the administration of finance in different departments.

- **Analyzing the Performance of funds and thereafter managing the accounts.** – The financial manager has to ensure the performance of the allocation and administration of funds, so as to achieve the objectives of the firm. And finally interpret the results while maintain the records and accounts thereof.

  i. **Evaluation of financial performance & reporting** – A CFO has to periodically review financial performance against set standards, take corrective measures as well as report performance to the board & management for facilitating timely decisions pertaining to finance at top level.

  ii. **Upkeep of records and other routine functions** – A CFO has to look in to following aspects:

  - supervision of cash receipts
  - safe custody of valuables & securities
  - maintenance of account
  - internal audit
  - compliance of govt regulations

D) – Subsidiary functions:

Besides core functions as above, a CFO has to perform following equally important functions such as:

- **Maintaining liquidity** – Adequate liquidity need to be maintained for paying obligations in time as well as meeting day to day expenses and for this, he has to keep close eyes on cash in-flows, cash out flows. Hence cash budget and cash for-casting becomes his important function.
- **Profitability** – For ensuring adequate profit and maximizing share holders wealth a CFO has to look in to:
  - Profit planning
  - Price fixation of goods & services

- Cost of funds/capital
- Cost control
- **Risk management** – Preparing strategies for combating risks arising out of
- Internal &
- External factors

E) Other Functions of Modern Age

- **Achieving corporate goals** – Besides goals of organization goals of different departments have to be achieved to increased market share of company's products.

- **Financial projections / forecasting** – for next 5-10 years consisting of cost & revenues for coming long term period keeping in view companies long term plans.

- **Corporate Governance** – for image building in the eyes of all stake holders of the company, transparency in systems / procedure and adherence of laws as well as rules & regulations.

- **Merger and acquisitions initiative** –
- Including new product lines
- Technological tie-up/ collaboration with foreign firms
- Financial restructuring for increasing profitability
- Tie-up arrangements for greater penetration in new markets in the country & abroad.

Q.4. Explain the scope and significance of financial management in the present day business world.

Ans. The scope and significance of financial management can be discussed from the following angles:

I – Importance to Organizations

- **Business organizations –** Financial management is important to all types of business organization i.e. Small size, medium size or a large size organization. As the size grows, financial decisions become more and more complex as the amount involves also is large.

- **Charitable organization / Non-profit organization / Trust –** In all those organizations, finance is a crucial aspect to be managed. A finance manager has to concentrate more on collection of donations/ revenues etc and has to ensure that every rupee spent is justified and is towards achieving Goals of organization.

- **Government / Govt. or public sector undertaking** – In central/ state Govt, finance is a key/ important portfolio generally given to most capable or competent person. Preparation of budget, monitoring capital /revenue receipt and expenditure are key functions to be performed by the person in charge of finance. Similarly, in a Govt or public sector organization, financial controller or Chief finance officer has to play a key role in performing/ taking all three financial decisions i.e. raising of funds, investment of funds and distributing funds.

- **Other organizations-** In all other organizations or even in a family finance is a key areas to be looked in to seriously by a competent person so that things do not go out of gear.

II – Importance to all Stake holders:-

- **Share holders** – Share holders are interested in getting optimum dividend and maximizing their wealth which is basic objective of financial management.

- **Investors / creditors** – these stake holders are interested in safety of their funds, timely repayment of the principal amount as well as interest on the same. All these aspect are to be ensured by the person managing funds/ finance.
- **Employees** – They are interested in getting timely payment of their salary/ wages, bonus, incentives and their retirement benefits which are possible only if funds are managed properly and organization is working in profit.

- **Customers –** They are interested in quality products at reasonable rates which is possible only through efficient management of organization including management of funds.
- **Public** –Public at large is interested in general public welfare activities under corporate social responsibility and this aspect is possible only when organization earns adequate profit.
- **Government** – Govt is interested in timely payment of taxes and other revenues from business world where again efficient finance manager has a definite role to play.
- **Management** – Management is interested in overall image building, increase in the market share, optimizing share holders wealth and profit and all these aspect greatly depends upon efficient management of financial resources.

III – Importance to other departments of an organization.

A large size company has many departments like (besides finance dept.)

- Production Dept.
- Marketing Dept.
- Personnel Dept.
- Material/ Inventory Dept.

All these departments look for availability of adequate funds so that they could manage their individual responsibilities in an efficient manner. Lot of funds are required in production/manufacturing dept for ongoing / completing the production process as well as maintaining adequate stock to make available goods for the marketing dept for sale. Hence, finance department through efficient management of funds has to ensure that adequate funds are made available to all department and these departments at no stage starve for want of funds. Hence, efficient financial management is of utmost importance to all other department of the organization.

Chapter 2

Financial Analysis: Financial statements - Income statement and lance-Sheet. Techniques of financial analysis. Ratio analysis, Liquidity, Activity, Profitability and Leverage Ratios.

Q.1 What is financial analysis technique. Explain.

Ans. Definition and Explanation of Financial Statement Analysis:

Financial statement analysis is defined as the process of identifying financial strengths and weaknesses of the firm by properly establishing relationship between the items of the balance sheet and the profit and loss account.

There are various methods or techniques that are used in analyzing financial statements, such as comparative statements, schedule of changes in working capital, common size percentages, funds analysis, trend analysis, and ratios analysis.

Financial statements are prepared to meet external reporting obligations and also for decision making purposes. They play a dominant role in setting the framework of managerial decisions. But the information provided in the financial statements is not an end in itself as no meaningful conclusions can be drawn from these statements alone. However, the information provided in the financial statements is of immense

use in making decisions through analysis and interpretation of financial statements.

Tools and Techniques of Financial Statement Analysis:

Following are the most important tools and techniques of financial statement analysis:

1. Horizontal and Vertical Analysis
2. Ratios Analysis

1. Horizontal and Vertical Analysis:

Horizontal Analysis or Trend Analysis:

Comparison of two or more year's financial data is known as **horizontal analysis**, or trend analysis. *Horizontal analysis* is facilitated by showing changes between years in both dollar and percentage form. Click here to read full article.

Trend Percentage:

Horizontal analysis of financial statements can also be carried out by computing **trend percentages**. *Trend percentage* states several years' financial data in terms of a base year. The base year equals 100%, with all other years stated in some percentage of this base. Click here to read full article.

Vertical Analysis:

Vertical analysis is the procedure of preparing and presenting common size statements. **Common size statement** is one that shows the items appearing on it in percentage form as well as in dollar form. Each item is stated as a percentage of some total of which that item is a part. Key financial changes and trends can be highlighted by the use of common size statements. Click here to read full article.

2. Ratios Analysis:

Accounting Ratios Definition, Advantages, Classification and Limitations:

The ratios analysis is the most powerful tool of financial statement analysis. Ratios

simply mean one number expressed in terms of another. A ratio is a statistical yardstick by means of which relationship between two or various figures can be compared or measured. Ratios can be found out by dividing one number by another number. Ratios show how one number is related to another. Click here to read full article.

Profitability Ratios:

Profitability ratios measure the results of business operations or overall performance and effectiveness of the firm. Some of the most popular profitability ratios are as under:

- Gross profit ratio
- Net profit ratio
- Operating ratio
- Expense ratio
- Return on shareholders′ investment or net worth
- Return on equity capital
- Return on capital employed (ROCE) Ratio
- Dividend yield ratio
- Dividend payout ratio
- Earnings Per Share (EPS) Ratio
- Price earnings ratio

Liquidity Ratios:

Liquidity ratios measure the short term solvency of financial position of a firm. These short term paying capacity of a concern or the firm's ability to meet its current obligat liquidity ratios.

- Current ratio
- Liquid / Acid test / Quick ratio

Activity Ratios:

Activity ratios are calculated to measure the efficiency with which the resources of a firm have been employed. These ratios are also called turnover ratios

because they indicate the speed with which assets are being turned over into sales. Following are the most important activity ratios:

- Inventory / Stock turnover ratio
- Debtors / Receivables turnover ratio
- Average collection period
- Creditors / Payable turnover ratio
- Working capital turnover ratio
- Fixed assets turnover ratio
- Over and under trading

Long Term Solvency or Leverage Ratios:

Long term solvency or leverage ratios convey a firm's ability to meet the interest costs and payment schedules of its long term obligations. Following are some of the most important long term solvency or leverage ratios.

- Debt-to-equity ratio
- Proprietary or Equity ratio
- Ratio of fixed assets to shareholders funds
- Ratio of current assets to shareholders funds
- Interest coverage ratio
- Capital gearing ratio
- Over and under capitalization

Limitations of Financial Statement Analysis:

Although financial statement analysis is highly useful tool, it has two limitations. These two limitations involve the comparability of financial data between companies and the need to look beyond ratios..

Advantages of Financial Statement Analysis:

There are various **advantages** of financial statements analysis. The major **benefit** is that the investors get enough idea to decide about the investments of their funds in the specific company. Secondly, regulatory authorities like International Accounting Standards Board can ensure whether the company is following

accounting standards or not. Thirdly, financial statements analysis can help the government agencies to analyze the taxation due to the company. Moreover, company can analyze its own performance over the period of time through financial statements analysis.

Q.2 What do you mean by leverage?

Ans. Leverage means the employment of assets or funds for which the firm pays a fixed cost or fixed return. The fixed cost or fixed return. The fixed cost or return may be thought of as the fulcrum of a lever. In mechanics the leverage concept is used for a technique by which more weight is raised with less power. In financial management the leverage is there an account of fixed cost. If any firm is using some part of fixed cost capital than the firm has leverage which can be used for raising profitability and financial strength of firm.

Q.3 What is operating leverage? Give the formula of calculating operating leverage and degree of operating leverage?

Ans. Operating leverage is defined as the ability to use fixed operating costs to magnify the effect of changes in sales on its operating profits. If the fixed operating costs are more as compared to variable operating costs, the operating leverage will be high and vice- versa. Thus, the term 'Operating leverage' refers to the sensivity of operating profit to changes in sales.

For example, if the sales increase by say 20% and the operating profit increases by 100% it is a case of high operating leverage.

Q.4 What is combined leverage, give its formula?

Ans. The combined leverage may be defined as the relationship between contribution and the taxable income; it is the combined effect of both the leverage.

Chapter 3

Funds flow analysis-Sources and uses of funds. Preparation of statement of changes in working capital and statement of source and uses of funds.

Q1. What do you understand by fund flow statement .Explain?

Ans. Introduction:

Balance sheet and profit and loss account are the two principal financial statements of a firm. But these two statements are deficient in providing certain useful information required for decision making. Hence there is a need of preparing a separate statement in addition to balance sheet and P & L account. Thus a statement is invented which can provide information about different sources of funds and their various uses or sources of inflows and outflows of funds. Such a statement is called Funds flow statement.

