

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

III Semester B.Com Examination, November/December 2019
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 Planning?

Financial planning is an important part of financial management. It is the process of determining the objectives, policies, procedures, programs and budgets to deal with the financial activities of an enterprise. The activities of financial planning is to decide the course of action to be taken in future by the organization in respect to financial management.

b. What is profit maximisation?

Earning profit by a company is a social obligation. Profit is the only mean through which an efficiency of an organization can be measured.

c. Give the meaning of cash inflow.

Cash inflow is the net amount of cash and cash equivalent being transferred into and out of a business. At the most fundamental level, a company's ability to create value for shareholders is determined by its ability to generate positive cash flow.

d. What are the four sources of working capital

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

e. What do you mean by 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.

f. What is Investment decision?

Investment decision is a decision concerned with allocation of funds to get proper yield from project, so that it can recover the cost associated with each source of fund and earn required amount of profit to compensate the risk involved in the business.

g. The investment of the project is Rs.2,00,000/-. Salvage value is 15% and its additional WC is 20,000/-. Calculate average investment.

$$\begin{aligned} \text{Average Investment} &= \frac{\text{Original Investment} - \text{Scrap value}}{2} \quad (\text{AWC} + \text{SV}) = \frac{200000 - 0.15}{2} (20000 + 0.15) \\ &= \mathbf{1,19,999.775} \end{aligned}$$

Section – B

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

2. What do you mean by bonus share? State the advantage of bonus shares.

Bonus share are the dividend paid to the shareholders in kind. The company follows a practice of transferring a portion of its surplus to the capital accounts. The funds accumulated are capitalized and offered to the existing shareholder in the form of additional shares. The number of shares held by each shareholders increase with the issue of extra shares by the company.

- It makes available capital to carry an a larger and more profitable business
- It is felt that financing helps the company to get rid of market influences
- When a company pays bonus to its shareholders in the value of shares and not in cash, its liquid resources are maintained and the working capital of the company is not affected
- It enables a company to make use of its profits on a permanent basis and increases creditworthiness of the company
- It is the cheapest method of raising additional capital for the expansion of the business
- Abnormally high rate of dividend can be reduced by issuing bonus shares which enables a company to restrict entry of new entrepreneurs into the business and thereby reduces competition
- The balance sheet of the company will reveal a more realistic picture of the capital structure and the capacity of the company

3. Briefly explain any six determinants of a capital structure.

The capital structure of a concern depends upon a large number of factors such as leverage or trading on equity, growth of the company, nature and size of business, the idea or retaining control, flexibility of capital structure, requirements of investors, costs of floatation of new securities, timing of issue, corporate tax rate and the legal requirements. The factors determining the capital structure.

- Financial leverage or trading on equity
- Growth and stability of sales

- Cost of capital
- Risk: There are two types of risk that are to be considered while planning the capital structure of a firm, business risk and financial risk.
- Cash flow ability to service debt
- Nature and size of a firm
- Requirements of investors
- Capital market conditions

4. Delta Co. is planning to buying a machine. Two alternatives P & Q, each costing Rs.50,000/-. You are required to call centre profitability index (PI) under 10%. Discount rate the expected cash inflows is given below:

Year	Cash in flows (Rs)	
	Machine P	Machine Q
1	25,000	42,000
2	28,000	39,000
3	31,000	36,000

Discount factor @ 10% is as below:

Year	1	2	3
Discount factor @ 10%	0.909	0.826	0.751

Solution : Statement of the calculation of PI

Year	Machine P			Machine Q		
	PV @ 9%	Cash flow	PV @ Cash Flow	Cash flow	PV @ Cash Flow	
1	0.909	25000	22725	42000	38178	
2	0.826	28000	23128	39000	32214	
3	0.751	31000	23281	36000	27036	
			69134		97428	

$$PI = \frac{\text{Total Present value of cash flow}}{\text{Investment}}$$

Machine P = $\frac{69134}{50000} = 1.38268$	Machine Q = $\frac{97428}{50000} = 1.94856$
NPV = 69139 - 50000 = Rs.19,134/-	NPV = 97428 - 50000 = Rs.47,428/-

5. From the following information calculate operating, financial and combined leverages. Sales Rs.10,00,000, Variable cost 30%, Fixed cost 2,00,000, 10% debenture capital is 15,00,000 and tax rate is 50%.

