

ACHARYA PATASHALA COLLEGE OF COMMERCE
Narasimharaja Colony, Bengaluru – 560 019

III Semester B.Com Examination, November/December 2018

Financial Management

Time: 3 Hours

Max. Marks: 70

Section – A

Answer any five Sub-question. Each Sub question carries two marks (5 X 2 = 10)

1. a. What is Financial Leverage?

Financial leverage is a measure of financial risk. It relates to the use of fixed financing costs by the company. The use of long term fixed interest/dividend bearing securities such as debt and preference share capital along with the equity share capital in the capital structure to maximize earnings to equity share holders (EPS) is called as Financial leverage.

b. What is wealth maximization?

Wealth Maximisation means maximization of the market price or value of equity shares of the company. Shareholders wealth will be maximized if the market price/value of the share is maximized, hence wealth maximization is also termed as value maximization.

c. What do you mean by stock dividend?

A Stock dividend is a dividend payment to shareholders that is made in shares rather than as cash. The stock dividend has the advantage of rewarding shareholders without reducing the company's cash balance, although it can dilute earnings per share.

d. Calculate the present value of Rs.40,000/- received after 5 years, if the discount rate is 10%

$$PV = \frac{A}{(1+i)^n} = \frac{40000}{(1+0.1)^5} = \frac{40000}{(1.1)^5} = 24,836.85$$

e. State four components of working capital.

1. Inventory
2. Cash and Bank balances
3. Creditors / account payable
4. Debtors / Accounts receivable

f. Initial investment of Rs.10,00,000/- residual value Rs.2,00,000/- working life is 5 years, additional working capital Rs.1,00,000/-. Calculate average investment.

$$\begin{aligned} \text{AI} &= \frac{(\text{Original Investment} - \text{Scrap value}) + \text{working capital} + \text{Scrap value}}{2} \\ &= \frac{(10,00,000 - 2,00,000) + 1,00,000 + 2,00,000}{2} \\ &= 700,000 \end{aligned}$$

g. Name the two models used for valuing equity shares.

Single period valuation share

Multi period valuation share

Section – B

Answer any Three questions, each question carries 6 marks: (3 X 6 = 18)

2. Briefly explain the various forms of Dividend?

A company's dividend policy involves the decision of its net earnings into two parts, dividend and retained earnings. Thus, dividend policy relates to what amount of profits to be distributed as dividends, and how much is to be retained.

Forms of Dividend

1. **Cash Dividend:** Dividend paid by the company to its shareholders in the form of cash of cash is known as cash dividend. It is most desirable by the investor because the investors after receiving their part of share in cash can invest in the manner they desire.
2. **Scrip or Bond Dividend:** when the earnings of the company ensure that the shareholders can be paid dividend but the cash position is temporarily weak in such a situation company issues promissory note which may or may not be interest bearing.
3. **Property dividend:** The dividend paid or declared by the company in the form of assets or property other than cash is known as property dividend.
4. **Stock dividend:** stock dividend means issue of additional shareholders existing shareholders. If a company capitalizes earning and distributes the capitalized earning in the form of shares to the existing shareholders, such shares are known as bonus share.

3. Mention the functions of financial management

- a. Anticipating financial needs
- b. Acquiring financial resources
- c. Allocating funds in business
- d. Administering allocation of funds
- e. Analyzing performance of finance
- f. Accounting and reporting to management
- g. Financial manager has to forecast and judge financial requirements for the business
- h. Funds should be used in an optimum way such that utmost benefits
- i. Accounting and reporting of performance of finance is important aspect of financial management
- j. The liquidity of a business concern can be known by having efficient financial analysis
- k. Effective utilization of funds is the key thing for a finance manager
- l. Appropriate sources of finance or avenue to raise funds should ascertain by the organization

4. The following information is available in respect of a product:

Units sold – 60,000/-, Sales price per unit – Rs.12/-, Fixed cost – Rs.60,000/-, Variable cost – Rs.6 per unit, 10% debt capital of Rs.1,20,000/-. Calculate all the types of leverages

Solution: **Calculation of Leverages**

Particulars	Amount
Sales (60000*12)	720000
Less: Variable Cost (60000*6)	360000
Contribution	360000
Less: Fixed Cost	60000
EBIT	300000
Less: Interest (120000*10%)	12000
EBT	288000

$$OL = \frac{\text{Contribution}}{\text{EBIT}} = \frac{360000}{300000} = 1.2$$

$$FL = \frac{\text{EBIT}}{\text{EBT}} = \frac{3,00,000}{2,88,000} = 1.04$$

$$CL = OL \times FL, = 1.2 \times 1.04, = 1.24$$

5. A bank manager offers a scheme in which Mr. Malleesh gets Rs.1,000/-, Rs.2,000/-, Rs.3,000/-, Rs.4,000/-, Rs.5,000/- at the end of each year for a period of 5 years at the discount rate of 9% for a lump sum deposit of Rs.12,000. Is it advisable to invest Rs.12,000/- to Mr. Malleesh? Advise index.