Definition:

A statement of source and application of funds is a technical device designed to analyze the changes in the financial position of business firm between two dates.

Techniques of preparation of fund flow Statement

- Schedule of statement of changes in working capital

- Statement of source and uses of fund or funds flow from operation

Q.2 How fund flow statement differs from Balance sheet and Income statement. Explain.

Ans. The Fund flow statement differs from balance sheet and income statement in the following way:

Difference between the fund flow statement & balance Sheet

	Fund flow Statement	**Balance sheet**
Nature	Dynamic in nature	Static in nature
Subject matter	It included the items causing changes in the working capital	It includes the balances of real personal accounts of ledger assets and liabilities and shows the total resources of the firm full life period

Utility	Useful in decision making	Examine the soundness of the firm
Users	Internal management	External parties
preparation	It is the exercise of post balance sheet	End product of all accounting period

Difference between fund flow statement and the income statement

Objective	Funds raised are matched with the uses	Expenses are matched with the income
Dependency	Not helpful in preparing income statement	Helpful in preparing the fund flow statement
utility	It is related to the movement of cash and all other items affecting the working capital	Highlights the operating result of an accounting period and changes in the financial position

Section-B

Break Even analysis

Q.1 Write a brief note on Break even analysis. Also explain how Break-even point is helpful in assessment of profit of the organization.

Ans: Introduction:

Break –Even Analysis is a method of studying the relationship between sales revenue, fixed costs and variable expenses so as to determine the minimum volume at which production can be profitable.

Definition: Break even point can be defined as that volume of activity at which total sales revenue exactly equals total costs of the output produced or sold.

Methods of computing BEP

There are two methods of computing BEP:

1. Algebraic methods	:	Contribution margin technique.
		Equation technique
2. Graphic Presentation	:	Break even Charts
		P/V Graph

Formulae

The Formulas for computing BEP are as follow:

$$BEP = \frac{\text{FIXED COSTS}}{\text{S.P-VARIABLE COST}}$$

$$BEP = \frac{\text{FIXED COSTS} * \text{S.P.}}{\text{CONTRIBUTION PER UNIT}}$$

$$BEP = \frac{\text{FIXED COST}}{\text{P/V RATIO}}$$

An Introduction Study of Financial Planning and Forecasting.

Q.1 What does financial planning signifies? Explain the meaning and concept of financial planning for a business. Explain.

Ans: **Introduction :** Financial planning is a growing industry with projected faster than average job growth. Financial managers must be able to analyze the current position of their own firms as well as that of their competition .They must also plan for the company's financial future. The financial manager is responsible for planning to ensure that the firm has enough funds for the needs. A useful tool for planning future cash needs to plan for the continuing profitability. Planning is an inevitable process in any business firm irrespective of its size and nature. So the financial planning encompasses both the business plan as well as analyzes the current as well as future financial position of the firm.

Meaning of financial planning

When you want to maximize your existing financial resources by using various financial tools to achieve your financial goals that is financial planning.
Financial Planning is the process of estimating the capital required and determining its competition. It is the process of framing financial policies in relation to procurement, investment and administration of funds of an enterprise.

The Definition of Financial Planning

Financial planning is a systematic approach whereby the financial planner helps the organization to maximize his existing financial resources by utilizing financial tools to achieve his financial goals.

Financial planning in mathematical form:

There are 3 major components:

- Financial Resources (FR)
- Financial Tools (FT)
- Financial Goals (FG)

Financial Planning: FR + FT = FG

In other words, financial planning is the process of meeting your life goals through proper management of your finances. Life goals can include buying a home, saving for your children's education or planning for retirement. It is a process that consists of specific steps that help you to take a big-picture look at where you are financially. Using these steps you can work out where you are now, what you may need in the future and what you must do to reach your goals.

Who is a Financial Planner?

A financial planner is someone who uses the financial planning process to help you figure out how to meet your life goals. The planner can take a `big picture` view of your financial situation and make financial planning recommendations that are right for you. The planner can look at all of your needs including budgeting and saving, taxes, investments, insurance and retirement planning.

A **financial planner** or **personal financial planner** is a practicing professional who prepares financial planning for people covering various aspects of personal finance which includes: cash flow management, education planning, retirement planning, investment planning, risk

management and insurance planning, tax planning, estate planning and business succession planning (for business owners). One of the key objectives with which a financial planner works is to provide inflation and risk adjusted returns for its clients

Financial planners are also known by the title financial adviser in some countries, although these two terms are technically not synonymous, and their roles have some functional differences.

When you have a professional relationship with a planner that does not mean that he replaces other professionals such as lawyers or accountants. A planner is a coordinator who works with others in making the planning process work.

Financial planner's job function

A financial planner specializes in the planning aspects of finance, in particular personal finance, as contrasted with a stock broker who is generally concerned with the investments, or with a life insurance intermediary who advises on risk products.

Q.2. What are the steps and the basic consideration followed in financial planning process. Explain.

Ans. Financial planning is usually a multi-step process, and involves considering the client's situation from all relevant angles to produce integrated solutions. The six-step financial planning process has been adopted.

- ✓ ***Determine Current Financial Situation***
- ✓ ***Develop your financial goals***
- ✓ ***Identify alternative courses of action***
- ✓ ***Evaluate alternatives on various considerations***
- ✓ ***Identify alternative courses of action***
- ✓ ***Create and implement your financial action plan***
- ✓ ***Review and Revise the financial plan***

Financial planning for the client’s perspective:

Step 1: Setting goals with the client This step (that is usually performed in conjunction with Step 2) is meant to identify where the client wants to go in terms of his finances and life.

Step 2: Gathering relevant information on the client This would include the qualitative and quantitative aspects of the client's financial and relevant non-financial situation.

Step 3: Analyzing the information The information gathered is analysed so that the client's situation is properly understood. This includes determining whether there are sufficient resources to reach the client's goals and what those resources are.

Step 4: Constructing a financial plan Based on the understanding of what the client wants in the future and his current financial status, a roadmap to the client goals is drawn to facilitate the achievements of those goals.

Step 5: Implementing the strategies in the plan Guided by the financial plan, the strategies outlined in the plan are implemented using the resources allocated for the purpose.

Step 6: Monitoring implementation and reviewing the plan The implementation process is closely monitored to ensure it stays in alignment to the client's goals. Periodic reviews are undertaken to check for misalignment and changes in the client's situation. If there is any significant change to the client's situation, the strategies and goals in the financial plan are revised accordingly.

In Short, the scope of planning would usually consider the following:

- ✓ Risk Management and Insurance Planning

    - Managing cash flow risks through sound risk management and insurance techniques
- ✓ Investment and Planning Issues
    - Planning, creating and managing capital accumulation to generate future capital and cash flows for reinvestment and spending
- ✓ Retirement Planning
    - Planning to ensure financial independence at retirement including 401Ks, IRAs etc.
- ✓ Tax Planning
    - Planning for the reduction of tax liabilities and the freeing-up of cash flows for other purposes
- ✓ Estate Planning
    - Planning for the creation, accumulation, conservation and distribution of assets
- ✓ Cash Flow and Liability Management
    - Maintaining and enhancing personal cash flows through debt and lifestyle management
- ✓ Relationship Management
    - Moving beyond pure product selling to understand and service the core needs of the client.

Q.3. What is the objective and importance of financial planning?
Ans. Objectives:

People enlist the help of a financial planner because of the complexity of performing the following:

- Providing financial security and ensuring that all goals of personal finance are met
- Finding direction and meaning in one's financial decisions;
- Understanding how each financial decision affects other areas of finance; and
- Adapting to life changes to feel more financially secure.

The best results of working with a comprehensive financial planner, from an individual client or family's perspective are:

- To create the greatest probability that all financial goals (anything requiring both money and planning to achieve) are accomplished by the target date, and
- To have a frequently-updated sensible plan that is proactive enough to accommodate any major unexpected financial event that could negatively affect the plan, and
- To make intelligent financial choices along the way (whether to "buy or lease" whether to "refinance or pay-off" etc.).

Before working with a comprehensive financial planner, a client should establish that the planner is competent and worthy of trust, and will act in the client's interests rather than being primarily interested in selling the client financial products for his own benefit. As the relationship unfolds, an individual financial planning client's objective in working with a comprehensive financial planner is to clearly understand what needs to be done to implement the financial plan created for them. So, in many ways, a financial planner's step-by-step written implementation plan of action items, created after the plan is completed, has more value to many clients than the plan itself. The comprehensive written lifetime financial plan is a technical document utilized by the financial planner, the written implementation plan of action is just a few pages of action items required to implement the plan; a much more "usable" document to the client.

Financial Planning has got many objectives in reference with the procedural steps to to look forward to. These are listed as following:

a. Determining capital requirements- This will depend upon factors like cost of current and fixed assets, promotional expenses and long- range planning. Capital requirements have to be looked with both aspects: short- term and long- term requirements.
b. Determining capital structure- The capital structure is the composition of capital, i.e., the relative kind and proportion of capital required in the business. This includes decisions of debt- equity ratio- both short-term and long- term.
c. Framing financial policies with regards to cash control, lending, borrowings, etc.

d. A finance manager ensures that the scarce financial resources are maximally utilized in the best possible manner at least cost in order to get maximum returns on investment.

Importance of Financial Planning

Financial Planning is process of framing objectives, policies, procedures, programs and budgets regarding the financial activities of a concern. This ensures effective and adequate financial and investment policies. The importance can be outlined as-

1. Adequate funds have to be ensured.
2. Financial Planning helps in ensuring a reasonable balance between outflow and inflow of funds so that stability is maintained.
3. Financial Planning ensures that the suppliers of funds are easily investing in companies which exercise financial planning.
4. Financial Planning helps in making growth and expansion programmes which helps in long-run survival of the company.
5. Financial Planning reduces uncertainties with regards to changing market trends which can be faced easily through enough funds.
6. Financial Planning helps in reducing the uncertainties which can be a hindrance to growth of the company. This helps in ensuring stability an d profitability in concern.

Short term and Long term sources of Finance: Equity vs. Debt.

Q.1 What are the short term and long term sources of finance? Throw light on their uses and specifications.

Ans. There are two main sources of financing a project i.e.

- Own funds and
- Loan funds.

The cost of a project depends on the nature of project i.e. a project set up for the first time, expansion project, modernization project, diversification project, take over project joint venture project, merger project etc.