Solution: Calculation of Leverages

Particulars	Amount
Sales	1000000
Less: Variable Cost (30%*1000000)	300000
Contribution	700000
Less: Fixed Cost	200000
EBIT	500000
Less: Interest (1500000*10%)	150000
EBT	350000
Less: Tax @ 50%	175000
EAT	175000

Operating Leverage =	Contribution	=	700000	=1.4
	EBIT		500000	

Financial Leverage =	EBIT	=	500000	=1.43
	EBT		350000	

Combined Leverage =	Contribution	=	700000	=2
	EBT		350000	

6. Evaluate the future value at the end of five years of the following payments at 10% rate of interest.

At the end of 1st year Rs.6,000

At the end of 2nd year Rs.8,000

At the end of 3rd year Rs.10,000

At the end of 4th year Rs.12,000

At the end of 5th year Rs.14,000

Solution: Future value = $PV (1 + i)^n$

1. for Rs.6,000/- at the end of 1st year		
=6000	$\left[1 + \frac{10}{100}\right]^1$	=6000 * 1.1 = 6,600/-
2. for Rs.8,000/- at the end of 2nd year		
=8000	$\left[1 + \frac{10}{100}\right]^2$	=8000 * 1.21 = 9,680/-
3. for Rs.10,000/- at the end of 3rd year		
=10000	$\left[1 + \frac{10}{100}\right]^3$	=10000 * 1.331 = 13,310/-
4. for Rs.12,000/- at the end of 4th year		
=12000	$\left[1 + \frac{10}{100}\right]^4$	=12000 * 1.4641 = 17,569/-
5. for Rs.14,000/- at the end of 5th year		
=14000	$\left[1 + \frac{10}{100}\right]^5$	=14000 * 1.6 = 22,540/-

Section – C

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

7. Explain in detail Goals 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.

GOAL	OBJECTIVES	ADVANTAGES	DISADVANTAGES
Profit maximization	Large amount of profits	1. Easy to calculate profits 2. Easy to determine the link between financial decisions and profits	1.Emphasizes the short term gains 2.Ignores risk or 3.Ignores the timing of returns 4.Requires immediate resources
Shareholders Wealth Maximization	Highest market value of shares	1. Emphasizes the long term gains 2. Recognises risk or uncertainty 3. Recognizes the timing of returns 4. Considers sharholder's return	1.Offers no clear relationship between financial decisions and share price 2.Can lead to management anxiety and frustration

General objectives

- a. **Balanced asset structure:** A proper balance between the fixed and current assets is an important factor for efficient management of an organization maximizes the present value not only for shareholders but for all including employee, customers, suppliers at large and for efficient of funds. This is one of the objectives of financial management that the size of current asset must permit the company to exploit the investment on fixed asset.
- b. **Liquidity:** Liquidity refers to available cash it is an indication of positive growth of a company. It is an important factor for meeting the short and long term obligation of a firm
- c. **Proper Planning of funds:** Proper planning of funds include acquisition and allocation of funds in the best possible manner i.e., minimum cost of acquisition of funds but maximum decision
- d. **Efficiency:** Efficiency and effectiveness are very much necessary in controlling the flow of funds. The efficiency level should continuously increase for betterment of the organization.

8. What do you mean by working capital? Explain the determinants of working capital.

Working capital management or current assets management is one of the vital parts of financial management. Working capital is concerned with short term finance or finance required for routine activities or operations. Effective and efficient management of working capital ensures the success of a business. The inefficiency of management may lead to loss, which in turn leads to shut down of business operations.

FACTORS DETERMINING WORKING CAPITAL REQUIREMENT

1. Nature or character of business
2. Size of business/scale of operations
3. Production policy
4. Manufacturing process/Length of production cycle
5. Seasonal variation
6. Working capital cycle
7. Rate of stock turnover
8. Credit policy
9. Business cycles
10. Rate of growth of business
11. Earning capacity and dividend policy
12. Price level changes
13. Other factors

9. The information given below is related to “E” Company Ltd.

Initial Investment is Rs.2,00,000/-, Salvage value is 10%, Economic life of project 5 years

The expected profit before depreciation and Tax is given below (PBDT)

Year	1	2	3	4	5
PBDT	38,000	48,000	58,000	68,000	78,000

PV Factor: @ 10% Discount rate is

Year	1	2	3	4	5
PV Factor	0.909	0.826	0.751	0.683	0.621

You are required to Calculate ARR and NPV

Solution: Calculation of Average Annual Income

Particulars	Amount
Average Earnings before Depr & Tax	58,000
Less: Depreciation	36000
Average earnings before tax	22,000
Less: Tax @ 50%	11000
Average Earnings after tax	11,000

Working Notes:

1. Calculation of average earnings before Depr & Tax

$$\begin{aligned} &= \frac{\text{Total Income}}{\text{No. of Years}} \\ X &= \frac{38000+48000+58000+68000+78000}{5} = \frac{290000}{5} = 58000 \end{aligned}$$

2. Calculation of Depreciation

$$\begin{aligned} &= \frac{\text{Orginal Investment} - \text{Scrap Value}}{\text{Life of the asset}} \\ &= \frac{200000 - 20000}{5} = 36000 \end{aligned}$$

3. Calculation of Average Investment

$$\begin{aligned} \text{Average Invest} &= \frac{(\text{Original Investment} - \text{Scrap})}{2} + \text{WC} + \text{Scrap} \\ &= \frac{(200000-20000)}{2} + 0 + 20000 = 110000/- \end{aligned}$$

Calculation of ARR

$$\text{ARR} = \frac{\text{Average Annual income after tax}}{\text{Average Investment}} = \frac{11000}{110000} = 10\%$$

10. The Ranga Co.Ltd. Operates its business with a equity capital of Rs.50,00,000/- of Rs.100 per share. Co. wants to raise further Rs.30,00,000/- for major expansion programme with following 4 alternative plans:

- All equity shares
- All debentures at 10% interest rate
- Rs.10,00,000/- from equity and Rs.20,00,000/- from 10% Debentures
- Rs.15,00,000/- from equity and Rs.15,00,000/- from 10% Pre.Shares

The Co. Tax rate is 50%. Calculate EPS of each plan if EBIT is Rs.8,00,000/-

Solution: Analysis Table

Particulars	I	II	III	IV
Equity share capital	50,00,000	50,00,000	50,00,000	50,00,000
Additional Equity share capital	3000000		1000000	1500000
Debenture (interest)		300000	200000	
Preference shares				150000
Total Equity share capital	80,00,000	50,00,000	60,00,000	65,00,000
Face Value	100	100	100	100
No of Equity shares	80000	50000	60000	65000

Calculation of EPS

Particulars	I	II	III	IV
EBIT	800000	800000	800000	800000
Less: Interest (3000000*10%)	0	300000		0
Less: Interest (2000000*10%)			200000	
Earning after interest before Tax	800000	500000	600000	800000
Less: Tax @ 50%	400000	250000	300000	400000
EBT	400000	250000	300000	400000
Less: Preference shares (15lac*10%)	0	0	0	150000
Earning available for Eqt shareholders	400000	250000	300000	250000

EPS = Earnings available for Eqt shareholders	400000	250000	300000	250000
No of Equity shares	80000	50000	60000	65000
	5.00	5.00	5.00	3.85

11. From the following information calculate pay-back period of both the machines Raja and Roja

Particulars	Machine Raja	Machine Roja
Cost of each machine	5,00,000	6,00,000
Life	5 years	6 years
Co. Tax rate	50%	50%
PBDT (Profit before Dep. & Tax)		
1 year	1,10,000	1,80,000
2 year	1,40,000	2,10,000
3 year	1,70,000	2,40,000
4 year	1,60,000	1,90,000
5 year	1,30,000	2,00,000

Solution:

Calculation of Payback Period

Year	Machine Raja (A)	Depr (B)	EBT (A-B) = C	Tax 50% (C * 50%) = D	EAT C-D	Dep	Cash flow (EBIT + Dep)	Cash flow
1	110000	100000	10,000	5000	5,000	100000	1,05,000	1,05,000
2	140000	100000	40,000	20000	20,000	100000	1,20,000	2,25,000
3	170000	100000	70,000	35000	35,000	100000	1,35,000	3,60,000
4	160000	100000	60,000	30000	30,000	100000	1,30,000	4,90,000
5	130000	100000	30,000	15000	15,000	100000	1,15,000	6,05,000

Pay Back Period = 4 years + 10000/115000 = 4+ 0.086
=4.086 years

Year	Machine Raja (A)	Depr (B)	EBT (A-B) = C	Tax 50% (C * 50%) = D	EAT C-D	Dep	Cash flow (EBIT + Dep)	Cash flow
1	180000	100000	80,000	40000	40,000	100000	1,40,000	1,40,000
2	210000	100000	1,10,000	55000	55,000	100000	1,55,000	2,95,000
3	240000	100000	1,40,000	70000	70,000	100000	1,70,000	4,65,000
4	190000	100000	90,000	45000	45,000	100000	1,45,000	6,10,000
5	200000	100000	1,00,000	50000	50,000	100000	1,50,000	7,60,000

Pay Back Period = 3 years + 35000/145000 = 3+ 0.93
=3.93 years