Solution: Calculation of present value factor

Year	Cash Flow	PV@9%	PV @ Cash flow
1	1000	0.917	917
2	2000	0.841	1682
3	3000	0.772	2316
4	4000	0.708	2832
5	5000	0.649	3245
			10992

Comment: It is not advisable for Mr.Malleesh to invest for the lump sum deposit of Rs.12,000/- his total return is only Rs.10,992/-. He is receiving what less than what he is depositing.

6. The initial cash out lay of a project is Rs.1,00,000/- and it generates cash inflows of Rs.40,000/-, Rs.30,000/-, Rs.50,000/- and Rs.20,000/- 10% rate of discount. Calculate profitability index

Years	1	2	3	4
Discount	0.909	0.826	0.751	0.683

Factors at 10%.

Solution

Calculation of PV of cash flow

Year	Cash Flow	PV @ 10%	PV @ Cash flow
1	40000	0.909	36360
2	30000	0.826	24780
3	50000	0.751	37550
4	20000	0.683	13660
			112350

$$PI = \frac{\text{Total Present value of cash inflow}}{\text{Total Present value of cash outflow}} = \frac{1,12,300}{1,00,000} = 1.12$$

Section C

Answer any Three questions. Each answer carries 14 marks: (3 X 14 = 42)

7. Briefly explain the factors influencing the amount of working capital.

The working capital requirements of a concern depend upon a large number of factors such as nature and size of business, the character of their operations, the length of production cycles, the rate of stock turnover and the state of economic situation. The following are important factors generally influencing the working capital requirements

- a. Nature or character of business
- b. Size of business/scale of operations
- c. Production policy
- d. Manufacturing process/length of production cycle
- e. Seasonal variation
- f. Working capital cycle
- g. Rate of stock turnover
- h. Credit policy
- i. Business cycles
- j. Rate of growth of business
- k. Earning capacity and dividend policy
- l. Price level changes
- m. Other factors

8. Explain the meaning, scope and importance of financial management.

Financial Management is concerned with the managerial decisions that result in the acquisition and financing of short term and long term credits for the firm.

SCOPE OF FINANCIAL MANAGEMENT:

The main objective of financial management is to arrange sufficient finance for meeting short term and long term needs. A financial manager will have to concentrate on the following areas of finance function.

- 1. Estimating financial requirements:** The first task of a financial manager is to estimate short term and long term financial requirements of his business. For that, he will prepare a financial plan for present as well as for future. The amount required for purchasing fixed assets as well as needs for working capital will have to be ascertained.
- 2. Deciding capital structure:** Capital structure refers to kind and proportion of different securities for raising funds. After deciding the quantum of funds required it should be

decided which type of securities should be raised. It may be wise to finance fixed assets through long term debts.

3. **Selecting a source of finance:** An appropriate source of finance is selected after preparing a capital structure which includes share capital, debentures, financial institutions, public deposits etc.

4. **Selecting a pattern of investment:** When funds have been procured then a decision about investment pattern is to be taken. The selection of an investment pattern is related to the use of funds.

5. **Proper cash management:** Cash management is an important task of finance manager. He has to assess various cash needs at different times and then make arrangements for arranging cash.

6. **Implementing financial controls:** An efficient system of financial management necessitates the use of various control devices. They are ROI, break even analysis, cost control, ratio analysis, cost and internal audit. ROI is the best control device in order to evaluate the performance of various financial policies.

7. **Proper use of surpluses:** The utilization of profits or surpluses is also an important factor in financial management. A judicious use of surpluses is essential for expansion and diversification plans and also in protecting the interests of share holders. The ploughing back of profits is the best policy of further financing but it clashes with the interests of share holders. A balance should be struck in using funds for paying dividend and retaining earnings for financing expansion plans.

Importance of Financial Management

The modern day corporate forms of business organizations have the following characteristics:

- The ownership is separated from management.
- There is a wide distribution of corporate wealth.
- The size and influence of business enterprises has increased.

The success and failure of any business enterprise depends on earning adequate returns on its investments. The investors and shareholders are attracted to a firm only when the firm maximizes the wealth of the shareholders through proper application of principles and procedures prescribed by the corporate finance.