The correct estimation of capital costs and working capital requirements is very necessary otherwise the project face serious problems and ultimately the project may remain incomplete or the project may take more time for want of funds. The capital cost may consists of items like land and site development, building and civil works, plant and machinery, technical knowhow fees, miscellaneous fixed assets, interest, provisions for contingencies etc. Similarly, working capital may consists of items like raw material, work in progress, finished products, debtors/receivables, power, fuel, salary & wages ,taxes, duties, overhead expanses and contingencies.

Main sources of finance-

I - **Own funds**

(i) Share capital

- Equity and
- Preference share capital

(ii) Premium on issue of share capital

(iii) Reserves and surplus including retained earnings

(iv) Subsidy received from central/state governments

II - **Loan funds or debt**

(i) Debentures – convertible, non convertible an partly convertible debentures

(ii) Term loans or long term loans from all India level development financing institutions AIDFI's and state level development financing institutions.

(iii) Unsecured loans – Like commercial paper referred credit- receiving goods, plan & machinery from suppliers on credit and payment in installments.

Sources and the uses of the funds

Sources	**Uses**

• Profit from operation • Increase in the long term liability • Increase in the share capital • Sale of fixed assets • Non trading receipts	• Loss from operation • Decrease in long term liability • Decrease in capital fund • Purchase of fixed assets • Non trading payments

Working capital management

Q.1. **Explain the meaning and concept of working capital and its management.**

Or

How working capital management meant a lot in achieving the goals of a firm.

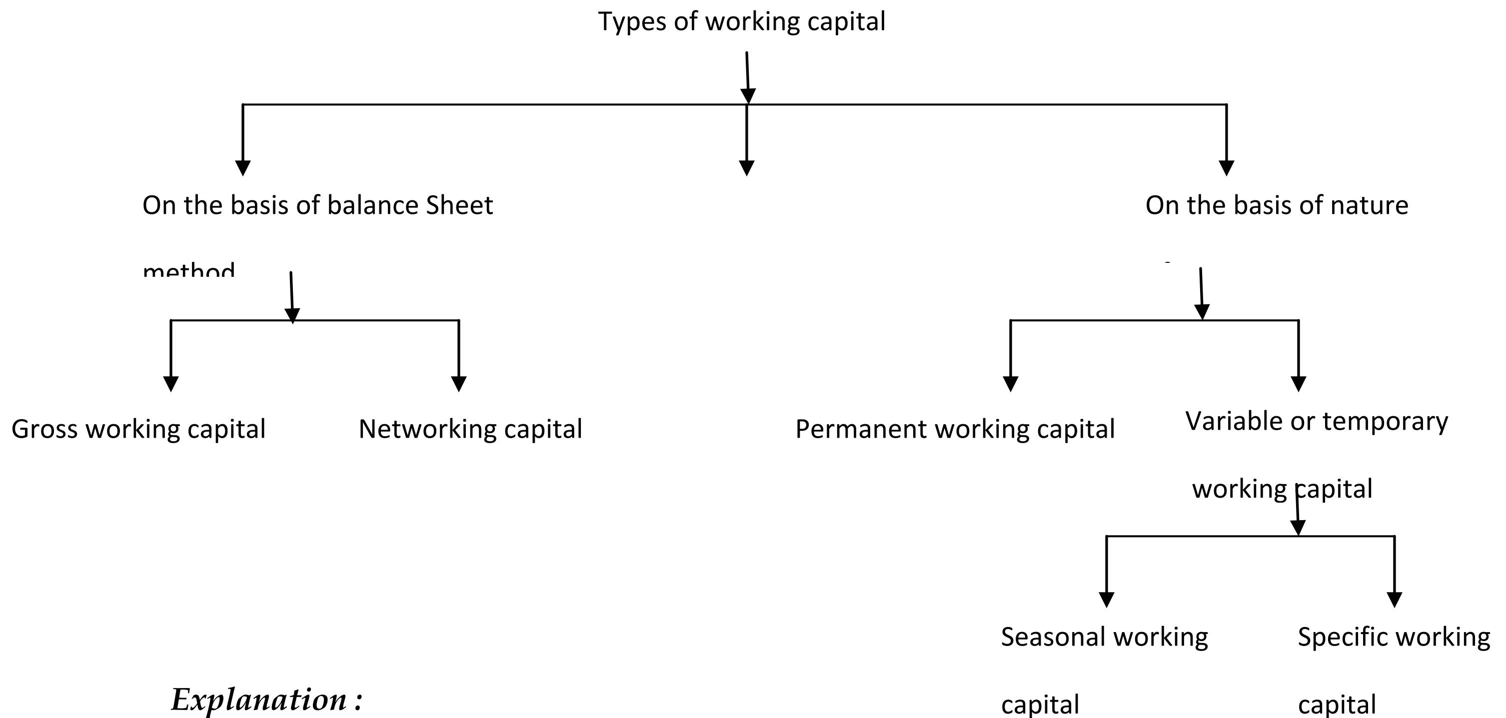
Ans. Introduction:

Working capital in that part of firms capital which is required for financing current assets such as cash, debtors, receivables inventories, marketable securities etc. Funds invested in such assets keep revolving with relative rapidity and are constantly converted in to cash.

Other names: Working capital is also known as circulating capital, revolving capital, short term capital or liquid capital.

Meaning and Definition:

Working capital is a financial metric which represents the amount of day-by-day operating liquidity available to a business. Along with fixed assets such as plant and equipment, working capital is considered a part of operating capital. It is calculated as current assets minus current liabilities. A company can be endowed with assets and profitability, but short of liquidity, if these assets cannot readily be converted into cash



Explanation :

- **Gross working capital** – Refers to firms investments in current assets which are converted in to cash during an accounting year such as cash, bank balance, short term investments, debtors, bills receivable, inventory, short term loans and advances etc.
- **Net working capital** – Refers to difference between current assets and current liabilities or excess of total current assets over total current liabilities.
- **Regular or permanent working capital** – Refers to minimum amount which permanently remain blocked and can not be converted in to cash such as minimum amount blocked in raw material, finished product debtors etc.
- **Variable or temporary working capital** – Refers to amount over and above permanent working capital i e difference between total working capital less permanent working capital.

- **Seasonal working capital** - Refers to capital required to meet seasonal demand e.g. extra capital required for manufacturing coolers in summer, woolen garments in winter. It can be arranged through short term loans.
- **Specific working capital** – Refers to part of capital required for meeting unforeseen contingencies such as strike, flood, war, slump etc.

Q.2 List out the various determinants of working capital?

Or

Explain in brief important factors which help in estimating requirements of working capital in an organization.

Ans. Important factors or determinants of working capital are:

i. **Nature of business:** firms dealing in luxury goods, construction business, steel industry etc need more capital while those dealing in fast moving consumer goods (FMCG's) need less working capital.

ii. **Size of business:** large size firms need more working capital as compared to small size firms.

iii. **Level of technology:** use of high level technology leads to fastening the process and reduce wastage and in such case, less working capital would be required.

iv. **Length of operating cycle:** longer is the operating cycle; higher would be the need of working capital.

v. **Seasonal nature:** firms dealing in goods of seasonal nature, higher capital during peak season would be required.

vi. **Credit policy:** If credit policy followed is liberal more working capital would be required and if the same is strict less working capital would be required.

vii. **Turnover of working capital:** If rate of turnover is more, less working capital would be required and this rate is less, more working capital would be required.

viii. **Dividend policy:** If a firm retains more profit and distributes fewer amounts as dividend, less working capital would be required.

ix. **Profit margin:** If rate of margin of profit is more, less working capital would be required.

x. **Rate of growth**: If growth rate is high and firm is continuously expending/ diversifying its production & business, more working capital would be needed.

xi. **Other factors like** :

- Means of transport
- Availability of water, power nearly
- Political stability

Coordination of activities also effect estimation of requirements of working capital.

Ques.3 Working capital is the lifeblood of any business." Comment. (Significance/Importance of adequate working capital

Ans: Effects of Adequate capital

- Prompt payment to supplies & benefit of cash/ trade discount.
- Increase in good will/ image
- Easy loans from banks
- Increase in the efficiency of employee's executives/ directors.
- Increase in the productivity as well as profitability

Inadequate or short working capital

- Stock out situation may arise
- Loosing customers
- Less profit
- Down fall of good will / image

Excess working capital

- Unnecessary piling of stock due to which loss of interest on amount blocked, theft, pilferage
- Lead to inefficiency of management
- Adversely effect production and profitability
- Dissatisfaction to share holders

Schedule of change in working capital

Working capital will increase when there is increase in current assets and decrease in current liability & working capital will decreases when there is decrease in the current assets and increase in current liability.

Net increase in the working capital is treated as a uses of funds and the net decrease in working capital is treated as source of funds

Statement of change in Working capital

Item	Previous year	Current year	Effect on the working capital	
Current assets • Cash at bank • Cash in hand • Stock • Debtors • Bills receivables' • Advance payment • Short term investment • Prepaid expenses • Accrued income Total (A)				
Current liabilities • Short term loans • Bank overdraft • Creditors • Bills payable • Outstanding expenses • unclaimed dividend Total (B)				

Q.4 Write short note on Operating cycle–

Ans Operating Cycle refers to capital/ amount required in different forms at successive stages of manufacturing operation/ process. It represents cycle during which cash is reconverted in to cash again. In manufacturing process, cash is required for purchasing raw material- raw material is converted in to work in progress – which is converted in to finished product – finished products are sold on credit- than cash is realized out of

credit sale. Total time taken in completing one cycle helps in ascertaining working capital requirements.

Q.5 What do you understand by "Financing of Working Capital?

Ans. Financing working capital refers to arranging working capital in an organization i.e. different sources from which working capital has to be raised. For this purpose, we have to classify working capital in to two main categories i.e.

I – Temporary/ Short term/ variable working capital

II – Permanent /fixed/ Long term working capital

Arranging or financing both these categories would be different as explained below:

I – **Financing temporary / short term / variable working capital** – different sources of financing this type of working capital are:

i. Commercial banks:- in the form of short term loan like short term credit limit, overdraft limit, pledge loan etc.

ii. Indigenous bankers/private money lenders in case of small business organization

iii. Trade credit :- Receiving goods on credit from suppliers

iv. Installment credit: - goods/ assets are purchased and payment is made in installments.

v. Advances from customers/ agents :- against orders received for supplying goods

vi. Deferred income :- i.e. incomes received in advance

vii. Commercial paper:- issuing unsecured promissory note

viii. Public deposits: - accepting deposit for short period i.e. 3 month, 6 months etc.

