**CHAPTER - 9**

**FINANCIAL MANAGEMENT**

Q1. \_\_\_\_\_\_\_\_\_\_\_ is about the quantum of finance to be raised from various long term sources. (1)

(a) Investment Decision

(b) Financing Decision

(c) Dividend Decision

(d) Capital Budgeting Decision

Q2. Which of the following is a factor affecting Capital Budget Decision? (1)

(a) Cash flows of the project

(b) The rate of return of the project

(c) Amount of investments ,interest rate ,etc.

(d) All of these

Q3. Borrowing @10% and the tax rate @30% means the after tax cost of debt is \_\_\_\_\_\_\_\_\_\_\_\_. (1)

(a) 20%

(b) 7%

(c) 3%

(d) 10%

Q4. Financial planning arrives at : (1)

(a) minimizing the external borrowing by resorting to equity issues

(b) entering that the firm always have significantly more fund than required so that there is no paucity of funds

(c) ensuring that the firm faces neither a shortage nor a glut of unusable funds

(d)doing only what is possible with the funds that the firms has at its disposal.

Q5. Higher Debt-equity ratio results in :

(a) lower financial risk

(b) higher degree of operating risk

(c) higher degree of financial risk

(d) higher EPS

Q6. The time lag between the placement of order and the actual receipt of the materials is called \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_.

(a) Production cycle

(b) Processing cycle

(c) Operating cycle

(d) Lead time

Q7. Financial management is based on three broad financial decisions. What are these? (3)

Q8. Discuss about working capital affecting both the liquidity as well as profitability of a business. (3)

Q9. A capital budgeting decision is capable of changing the financial fortune of a business. Do you agree? Why or why not? (4)

Q10. Explain the importance of having a financial plan for this company. (4)

Q11. What are the factors affecting financing decision? (4)

Q12. What is meant by working capital? How is it calculated? Discuss five important determinants of working capital requirements. (6)

Q13. Explain factors affecting the dividend decision. (6)

Q14. Explain the term ‘trading on equity’. Why, when and how it can used by a business organisation? (6)

Q15. What is the role and objectives of financial management for this company?(6)

**Answers**

Ans 1. (b) Financing Decision

Ans 2. (d) All of these

Ans 3. (b) 7%

Ans 4. (c) ensuring that the firm faces neither a shortage nor a glut of unusable funds

Ans 5. (c) higher degree of financial risk

Ans 6. (d) Lead time

Ans 7. Financial management is concerned with the solution of three major issues relating to the financial operations of a firm corresponding to the three questions of investment, financing and dividend decision. In a financial context, it means the selection of best financing alternative or best investment alternative. The finance function therefore, is concerned with three broad decision which are as follows  
(i) Investment Decision: The investment decision relates to how the firm’s funds are invested in different assets.  
(ii) Financing Decision: This decision is about the quantum of finance to be raised from various long term sources and short term sources. It involves identification of various available sources of finance.  
(iii) Dividend Decision: This decision relates to distribution of dividend. Dividend is that portion of profit which is distributed to shareholders the decision involved here is how much of the profit earned by company is to be distributed to the shareholders and how much of it should be retained in the business for meeting investment requirements.

Ans 8. The working capital should neither be more nor less than ; required. Both these situations are harmful. If the amount of working capital  
is more than required, it will no doubt increase liquidity but decrease profitability. For instance, if large amount of cash is kept as working capital, i then this excessive cash will remain idle and cause the profitability to fall.  
On the contrary, if the amount of cash and other current assets are very ‘ little, then lot of difficulties will have to be faced in meeting daily expenses  
and making payment to the creditors. Thus, optimum amount of both current assets and current liabilities should be determined so that profitability of the business remains intact and there is no fall in liquidity.

Ans 9. Investment decision can be long term or short term. A long term investment decision is also called a capital budgeting decision. It involves commiting the finance on a long term basis, e.g., making investment in a new machine to replace an existing one or acquiring a new fixed assets or opening a new branch etc. These decisions are very crucial for any business. They affect its earning capacity over the long-run, assets of a firm, profitability and competitiveness, are all affected by the capital budgeting decisions. Moreover, these decisions normally involve huge amounts of investment and are irreversible except at a huge cost. Therefore, once made, it is almost impossible for a business to wriggle out of such decisions. Therefore, they need to be taken with utmost care. These decisions must be taken by those who understand them comprehensively A bad capital budgeting decision normally has the capacity to severely damage the financial fortune of a business.

Ans 10. Importance of financial plan for the company  
(i) Financial Planning ensures provision of adequate funds to meet working capital requirements.  
(ii) It brings about a balance between in flow and out flow of funds and ensures liquidity throughout the year.  
(iii) It solves the problems of shortage and surplus of funds and ensures proper and optimum utilisation of available resources.  
(iv) It ensures increased profitability through cost benefit analysis and by avoiding wasteful operations.  
(v) It seeks to eliminate waste of funds and provides better financial control.  
(vi) It seeks to avail the benefits of trading on equity

## Ans 11. Factors Affecting Financing Decisions:

While taking financing decisions the finance manager keeps in mind the following factors:

1. Cost: The cost of raising finance from various sources is different and finance managers always prefer the source with minimum cost.

2. Risk: More risk is associated with borrowed fund as compared to owner’s fund securities. Finance manager compares the risk with the cost involved and prefers securities with moderate risk factor.