- Successful promotion to ensure it becomes a going concern,
- Sound financial planning that ensures future expansion and diversification.
- Acquiring of funds at suitable times at costs advantageous to the firm.
- Proper allocation of funds to profitable projects and proper use of funds to ensure adequate return on investment.
- Ensuring that the financial decisions are sound and in the interests of both the shareholders and the concern
- Ensuring proper financial controls for profitability.
- Maximisation of the wealth of the investors and the nation.

9. Sonu Ltd., Company has equity share capital for Rs.10,00,000/- dividend into shares of Rs.100 each. It wishes to raise further Rs.6,00,000/- for expansion plans. The company plans the following financing schemes:

- a. All Equity Shares
- b. Rs.2,00,000/- in equity shares and Rs.4,00,000/- in debt @ 10% p.a
- c. All debt at 10% p.a
- d. Rs.2,00,000/- equity shares and Rs.4,00,000/- in preference share capital with rate of dividend at 8%.

The company has estimated EBIT at Rs.3,00,000/-. The corporate rate of tax is 50%. Calculate EPS in each case. Give a comment as to which capital structure is suitable.

Solution : Analysis Table

Particulars	I	II	III	IV
Equity share capital	10,00,000	10,00,000	10,00,000	10,00,000
Additional Equity share capital	600000	200000	-	200000
Debenture (interest)		400000	1000000	
Preference shares				400000
`	16,00,000	12,00,000	10,00,000	12,00,000
Face Value	100	100	100	100
No of Equity shares	16000	12000	10000	12000

Calculation of EPS

Particulars	I	II	III	IV
EBIT	300000	300000	300000	300000
Less: Interest (400000*10%)	0	40000	0	0
Less: Interest (1000000*10%)			100000	
Earning after interest before Tax	300000	260000	200000	300000
Less: Tax @ 50%	150000	130000	100000	150000
EBT	150000	130000	100000	150000
Less: Preference shares (4lac*8%)	0	0	0	32000
Earnings available for Eqt shareholders	150000	130000	100000	118000

EPS = Earnings available for Eqt shareholders	150000	130000	100000	118000
No of Equity shares	16000	12000	10000	12000
	9.38	10.83	10.00	9.83

10. A company is considering purchasing a machine. Two alternative machines are available machine A and B each costing Rs.1,00,000/-. Earnings after depreciation and taxation are expected to be as follows:

Years	Estimated net cash flows	
	Machine A (Rs.)	Machine B (Rs.)
1	30,000	10,000
2	40,000	30,000
3	50,000	40,000
4	30,000	60,000
5	20,000	40,000

Calculate: a. Payback period b. Net present value, at 9%
Assume straight line method of depreciation. The discount factor is as under:

Year	Machine A			Machine B	
	Cash flow	PV @ 9%	PV @ Cash Flow	Cash flow	PV @ Cash Flow
1	30000	0.971	29130	10000	9710
2	40000	0.842	33680	30000	25260
3	50000	0.772	38600	40000	30880
4	30000	0.708	21240	60000	42480
5	20000	0.650	13000	40000	26000
			135650		134330

11. Following information is given to you, evaluate the projects by using return on investment and NPV methods

	Project X	Project Y	Project Z
Investment	70000	80000	90000
Return at the end of 1st year	40000	50000	55000
Return at the end of 2nd year	30000	25000	40000
Return at the end of 3rd year	20000	25000	20000

NPV may be calculated at 20% discount factor

Year	1	2	3
DF @ 20%	0.833	0.694	0.578

Solution:

Calculation of NPV

Year	CF (X)	CF (Y)	CF (Z)	DF @ 20%	PV (X)	PV (Y)	PV (Z)
1	40000	50000	55000	0.833	33320	41650	45815
2	30000	25000	40000	0.694	20820	17350	27760
3	20000	25000	20000	0.578	11560	14450	11560
			Total Present Value		65700	73450	85135
			Less: Outflow		70000	80000	90000
			NPV		-4300	-6550	-4865

Calculation of Average Annual Income

AAI =	$\frac{\text{Total Profit after Tax}}{\text{No of year}}$	
Project X =	$\frac{40000+30000+20000}{3} = 30000$	
Project Y =	$\frac{50000+25000+25000}{3} = 33333$	
Project Z =	$\frac{55000+40000+20000}{3} = 38333$	

Calculation of Annual Income

AI =	$\frac{\text{Original Investment} - \text{Scrap value}}{2}$
Project X =	$\frac{70000 - 0}{2} = 35000$
Project Y =	$\frac{80000 - 0}{2} = 40000$
Project Z =	$\frac{90000 - 0}{2} = 45000$

Calculation of Average Rate of Return

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

Project X =	$\frac{30000}{35000} \times 100 = 85.71\%$
Project Y =	$\frac{33333}{40000} \times 100 = 83.33\%$
Project Z =	$\frac{38333}{45000} \times 100 = 85.18\%$