II – **Permanent /fixed/ long term working capital** – Different sources for financing such capital are.

i. Shares – In the form of equity shares, preference shares, deferred shares etc.

ii. Debentures – debentures may be of different type ie secured, unsecured, redeemable, unredeemable convertible, non-convertible etc.

iii. Ploughing back of profit- retaining profit for growth. It is a internal source and a source which is cost free.

iv. Public deposits – accepting fixed deposits from public for a period of one year and above.

v. Loan from financing institutions – term loan from institutions like:

- Commercial banks

National state level financing institutions like
IFCI, IDBI, State Finance corporations, SIDC's etc.

Section-C

Management of cash and marketable securities.

Q.1. Explain in brief all aspects of management of cash in a business organization.

Ans. Efficient management of cash is crucial to the solvency of business. It implies making sure that all business generated revenues are efficiently controlled and utilized in best possible manner to result in gains to the organization. Cash management is concerned with optimizing amount of cash available to the company & maximizing interest on spare funds not required immediately by the company.

Objectives of cash management:-

- Ensuring availability of cash as per payment schedule
- Minimize amount of idle cash
- Effective control of cash (Maximizing interest on cash/funds not required immediately by the firm)

Motives of holding cash:-

(i) **Transaction motive**: - Refers to cash required for making payments like wages, operating expenses, taxes, dividend, interest etc.

(ii) **Precautionary motive:**- To make payment for unpredictable contingencies like strike, lockout, fire, sharp rise in prices etc.

Speculative motive:- To take advantages of unexpected opportunities e.g. purchase of raw material at reduced prices on cash basis, buying securities at a time when prices have fallen etc.

Importance /advantages of efficient management of cash:-

- firms goodwill is maintained by meeting obligations in time
- cash discount can be availed
- healthy relations can be maintained
- Unforeseen events can easily by face.

Scope of cash management: - In includes:

- Cash planning & forecasting
    - Cash budged
    - Cash flow statement
    - Ratio analysis
- Managing cash flows
    - Inflows
    - Out flows
- Determining optimum level of cash
- Investing surplus cash.

Cash budget: - A statement showing estimate of cash receipts, cash disbursement and net cash balance for a future period of time. It is a time based schedule & covers a specific period.

There are two methods of preparing cash budget

(i) Cash budget for a short period (up to one year) A statement projecting cash inflows and flows for a firm over various interim periods (months, quarters). For each period, expected cash inflows are put against expected out follows to find out if there is any surplus or deficiency.

(ii) Long term cash budget (3 to 7 year) under this method profit and loss account is adjusted to know estimates of eash receipts/ payments

This cash budgets helps in

- planning for borrowings
- planning for repayment of loans
- distribution of dividends
- estimation of idle cash
- better coordination of timings of each inflows & out flows
- identification of cash surplus position and planning for alternative investments in advance

Collection and disbursement methods to improve cash management efficiency.

Collection methods:

Concentration banking – improving flow of cash by establishing collection centers at different places i.e. multiple collection centers instead of single centre. Even the local cheques received are collected fast and amount is deposited in bank. The bank in the head office of firm is known as concentration bank.

Lock Box system – A firm takes on rent post office boxes in selected areas and instructs customers to mail their payment in these boxes. The bank of the firm is authorized to open these boxes, pick up mails and deposit cheques in the account of firm and sends a list of cheques received for the record of firm.

Disbursement methods –

(i) **Centralized disbursement centre** – Establishing a centralized disbursement centre at head office of firm and all payments only through this centre. This would help in consolidating all funds in a single account and making a proper schedule of payments/ handling funds.

(ii) **Payment on due date** – all payment on their due dates (not early & not late) strictly according to agreed terms so that there is no loss of cash/ trade discount and credit worthy ness of firm is maintained.

(iii) Proper synchronization of receipts and payments

(iv) **Utilizing float** – float indicates difference between bank balance and firms bank account & bank pass book. It arises due to time gap between cheque written/issued and time when it is presented or time gap between cheque deposited and time when credit is actually given by the bank to the firm this float may be

Postal float – Time required for receiving cheque from customers through post

Deposit float –Time required processing the cheques received and depositing them in bank.

Bank float – Time required by banker to collect the payment from customer's bank.

Models of cash management:

(i) **Bamoul Model: -** It is like EOQ model of inventory control. According to this model, optimum level of cash is one at which carrying cost of cash or cost of receiving cash is minimum. Carrying cost of cash refers to interest for gone on marketable securities. This is also called opportunity cost. Cost of receiving cash or transaction cost is the cost of converting marketable securities in cash.

(ii) **Hiller Orr model** – This model is based on assumption that cash balance changes randomly over a period of time in size. This model prescribes two levels i.e. upper limited and lower limit. Optimum balance of cash lies between upper and lower limit. When cash balance reaches upper limit, cash equal to difference between upper limit and optimum limit, it should be invested in marketable securities. When cash balance reaches to lower limit, cash equal to difference between optimum limit and lower limit, finance manager

should immediately sell marketable securities so that cash balance reaches normal level.

Treasury management (TM)

T.M mainly deals with working capital management and financial risk management. The working capital management includes cash management and decide asset liability mix. Financial risk includes forex and interest and interest rate management. Hence, key goal of TM is planning organizing and controlling cash assets to satisfy financial objectives of organization. The goal is to:

- Maximize return on available cash
- Minimize interest cost
- Mobilize as much cash as possible for corporate returns.

Key responsibilities of T.M.

- Maintaining good relations with banks and other financing institutions
- Managing cost while earning optimum return from any surplus fund.
- Providing long term and short term funds for business at minimum cost.
- Managing interest rate risk in accordance with firms/groups policy
- Advising on all matters of corporate finance including capital structure, merger & acquisitions etc.

Functions of a treasury manager

1. Cash management: - efficient collection & payment of cash.
2. Fund management: - Planning and sourcing of short/medium/long term funds.
3. **currency management** :- managing foreign currency risk in a multinational company by T.M
4. **Banking function**: - negotiating with banks and maintaining good contact with banks.

Q.2 Explain the concept of Marketable securities

Ans. Cash surplus left in excess of daily cash requirements need to be invested in readily **marketable short term securities.** These securities are also called cash equivalents. Investments in such securities are made keeping in view the following objectives:

- to earn interest for holding period
- to convert securities in cash as & when required
- increase return on excess cash through investments
- to maintain a proper mix of investments

These short term marketable securities include

- Treasury bills
- Certificate of deposits
- Money market mutual funds
- Bill discounting

Key criterions for investing for surplus cash in marketable securities are:

1. Liquidity or marketability: - converting securities in cash in minimum time and minimum transaction cost.
2. Safety: - i.e. Absence of risk. One should be prepared to sacrifice extra return for sake of safety
3. Yield/profit /return:- Maximum possible income from investment in such securities

Receivables and inventory management

Q1 What do you understand by "Management of receivable"? Explain in brief its scope and costs associated with it.

Ans. Receivables are created on account of credit sales. They are represented in the balance sheet in the form of sundry debtors, trade debtors, and book debts, accounts receivable, bills receivable etc. Receivables constitute around 15 to 20% of assets or around 1/3 of working capital in a big organization and substantial amount of working is blocked in this asset. Hence, their efficient management occupies great significance in financial management.

Receivable Management means matching the cost of increasing sales with the benefits arising out of increased sales and maximizing return on investment of firm under this head. Hence, the prime objective of receivables management is to:

- Optimize return on investment
- By minimizing costs associated with receivables

Features of receivables

- They involve risk based on present economic value and seller expects the same value ot a later date
- Implies futurity

Benefits of receivables

- Growth in sales- If a firm does not sell on credit, sales cant grow

- Increase in profit – Growth in sales leads to increase in profit. At times, credit sales are at a price more than price of cash sales
- Enables to face competition in market

Costs associated with receivables are:

1. Carrying cost – cost of amount blocked in the form of

- Interest if amount is borrowed
- Opportunity cost if amount blocked is out of retained earnings.

2. Administrative costs – Cost incurred on maintaining staff, for keeping records and for process of collecting amount from debtor's e.g.

- Salary to staff
- Cost of collecting information about debtors
- Record keeping
- Cost of collecting cheques
- Cost on phone calls, reminders follow up
- Cost on office space, equipments etc and expenditure on staff assigned the duty of collection of amount from debtors.

3. Delinquency cost - cost on following up with delinquent debtors, reminders, legal charges etc.

4. Default cost – cost of debtors becoming bad debts

Factors effecting investments in receivables

(i) Level of sales – Higher the sales, high would be amount of credit sales & receivable would also be high

(ii) Nature and conditions of business – In competitive market, more credit sales in consumer durables like furniture, refrigerators etc.

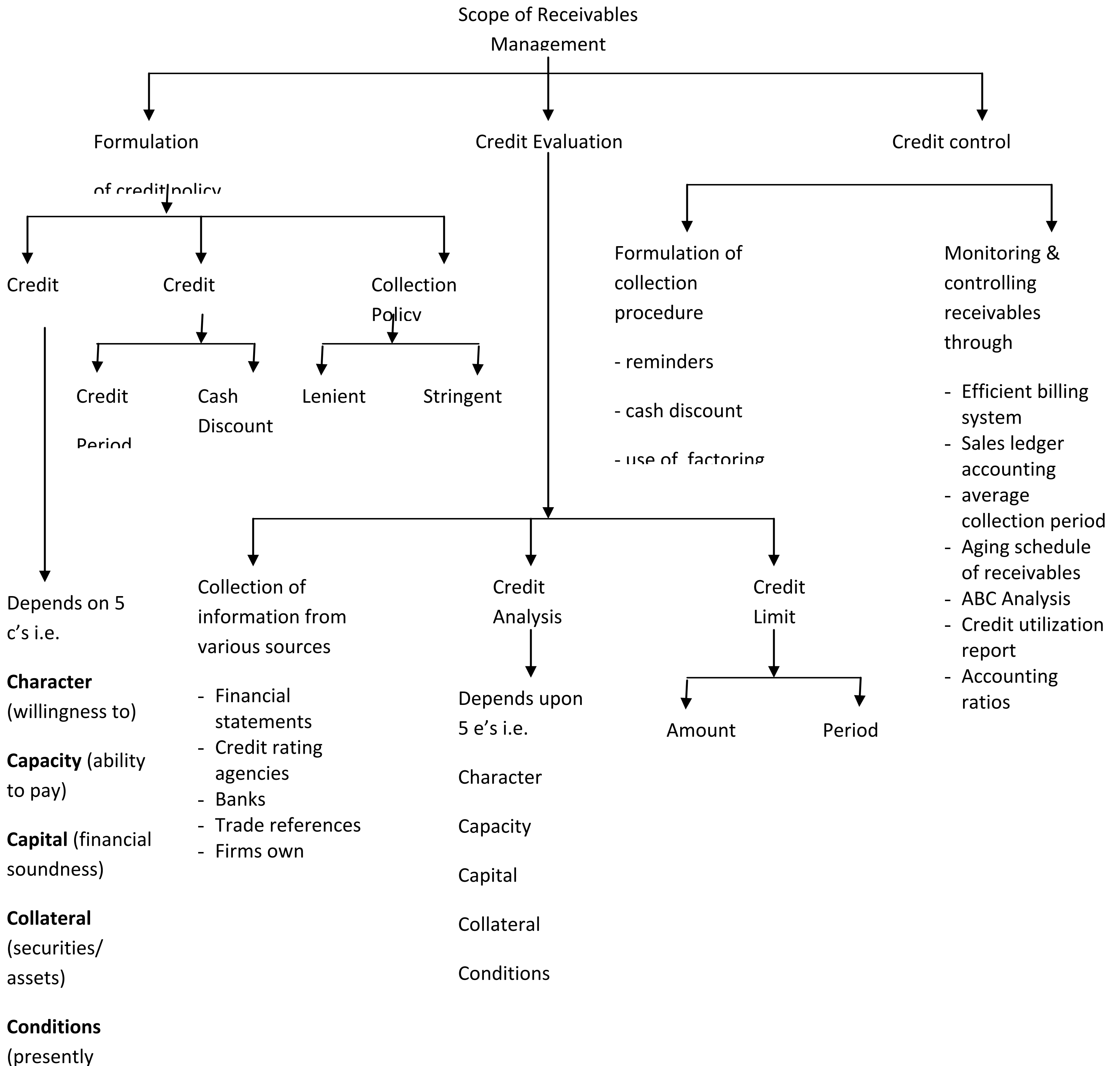
(iii) Credit policy of firm – If credit policy is liberal, more would be amount of receivables

