202- FINANCIAL MANAGEMENT
Unit- 1:

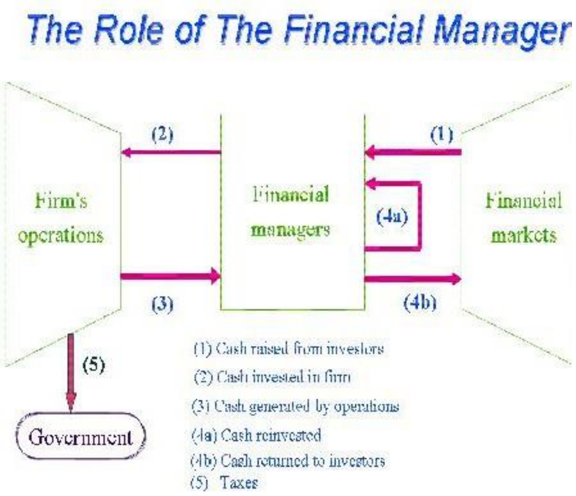
1. What is financial management? Explain the role of financial manager in financial decision making?

Ans:Financial management refers to the efficient and effective management of money (funds) in such a manner as to accomplish the objectives of the organization.

Role of financial manager:

A financial manger is a person who takes care of all the important financial functions of an organization.

- **Raising of Funds**
- **Allocation of Funds**
- **Profit Planning**
- **Understanding Capital Markets**

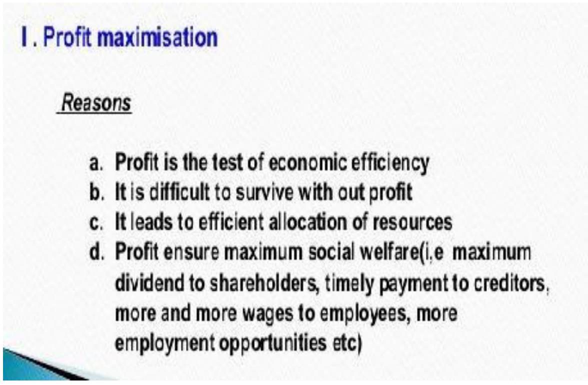


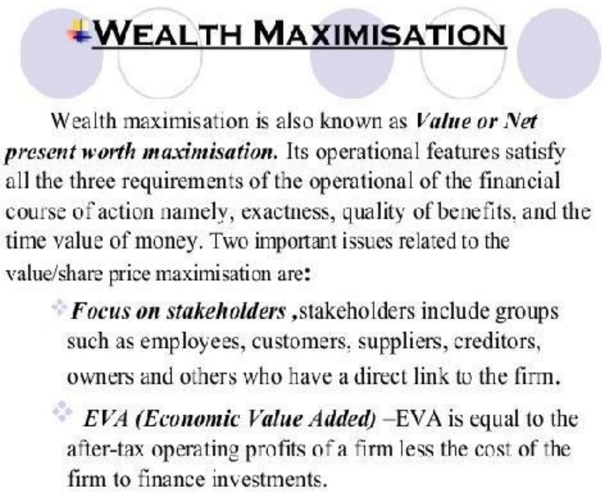
2. Explain the goals of financial management?

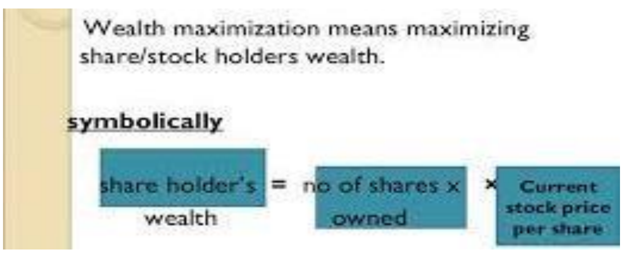
Ans: "Financial Management is the Operational Activity of a business that is responsible for obtaining and effectively utilizing the funds necessary for efficient operation." by Joseph Massie.