3. Cash Flow Position: The cash flow position of the company also helps in selecting the securities. With smooth and steady cash flow companies can easily afford borrowed fund securities but when companies have shortage of cash flow, then they must go for owner’s fund securities only.

4. Control Considerations: If existing shareholders want to retain the complete control of business then they prefer borrowed fund securities to raise further fund. On the other hand if they do not mind to lose the control then they may go for owner’s fund securities.

5. Floatation Cost: It refers to cost involved in issue of securities such as broker’s commission, underwriters fees, expenses on prospectus, etc. Firm prefers securities which involve least floatation cost.

Ans 12 . Working capital is that part of total capital which is required to H meet day-to-day expenses, to buy raw materials, to pay wages and other  
expenses of routine nature in the production process or we can say it refers 2 to excess of current assets over current liabilities.  
Working Capital = Current Assets – Current Liabilities  
Factors affecting working capital requirement are :  
(i) Nature of Business The basic nature of a business influences the  
amount of working capital required. A trading organisation usually needs a lower amount of working capital compared to a manufacturing organisation. This is because in trading, there is no processing required. In a manufacturing business, however, raw materials need to be converted into finished goods, which increases the expenditure on raw material, labour and other expenses,  
(ii) Scale of Operation : The firms which are operating on a higher scale of operations, the quantum of inventory, debtors required is generally high, Such organisations, therefore, require large amount of working capital as compared to the organisations which operate on a lower scale.  
(iii) Production Cycle : Production cycle is the time span between the receipts of raw materials and their conversion into finished goods.  
Some businesses have a longer production cycle while some have a shorter one. Working capital requirement is higher in terms with longer processing cycle and lower in firms with shorter processing cycle.  
(iv) Credit Allowed : Different firms allow different credit terms to their customers. A liberal credit policy results in higher amount of debtors, increasing the requirements of working capital.  
(v) Credit Availed : Just as a firm allows credit to its customers it also may get credit from its suppliers. The more credit a firm avails on its purchases, the working capital requirement is reduced.

Ans 13. Dividend decision relates to distribution of profit to the shareholders and its retention in the business for meeting the future investment requirements.  
How much of the profits earned by a company will be distributed as profit and how much will be retained in the business is affected by many factors. Some of the important factors are discussed as follows  
(i) Earnings:Dividends are paid out of current and past year earnings. Therefore, earnings is a major determinant of the decision about dividend.  
(ii) Stability of Earnings:Other things remaining the same, a company having stable earning is in a position to declare higher dividends. As against this, a company having unstable earnings is likely to pay smaller dividend.  
(iii) Growth Opportunities :Companies having good growth opportunities retain more money out of their earnings so as to finance the required investment. The dividend in growth companies, is therefore, smaller than that in non-growth companies.  
(iv) Cash Flow Position: Dividends involve an outflow of cash. A company may be profitable but short on cash. Availability of enough cash in the company is necessary for declaration of dividend by it.  
(v) Shareholder Preference: If the shareholder in general, desire that at least a certain amount should be paid as dividend, the companies are likely to declare the same.  
(vi) Taxation Policy : If tax on dividend is higher it would be better to pay less by way of dividends. As compared to this, higher dividends may be declared if tax rates are relatively lower.  
(vii)Stock Market Reaction: For investors, an increase in dividend is a good news and stock prices react positively to it. Similarly, a decrease in dividend may have a negative impact on the share prices in the stock market.

Ans 14. Trading on equity refers to the increase in profit earned by the equity shareholders due to presence of fixed financial charges. When the rate of earning or Return on Investment (ROI) of a company is higher than the rate of interest on borrowed funds only then a company should opt for trading on equity. Let us consider the following example

|  |  |  |
| --- | --- | --- |
|  | Company 'X' | Company 'Y' |
| Share Capital | 10 lakhs | 4 lakhs |
| Loan @15% p.a. | - | 6 lakhs |
| Total Capital | 10 lakhs | 10 lakhs |
| Profit before interest + Tax | 3 lakhs | 3 lakhs |
| Interest | Nil | 9 lakhs |
| Profit before tax | 3 lakhs | 2.01 lakhs |
| Tax @50% | 1.5 lakhs | 1.05 lakhs |
| Profit after tax | 1.5 lakhs | 1.05 lakhs |
| Share capital | 10 lakhs | 4 lakhs |
| Rate of return on share | 15 lakhs | 26.25 |

It should be clear from the above example, that shareholders of the company ‘X’ have a higher rate of return than company ‘Y’ due to loan component in the total capital of the company.

Ans 15. Role of Financial Management Financial management is concerned with the proper management of funds. It involves  
(i) Managerial decisions relating to procurement of long term and short term funds.  
(ii) Keeping the risk associated with respect to procured funds under control.  
(iii) Utilisation of funds in the most productive and effective manner  
(iv) Fixed debt equity ratio in capital.

Objective of Financial Management   
The objective of financial management is maximisation of shareholder’s wealth. The investment decision, financial decision and dividend decision help an organisation to achieve this objective. In the given situation, S limited envisages growth prospects of steel industry due to the growing demand. To expand the production capacity, the company needs to invest. However, investment decision will depend on the availability of funds, the financing decision and the dividend decision. However, the company will take those financial decisions which result in value addition, i.e., the benefits are more than the cost. This leads to an increase in the market value of the shares of the company.