(iv) Terms of credit - Terms of cash & trade discount and period in which payment is expected from debtors.

(v) Capacity of credit department – With reference to :-

- Scrutiny of orders placed by customers
- Assessing creditworthiness for which collecting information from various sources
- Timely collection of receivables from debtors

Scope of Receivables Management – There are three part under which scope of receivables management can be discussed i.e. Formulation of credit policy, credit evaluation and credit control. This scope has been presented in the form of a chart on next page.


Scope of Receivables Management
Formulation of credit policy
Credit Evaluation
Credit control
Credit
Credit
Collection Policy
Credit Period
Cash Discount
Lenient
Stringent
Formulation of collection procedure
- reminders
- cash discount
- use of factoring
Monitoring & controlling receivables through
- Efficient billing system
- Sales ledger accounting
- average collection period
- Aging schedule of receivables
- ABC Analysis
- Credit utilization report
- Accounting ratios
Depends on 5 c's i.e.
Character (willingness to)
Capacity (ability to pay)
Capital (financial soundness)
Collateral (securities/ assets)
Conditions (presently
Collection of information from various sources
- Financial statements
- Credit rating agencies
- Banks
- Trade references
- Firms own
Credit Analysis
Depends upon 5 e's i.e.
Character
Capacity
Capital
Collateral
Conditions
Credit Limit
Amount
Period

Q.2 What do you understand by term "inventory" and "Inventory management "? Explain the key objectives of inventory control.

Ans. Inventory means stock of goods in the form of raw material, stores or supplies, work in progress and finished product waiting for sale. Important features of inventory are.

- If accounts for large share of working capital
- Risk factor is high in holding inventory
- If involves many types of costs.
- It influences price and income of the firm as well as profitability.
- It involves almost all functional areas of management i.e. purchase, production, marketing & finance.

Various types of risks associated with inventory are.

- risk of price fluctuation
- risk of deterioration of quality of goods
- risk of obsolescence
- risk of pilferage & loss

Inventory management – means efficient management/ control of capital invested in inventory for obtaining maximum return by keeping inventory costs at minimum.

Objectives of inventory control – are two i.e.

Operating objectives

(i) Regular flow of material
(ii) Minimization of risks due to Stock out.
(iii) Avoid obsolescence of stored Goods due to change in demand, Technology

Financial objective

(i) Minimum investment or maximization Of returns on investments
(ii) Minimizing inventory costs.

Key functions of inventory control are:

- effective use of financial resources
- economy in purchasing
- uninterrupted production of goods & services
- protection against loss of material
- prompt delivery of goods to customers
- eliminating redundant inventory
- providing information to management for decision making

Dangers of over stocking of inventory

- **Blocking of funds** – which may lead to reduction in profit due to interest cost or opportunity cost
- **Increase in holding cost** – besides interest rent of space, insurance, loss on account of theft pilferage etc.
- **Loss of liquidity** – as it is difficult to sell stores, woks in proposes as well as semi-finished goods.
- **Dangers of under stocking of inventory/stock out/ shortage of inventory items**
- Loss of profit due to loss of sales
- Loss of future sales as customers may go else where
- Loss of customers confidence resulting to loss of good will

- Loss of machine and men hours as they may remain idle which lead to frustration in labour may force, unnecessary stoppage in production, extra costs in urgent replenishment of items.

Q.2. Explain in brief different types of costs associated with inventory. Also explain different techniques of inventory control.

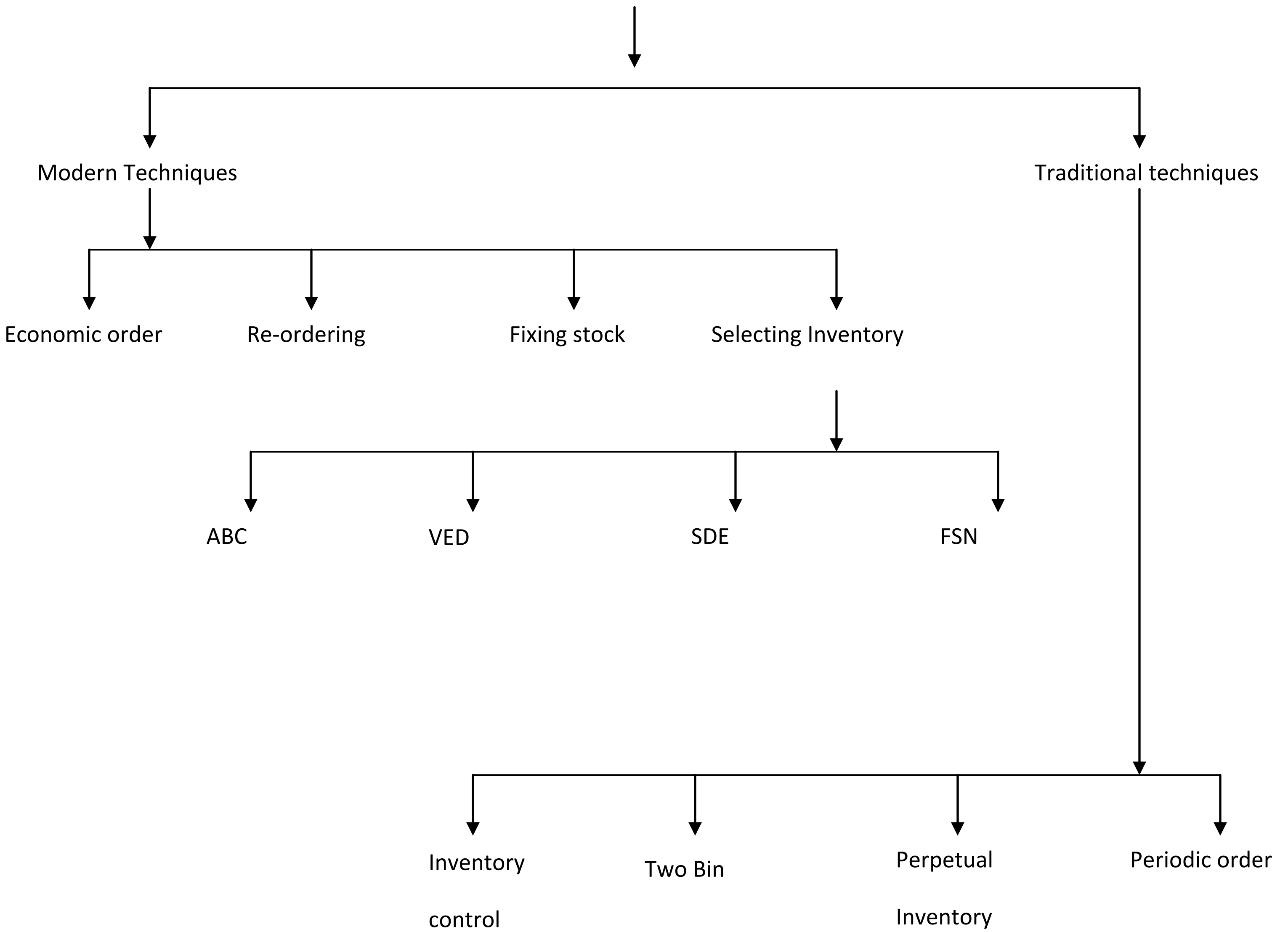
Ans. Following are the key types of costs associated with inventory:

(i) **Material cost** – Which include cost of purchasing material/ Goods including transportation cost, sales tax, octroi, handling cost (loading unloading) etc.

(ii) **Ordering costs**: Clerical & administrative costs such as salary, postage, stationary telephone etc associated with purchasing, cost of requisition of material for order, follow up, receiving/evaluating quotations, checking of material when received (quality/quantity) accounting costs such as checking supplies against orders, making payment, maintaining records of purchase etc. setup costs when items are manufactured internally.

(iii) **Carrying costs**- storage cost e.g. Rent, lighting heating, refrigeration, labour costs in handling material, store staff equipments, taxes, depreciation, insurance, product deterioration obsolescence spoilage, breakage, pilferage, audit & accounting cost and lastly interest cost on capital or opportunity cost.

(iv) **Stock out costs or shortage of material** – Which include loss of profit due to loss of sale, loss of future sales, loss of loosing goodwill in the eyes of customers and loss of man and machine hours.


Techniques of Inventory Control
Modern Techniques
Traditional techniques
Economic order
Re-ordering
Fixing stock
Selecting Inventory
ABC
VED
SDE
FSN
Inventory control
Two Bin
Perpetual Inventory
Periodic order

EOQ - Optimum size of an order for replenishment of an item of inventory is called EOQ

ROP - Re-ordering point is the level of inventory at which an order should be placed for replenishment of on item of inventory.

Stock levels - Fixing levels like minimum, maximum, re-order and danger level.

ABC analysis – Always Better control. All items of inventory are divided in to three categories i.e. 'A', 'B', & 'C'.

Category	'A'	value	70% to 80%	Where quantity is	5% to 10%
" "	'B'	" "	20%	" " "	20%
" "	'C'	""	10%	" " "	70%

VED Analysis – Vital, Essential & Desirable (used for spare parts)

SDE Analysis

- Scarce (items in short supply)
- Difficult (items cant be procured easily)
- Easy (items which are easily available)

FSN Analysis

- Fast moving (stock to be maintained in large quantity)
- Slow moving (not frequently required by production dept.)
- Non-moving (items which are rarely required by production dept)

Elementary study of capital budgeting including methods of evaluating capital expenditure proposal under certainty.

Q.1 What do you understand by the term Capital budgeting? Explain its concept.

Ans. Introduction:

A firm incurs two types of expenses i.e.

Revenue expenditure – The benefits of which are supposed to be exhausted within the year concerned and their planning and control is done through various functional departments

Capital expenditure – The benefits of which are expected to be received over long period a series of years in future like building, plant, machinery or to undertake a program on

- Research and development of a product
- Diversification in to a new product line
- Replacement of a machine
- Expansion in production capacity
- Promotional campaign

Capital expenditure involves investment of substantial funds for longer period and the benefits of such investment are in the form of increasing revenues or decreasing costs. Wrong decision under this head may effect future earnings, employment capacity, quantity and quality of production. Hence, long term planning and right decision to incur or not to incur such expenditure is a crucial responsibility of management.

The techniques used by management to carry out this responsibility is known as capital budgeting. Hence planning and control of capital expenditure is termed as capital budgeting.

Definitions:

According to Milton "*Capital budgeting involves planning of expenditure for assets and return from them which will be realized in future time period*".

According to I.M pandey "*Capital budgeting refers to the total process of generating, evaluating, selecting, and follow up of capital expenditure alternative*"

Nature / Features of Capital budgeting decisions

(1) **Long term effect** - such decisions have long term effect on future profitability and influence pace of firms growth. A good decision may bring amazing/good returns and wrong decision may endanger very survival of firm. Hence capital budgeting decisions determine future destiny of firm.

(2) **High degree of risk** - decision is based on estimated return. Changes in taste, fashion, research and technological advancement leads to greater risk in such decisions.

(3) **Huge funds** – large amount/funds are required and sparing huge funds is problem and hence decision to be taken after proper care/analysis

(4) **Irreversible decision** – Reverting back from a decision is very difficult as sale of high value asset would be a problem.

(5) **Most difficult decision** – decision is based on future estimates/uncertainty. Future events are affected by economic, political and technological changes taking place.

(6) **Impact on firms future competitive strengths** – These decisions determine future profit/ cost and hence affect the competitive strengths of firm.

(7) **Impact on cost structure** – Due to this vital decision, firm commits itself to fixed costs such as supervision, insurance, rent, interest etc. If

investment does not generate anticipated profit, future profitability would be affected.

Q.2 Discuss the objectives of using Capital budgeting techniques and the factors affecting the decision making.

Ans. Objectives of capital Budgeting

(1) **Share holder's wealth maximization**. In tune with objectives of financial management, its aim is selecting those projects that maximize shareholders wealth. The decision should avoid over/under investment in fixed assets.

(2) **Evaluation of proposed capital expenditure** – Capital budgeting helps in evaluating expenditure to be incurred on various assets to measure validity of each expenditure

(3) **Controlling costs** - by evaluating expenditure costs can be controlled.

(4) **Determining priority** – arranging projects in order of their profitability enabling the management to select most prof e project.

Factors affecting capital Budgeting Decisions (CBD)

(1) **Technological changes** – Before taking CBD, management will have to undertake in-depth study of cost of new product /equipment as well productive efficiencies of new as well as old equipment.

(2) **Demand forecast** – Analysis of demand for a long period will have to be undertaken before CBD.

(3) **Competitive strategy** – If a competitor is going for new machinery /equipment of high capacity and cost effective, we may have to follow that.

(4) **Type of management** – If management is innovative, firm may go for new equipments/ investment as compared to conservative management.

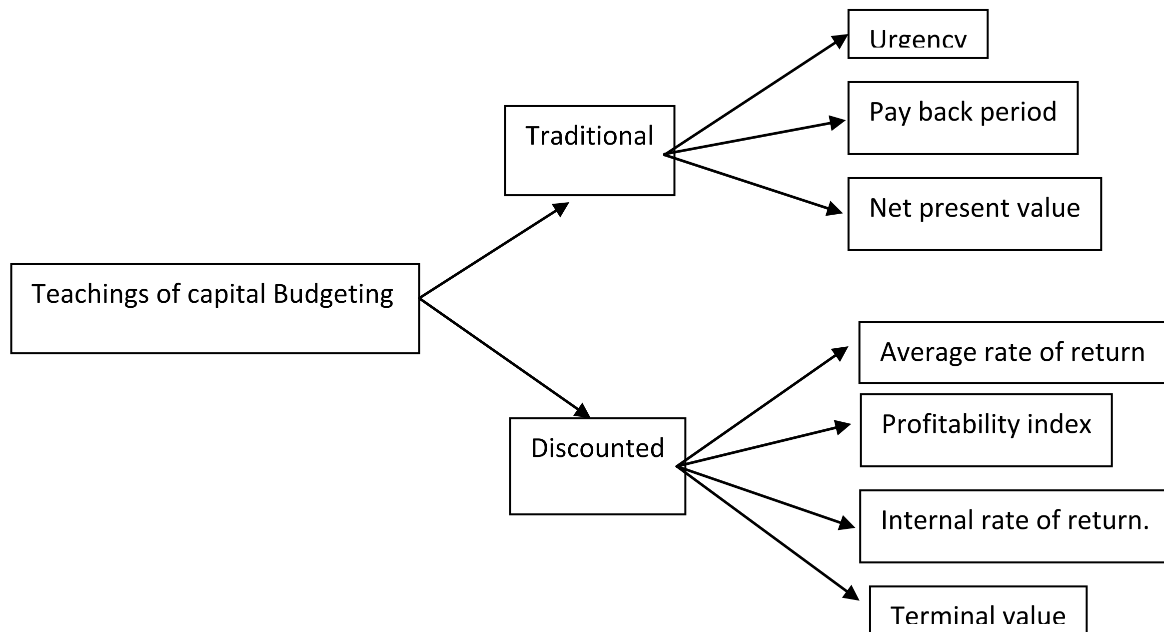
(5) **Cash flow** – cash flow statement or cash budget helps a firm in identifying time when a firm can make investment in CBD.

(6) **Other factors**- Like fiscal policy (tax concessions, rebate on investments) political salability, global situation etc.

Q3 What are the various methods used in Capital Budgeting? What are its merits and Demerits?

Or

How capital budgeting is helpful in making investments decisions. Explain.



Capital budgeting decision may be thought of as a cost-benefit analysis. We are asking a very simple question: "If I purchase this fixed asset, will the benefits to the company be greater than the cost of the asset?" In essence, we are placing the cash inflows and outflows on a scale (similar to the one above) to see which is greater.

A complicating factor is that the inflows and outflows may not be comparable: cash outflows (costs) are typically concentrated at the time of the purchase, while

cash inflows (benefits) may be spread over many years. The *time value of money* principle states that dollars today are not the same as dollars in the future (because we would all prefer possessing dollars today to receiving the same amount of dollars in the future). Therefore, before we can place the costs and benefits on the scale, we must make sure that they are comparable. We do this by taking the present value of each, which restates all of the cash flows into "today's dollars." Once all of the cash flows are on a comparable basis, they may be placed onto the scale to see if the benefits exceed the costs.

The Major Capital Budgeting Techniques

A variety of measures have evolved over time to analyze capital budgeting requests. The better methods use *time value of money* concepts. Older methods, like the payback period, have the deficiency of not using time value techniques and will eventually fall by the wayside and be replaced in companies by the newer, superior methods of evaluation.

1. Payback Period

It **is the length of time that it takes to recover your investment.**

For example, to recover $30,000 at the rate of $10,000 per year would take 3.0 years. Companies that use this method will set some arbitrary payback period for all capital budgeting projects, such as a rule that only projects with a payback period of 2.5 years or less will be accepted. (At a payback period of 3 years in the example above, that project would be rejected.)

The payback period method is decreasing in use every year and doesn't deserve extensive coverage here.

2. Profitability index (PI), also known as **profit investment ratio** (PIR) and **value** investment **ratio** (VIR), is the ratio of payoff to investment of a proposed project. It is a useful tool for ranking projects because it allows you to quantify the amount of value created per unit of investment.

The ratio is calculated as follows:

Assuming that the cash flow calculated does not include the investment made in the project, a profitability index of 1 indicates breakeven. Any value lower than

one would indicate that the project's PV is less than the initial investment. As the value of the profitability index increases, so does the financial attractiveness of the proposed project.

Rules for selection or rejection of a project:

- If PI > 1 then accept the project
- If PI < 1 then reject the project

3. Accounting rate of return, also known as the **Average rate of return**

ARR is a financial ratio used in capital budgeting. The ratio does not take into account the concept of time value of money. ARR calculates the return, generated from net income of the proposed capital investment. The ARR is a percentage return. Say, if ARR = 7%, then it means that the project is expected to earn seven cents out of each dollar invested. If the ARR is equal to or greater than the required rate of return, the project is acceptable. If it is less than the desired rate, it should be rejected. When comparing investments, the higher the ARR, the more attractive the investment. Over one-half of large firms calculate ARR when appraising projects.

ARR=Profit / Investment

3. Net Present Value

Using a minimum rate of return known as the hurdle rate, the *net present value* of an investment is the *present value of the cash inflows* minus the *present value of the cash outflows.* A more common way of expressing this is to say that the net present value (NPV) is the present value of the benefits (PVB) minus the present value of the costs (PVC)

NPV = PVB - PVC

By using the hurdle rate as the discount rate, we are conducting a test to see if the project is expected to earn our minimum desired rate of return. Here are our decision rules:

If the NPV is:	Benefits vs. Costs	Should we expect to earn at least our minimum rate of return?	Accept the investment?
Positive	Benefits > Costs	Yes, more than	Accept
Zero	Benefits = Costs	Exactly equal to	Indifferent
Negative	Benefits < Costs	No, less than	Reject

Remember that we said above that the purpose of the capital budgeting analysis is to see if the project's benefits are large enough to repay the company for (1) the asset's cost, (2) the cost of financing the project, and (3) a rate of return that adequately compensates the company for the risk found in the cash flow estimates.

Therefore, if the NPV is:

- Positive, the benefits are more than large enough to repay the company for (1) the asset's cost, (2) the cost of financing the project, and (3) a rate of return that adequately compensates the company for the risk found in the cash flow estimates.
- Zero, the benefits are barely enough to cover all three but you are at breakeven - no profit and no loss, and therefore you would be indifferent about accepting the project.

- Negative, the benefits are not large enough to cover all three, and therefore the project should be rejected.

4. Internal Rate of Return

The *Internal Rate of Return (IRR)* is the rate of return that an investor can expect to earn on the investment. Technically, it is the discount rate that causes the present value of the benefits to equal the present value of the costs. According to surveys of businesses, the IRR method is actually the most commonly used method for evaluating capital budgeting proposals. This is probably because the IRR is a very easy number to understand because it can be compared easily to the expected return on other types of investments (savings accounts, bonds, etc.). If the internal rate of return is greater than the project's minimum rate of return, we would tend to accept the project.

The calculation of the IRR, however, cannot be determined using a formula; it must be determined using a trial-and-error technique. This process is explained in the following link.

5. Modified Internal Rate of Return

The *Modified Internal Rate of Return (MIRR)* is an attempt to overcome the above two deficiencies in the IRR method. The person conducting the analysis can choose whatever rate he or she wants for investing the cash inflows for the remainder of the project's life.

For example, if the analyst chooses to use the hurdle rate for reinvestment purposes, the MIRR technique calculates the present value of the cash outflows (i.e., the PVC), the future value of the cash inflows (to the end of the project's life), and then solves for the discount rate that will equate the PVC and the future value of the benefits. In this way, the two problems mentioned previously are overcome:

1. the cash inflows are assumed to be reinvested at a reasonable rate chosen by the analyst, and

2. There is only one solution to the technique.

Q. 3 Which Method Is Better: the NPV or the IRR? Give reasons for your answer.

Ans: The NPV is better than the IRR. It is superior to the IRR method for at least two reasons:

1. Reinvestment of Cash Flows: The NPV method assumes that the project's cash inflows are reinvested to earn the hurdle rate; the IRR assumes that the cash inflows are reinvested to earn the IRR. Of the two, the NPV's assumption is more realistic in most situations since the IRR can be very high on some projects.

2. Multiple Solutions for the IRR: It is possible for the IRR to have more than one solution. If the cash flows experience a sign change (e.g., positive cash flow in one year, negative in the next), the IRR method will have more than one solution. In other words, there will be more than one percentage number that will cause the PVB to equal the PVC.

   When this occurs, we simply don't use the IRR method to evaluate the project, since no one value of the IRR is theoretically superior to the others. The NPV method does not have this problem.

Q4 Explain the methods of time value of money.

Ans. Two methods of taking care of time value of money:-

1. <u>Compounding/ future value</u> :- Future value or compounding is the value of an asset or cash at a specified date in the future that is equivalent in value to a specified sum today

Future Value(n) = Present Value * (1+k)n

Future Value= PV* FVIF(k,n)

Where, FV(n) = Future value of the initial flow n years hence

PV = Initial cash flow

K = Annual Rate of interest

n = Life of investment.

FVIF= Future Value Interest Factor (it will be calculated by fv table value)

2. <u>Discounting / present value</u> -- The current worth of a future sum of money or stream of cash flows given a specified rate of return. Future cash flows are discounted at the discount rate, and the higher the discount rate, the lower the present value of the future cash flows

Under the method of discounting, in time value of money, we compare the initial outflow with the sum of present value (PV) of the future inflows at a given rate of interest.

PV = FV/(1+k)n

PV= FV* PVIF (k,n)

Where PVIF= Present value interest factor (calculated by table value)

Dividend Policy

Q.1 What do you understand by dividend policy?
Explain in brief models of dividend theories.

Ans. Dividend is divisible profit distributed amongst members/shareholders of a company in proportion to shares in the manner as prescribed under law. A dividend cannot be declared unless:

1. Sufficient profit is there in a company.
2. It has been recommended by Board of Directors.
3. Its acceptance has been given by the shareholders in Annual General Meeting (AGM)

Kind of Dividend -

I. Type of Security – Preference Dividend, - Equity Dividend
II. Timings of Dividends – Interim Dividend – Regular Dividend
III. Mode of Payment–Cash–Stock dividend (Bonus)–Script or Bond.

Dividend Policy - Policy followed by Board of Directors concerning quantum of profit to be distributed as dividend. It also includes principal rules and procedure for planning and distributing dividend after deciding rate of dividend.

- Stable: Long term policy without frequent changes i.e. long term policy which is not affected by changes or quantum of profit.
- Lenient: Most of the profit is distributed amongst share holders and a very small part is kept as retained earnings. Even 90% to 95% profit is distributed as dividend. This is generally done in initial years to gain confidence of share holders.

Factors affecting dividend policy or determinants of dividend policy

(i) Legal requirements: As per companies Act, dividend only out of earned profit.

(ii) Liquidity position: In tight liquidity position, instead cash dividend, bonus shares or scripts/bonds are issued.

(iii) Trade Cycle: In boom conditions, higher profits are there and hence high dividend.

(iv) Expectations of share holders

(v) Future needs: If future needs are high, low dividend and high retained earnings.

(vi) Debt repayment: If heavy debt liability, low dividend.

(vii) Stability of Income: If income is stable, high dividend.

(viii) Public Opinion: High dividend to gain public confidence.

(ix) Composition of Owners: If preference shareholders are large, less dividend to ordinary shareholders.

Q2. What are the theories or models or say approaches given under Dividend policy?

Ans. Models of Dividend (Theories)

1. Walter's Model – As per this model, dividend policy of a firm is based on the relationship between internal rate of return (r) earned by it and the cost of capital or required rate of return (k). The optimum dividend policy will have to be determined by relationship of r & k under following assumptions.

- Internal rate of return ® and cost of capital (k) are constant.
- All new investment opportunities are to be financed through retained earnings and no external finance is available to the firm.
- A firm has perpetual or an infinite life

Hence, as per this Model, a firm should retain its earnings if the return on investment exceeds cost of capital.

2. Gordon's Model – This model is like Walters Model but a few extra assumptions are:

- The firm operates its investment activity only through equity.
- The retention ratio once decided is constant for ever.

As per this Model, Market value of share is equal to present value of its expected future dividend.

3. **Modigliani & Miller (M M Model)** – This model says that dividend decision and retained earnings decision do not influence market value of shares. As per this model, "Under conditions of Perfect Capital Market, rational investors, absence of tax, discrimination between dividend income and capital appreciation given the firms investment policy. Its dividend policy may have no influence on the Market price of shares.

Case Problems

Q 1 Calculate Average Rate of Return for the following information:

Year	0	1	2	3
Investment	100000			
Sales Revenue		120000	100000	80000
Operating Expenses (Excluding Depreciation)		60000	50000	40000
Depreciation		30000	30000	30000
Annual Income		30000	20000	10000

Average annual income = (30000+20000+10000)/3 = 20000

Average net book value if the investment = (100000+0)/2 = 50000

Accounting rate of return = 20000/50000 * 100 = 40%

The firm will accept the project if its target rate is less than 40%. \

Q2 **A ltd is considering the purchase of a new leather cutting machine to replace an existing machine which has a book value of Rs. 3000 and can be sold for Rs. 1500. The estimated salvage value of the old machine in four years would be zero, and it is depreciated on a straight line basis. The new machine will reduce costs (before tax) by Rs. 7000 per year i.e. Rs. 7000 cost savings over the old machine. The new machine has a four year life, costs Rs. 14000 and can be sold for an expected amount of Rs. 2000 at the end of the fourth year. Assuming straight line depreciation and a tax rate of 40%, calculate the cash flows associated with the investment and calculate the NPV of the project assuming the cost of funds to the firm is 12% and straight line method is used for tax purposes?**

Ans. Cash flows associated with the replacement decisions

Year		0	1	2	3	4
1.	Net investment in new machine	(12500)				
2.	Savings in costs		7000	7000	7000	7000
3.	Incremental Depreciation		2250	2250	2250	2250
4.	Pre-Tax profits		4750	4750	4750	4750
5.	Less Tax		1900	1900	1900	1900
6.	Post-tax profits		2850	2850	2850	2850
7.	Initial Flow (=1)	(12500)				
8.	Operating Flow (= (6) + (3))		5100	5100	5100	5100
9.	Terminal Flow					2000
10.	Net Cash flow(=7+8+9)	12500	5100	5100	5100	7100

Year	1	2	3	4
Net cash flows	5100	5100	5100	7100
PVIF @k = 12%	0.893	0.797	0.712	0.636
Present Value (Rs.)	4554	4065	3631	4516

Net present value

= (-12500) + (4554 + 4065 + 3631 + 4516)

= Rs. (-12500 + 16766)

= Rs. 4266

The decision rule based on NPV is obvious. A project will be accepted if the NPV is positive and rejected if NPV is negative.

Q3 Project has the following patterns of cash flows:

Year	Cash Flow (Rs. In Lacs)
0	(10)
1	5
2	5
3	3.08
4	1.20

What is the IRR of this project?

Ans: To determine the IRR, we have to compare the NPV of the project for different rates of interest until we find that rate of interest at which the NPV of the project is equal to zero. To reduce the number of iterations involved in this hit and trial process, we can use the following short cut procedure:

Step 1

Find the average annual net cash flow based on given future net cash inflows.

= (5 + 5 + 3.08 + 1.20)/4 = 3.57

Step 2

Divide the initial outlay by the average annual net cash inflows i.e. 10/3.57 = 2.801

Step 3

From the PVIFA table find that interest rate at which the present value of an annuity of Rs. 1 will be nearly equal to 2.801 in 4 years i.e. the duration of the project. In this case the rate of interest will be equal to 15%.

We use 15% as the initial value for starting the hit and trial process and keep trying at successively higher rates of interest until we get an interest rate at which the NPV is zero.

The NPV at r = 15% will be equal to:

= - 10 + (5 * .0870) + (5 * .756) + (3.08 * .658) + (1.2 * .572) = 0.84

NPV at r = 16 % will be equal to:

= - 10 + (5 * .862) + (5 * .743) + (3.08 * .641) + (1.2 * .552) = .66

NPV at r = 18% will be equal to:

= - 10 + (5 * .848) + (5 * .719) + (3.08 * .0609) + (1.2 * .516) = .33

NPV at r = 20% will be equal to:

= -10 + (5 * .833) + (5 * .694) + (3.08 * .609) + (1.20 * .482) = 0

We find that at r= 20%, the NPV is zero and therefore the IRR of the project is 20%.

Q4 Explain Operating Cycle Approach to Working Capital Management.

Ans. Operating cycle approach has following periods.

Raw Material Storage Period (n1)

1. Annual consumption of raw materials, components etc.
2. Average daily consumption of raw material by dividing the first point above by 360.
3. Average stock of raw materials, components etc. opening + closing stock /2.
4. Raw material storage period = 3/2 = n1 days.

Conversion Period (n2)

1. Annual cost of production = Opening WIP + Raw material consumed + other manufacturing costs like wages fuel etc. + Depreciation – Closing WIP.
2. Average daily cost of production = 1/360
3. Average stock of WIP = opening WIP + Closing WIP /2
4. Average conversion period = 3/2 = n2 days

Finished Goods Storage Period (n3)

1. Annual cost of sales = Opening stock of finished goods + cost of production + Excise duty + Selling and distribution costs + General administrative costs + Financial costs – Closing stock of finished goods.
2. Average daily cost of sales = 1/360
3. Average stock of finished goods = Opening stock + Closing stock/2
4. Finished goods storage period = 3/2 = n3 days

Average Collections Period (n4)

1. Annual credit sales of the company.
2. Average daily credit sales = 1/360
3. Average balance of sundry debtors = Opening balance + Closing balance /2
4. Average collection period = 3/2 = n4 days

Average Payment Period (n5)

1. Annual credit purchases made by a company.
2. Annual daily credit purchases = 1/360
3. Average balance of sundry creditors = opening balance + closing balance /2
4. Average payment period = 3/2 = n5 days.

Gross Operating Cycle = n1 + n2 + n3 + n4

Net Operating Cycle = n1 + n2 + n3 + n4 – n5

Q5. Calculate the gross and net operating cycle periods from the data given below:-

Particulars	Amount (Rs. In Lakh)
1. Opening Balances of o Raw Materials, Stores and Spares, etc o Work – in – Process o Finished Goods o Accounts Receivable o Accounts Payable	3454.84 56.15 637.92 756.45

2. Closing Balances of o Raw Materials, Stores and Spares, etc o Work – in – Process o Finished Goods o Accounts Receivable o Accounts Payable 3. Purchases of Raw Materials, Stores and Spares, etc. 4. Manufacturing Expenses etc. 5. Depreciation 6. Customs and Excise Duty 7. Selling administration and financial expenses 8. Sales	2504.18 4095.41 72.50 1032.74 1166.32 3087.47 10676.10 1146.76 247.72 35025.56 4557.48 54210.65

Ans. Raw Material Storage Period

1. Annual Consumption of Raw Materials

   = Opening Stock + Purchases – Closing Stock

   = 3454.84 + 10676.10 – 4095.41

   = 10035.53

2. Average daily consumption of raw materials:-

   = 10035.53/360 = 27.88

3. Average stock of Raw Materials

   = (3454.84 + 4095.41)/2

4. Raw Material Storage Period

= 3775.13/27.88 = 135 days

B. Average Conversion or Work-in-process Period

1. Annual Cost of Production

   = Opening WIP + Consumption of Materials + Manufacturing Expenses + Depreciation – Closing WIP

   =56.15 + 10035.53 + 1146.76 + 247.72 – 72.50

   =11413.66

2. Average Daily Cost of Production

   = 11413.66/360 = 31.70

3. Average Stock of Work- in – Progress

   = (56.15 + 72.50)/2 = 64.33

4. Average Conversion Period

   = 64.33/31.70 = 2 days

C. Finished Goods Storage Period

1. Annual cost of sales

   = Opening stock of finished goods + cost of production + Selling, administration and financial expenses + customs and excise duties – closing stock of finished goods.

   = 637.92 + 11413.66 + 4557.48 + 35025.56 – 1032.74

   = 50601.88

2. Average daily cost of sales : = 50601.88/360 = 140.56

3. Average inventory of finished goods = (637.92 + 1032.74)/2 = 835.33

4. Finished goods storage period = 835.33/140.56 = 6 days

D. Average Collection Period

1. Annual Sales = 54210.65
2. Average Daily Sales = 54210/360 = 150.59

3. Average Book Debts =(756.45+1166.32)/2 = 961.38

4. Average Collection Period = 961.38/150.59 = 6 days

E. Average Payment Period

1. Annual Purchases = 10676.10

2. Average Daily Purchases = 10676.10/360 = 29.66

3. Average balance of trade creditors = (2504.18 + 3087.47)/2= 2795.82

4. Average payment period = 2795.82/29.66 = 94 days

Operating Cycle Period= 135 + 2 + 6 + 6 – 94 = 55 days

Inventory Management Techniques

Q 1 What is Economic Order Quantity?

Ans. The economic order quantity (EOQ) refers to the optimal order size that will result in the lowest total of order and carrying costs for an item of inventory given its expected usage, carrying costs and ordering cost. By calculating the economic order quantity, the firm determines the order size that will minimize the total inventory costs.

EOQ = √2RO/C

Where R= Annual Requirement

O= Ordering Cost

C= Carrying Cost

Example:-

A firm expects a total demand for its product to be 10000 units, while the ordering cost per order is Rs. 100 and the carrying cost per unit is Rs. 2.

EOQ = under root of 2*10000*100/2 = 1000 units.

Q2 Explain Reorder Point Formula.

Ans. At what point in the level of inventory a reorder has to be placed for replenishment of stock.

Reorder Point

= U * L + F * √U * R * L

Where,

U= Usage in units per day

L= Lead time in days

R= Average number of units per order

F= Stock out acceptance factor

Q 3 For a company the average daily usage of a material is 100 units, lead time for procuring material is 20 days and the average number of units per order is 2000 units. The stock out acceptance factor is considered to be 1.3. What is the reorder level for the company?

Ans.

From the data contained in the problem we have

U = 100 units

L = 20 Days

R = 2000 Units

F = 1.3

Reorder Level = U * L + F * √U*R*L

= 100 * 20 + 1.3 * Under root of 100 * 2000 * 20

= 2000 * 1.3 + 2000 = 4600

Multiple Choice Questions

1 What is Finance?

1. Getting things on loan
2. **Study of money and its flow.**
3. Finance means money and cash
4. Finance is only the supply of funds

2 Which of the following does not come under the key areas of finance?

1. raising of funds
2. investment of funds
3. distribution of funds
4. **getting loans from banks**

3 Which of the following determine the basic functions of financial management?

1. six p's
2. three t's
3. four i'
4. **six a's**

4 The objectives of financial manager constitute:

1. acquisition of assets
2. **profit maximization & wealth maximization**
3. increase in the property of the properietor
4. issue of shares and debentures.

5 Cost of capital is the combination of

1. cost of transaction and sunk cost
2. **cost of equity and cost of debt**
3. variable cost and marginal cost
4. cost of earnings and expenses.

6 Working capital should be

1. maximum

2. minimum
3. ***adequate***
4. not important

7 Current ratio should be ________ for the better performance of the firm

1. less then 1
2. should be more than 1
3. ***equal to one***
4. zero

8 Operating cycle does not constitute the following

1. cash
2. ***fixed assets***
3. inventory
4. work in progress

9 Capital budgeting is a technique used for making

1. **long term investment decisions**
2. calculation of cash flows
3. short term investments
4. consideration of time value of money

9. npv stands for

1. **net present value**
2. net profit value
3. null present value
4. net profitability value

11 Which technique of capital budgeting is considered better than npv

1. profitability index
2. **internal rate of return**
3. pay back period
4. accounting rate of return

12 Which of the following is not the approach for capital structure

1. mm theory
2. net operating income approach
3. **capital asset pricing theory**
4. net income approach

13 One should accept the proposal whose npv is

1. ***positive***
2. negative

3. zero
4. maximum

14. Which is not the constituent of current asset

1. cash at bank
2. **bills payable**
3. debtors
4. inventory

15 Financial management does not include the following

1. acquisition of funds
2. anticipation of funds
3. ***assesing the competition***
4. administration of funds

Key Terminologies

Money – Value of exchange, store of value, unit of account.

Cash- Money in liquid form.

Fund- Accumulated amount of money invested in a project.

Finance – Science or the study of money and its flow.

Financial management- Financial management means planning, organizing, directing and controlling the financial activities such as procurement and utilization of funds of the enterprise. It means applying general management principles to financial resources of the enterprise.

Finance manager-The person responsible for financial management.

Financial planning- Financial planning is a systematic approach whereby the financial planner helps the organization to maximize his existing financial resources by utilizing financial tools to achieve his financial goals.

Financial planner- A financial planner is someone who uses the financial planning process to help you figure out how to meet your life goals.

Cost of capital- The required return necessary to make a capital budgeting project, such as building a new factory, worthwhile. Cost of capital includes the cost of debt and the cost of equity

Capital structure- Capital structure refers to the way a corporation finances its assets through some combination of equity, debt, or hybrid securities

Leverage-In finance, leverage (also known as gearing or levering) refers to the use of debt to supplement investment

Wacc the total capital for a firm is the value of its equity (for a firm without outstanding warrants and options, this is the same as the company's market capitalization) plus the cost of its debt (the cost of debt should be continually updated as the cost of debt changes as a result of interest rate changes)**.**

Capital budgeting: "capital budgeting involves planning of expenditure for assets and return from them which will be realized in future time period

Cash inflow The amount of cash generated from the course of action done in the business.

Cash outflow The amount of cash moved as expenses for carrying the business.

Pay back period It is the length of time that it takes to recover your investment

Average rate of return arr calculates the return, generated from net income of the proposed capital investment.

Profitability index -It is the ratio of payoff to investment of a proposed project. It is a useful tool for ranking projects because it allows you to quantify the amount of value created per unit of investment.

Net present value The net present value of an investment is the present value of the cash inflows minus the present value of the cash outflows.

Internal rate of return The internal rate of return (irr) is the rate of return that an investor can expect to earn on the investment.

Time value of money value of money depreciates with time

Working capital- Working capital is a financial metric which represents the amount of day-by-day operating liquidity available to a business.

Working capital in that part of firms capital which is required for financing current assets such as cash, debtors, receivables inventories, marketable securities etc.

Current ratio This is a ratio obtained by dividing current assets and current liabilities.it must be 1.

Operating cycle - Refers to capital/ amount required in different forms at successive stages of manufacturing operation/ process. It represents cycle during which cash is reconverted in to cash again.

Inventory -Inventory means stock of goods in the form of raw material, stores or supplies, work in progress and finished product waiting for sale.

Recievable- Receivables are created on account of credit sales. They are represented in the balance sheet in the form of sundry debtors, trade debtors, and book debts, accounts receivable, bills receivable etc.

Cash budget: - A statement showing estimate of cash receipts, cash disbursement and net cash balance for a future period of time. It is a time based schedule & covers a specific period.

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