POSSIBLE GOALS

- Survive.
- Avoid financial distress and bankruptcy.
- Beat the competition.
- Maximize sales or market share.
- Minimize costs.
- Maximize profits.
- Maintain steady earnings growth.



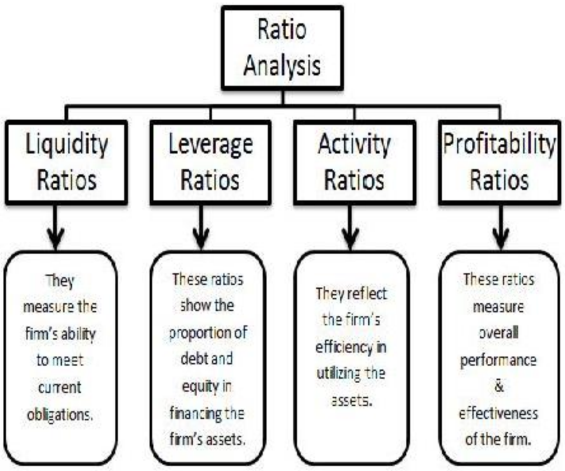




Unit- 2:

3. What is Financial Ratio? Explain the importance of ratio analysis?

Ans: A *financial ratio* or accounting *ratio* is a relative magnitude of two selected numerical values taken from an enterprise's *financial* statements.



Ratio analysis is an important tool for analyzing the company's financial performance. The following are the important advantages,

1. Analyzing Financial Statements
2. Judging Efficiency
3. Locating Weakness
4. Formulating Plans
5. Comparing Performance

4. What is leverage? Explain financial, operating and combined leverages?

Ans: In finance, leverage is any technique to multiply gains and losses.

$$\mathrm{DOL} = \frac{\mathrm{EBIT} + \text{Fixed Costs}}{\mathrm{EBIT}}$$

$$\mathrm{DFL} = \frac{\mathrm{EBIT}}{\mathrm{EBIT} - \text{Total Interest Expense}}$$

$$\mathrm{DCL} = \mathrm{DOL} * \mathrm{DFL} = \frac{\mathrm{EBIT} + \text{Fixed Costs}}{\mathrm{EBIT} - \text{Total Interest Expense}}$$

- Main aim of leverage testing is maximize the earning of shareholder and reduce the risk of company.

Different types of leverage:

operating leverage
financial leverage
combined leverage

Financial leverage

It is second type of leverage . Financial leverage is known as trading on equity . If any company's finance manager knows that company's return on investment is more than interest on loan or borrowing obligation . At this time , if company needs more money , then finance manager gets its loan and bought the asset from same loan . So, any technique in which any asset is purchased with loan and trying to increase EPS , then this is called financial leverage .

Formula for calculating financial leverage

= % change in Earning per share / % change in earning before interest and tax

= % change in EPS / % change in EBIT

This formula explains the relationship between % change in EPS and % change in EBIT and after deep study of this financial leverage , finance manager decides to get appropriate loan for buying assets .

OPERATING LEVERAGE

➢The leverage associated with investment (asset acquisition) activities is referred as operating Leverage.

Formula : operating leverage=contribution/operating profit

Where , contribution=sales-variable cost

operating profit=sales-variable cost-fixed cost

➢Operating leverage is also defined as the ratio of the percentage change in operating income for a given percentage change in sales.

DOL=%change in operating income/%change in sales

➢The risk associated with operating leverage is called operating risk . It is the risk of not being able to cover fixed operating costs by firm

Unit- 3

5. Explain capital structure theories in firm's decision making?

Ans: Capital Structure refers to the mix of securities (Debt & Equity) used to finance the firm's investment projects.

Capital Structure Theories

The total capital structure theories can be categorised into tw relevant and irrelevant theories.

The following are the main theories/Approaches of capital structure:

1. Net income (theory) Approach (Relevant)
2. Net operating income Approach (Irrelevant)
3. Modigliani and Miller Approach (Irrelevant)
4. Traditional Approach (Neutral)

Capital Structure Theories – A) Net Income Approach (NI)

- As per NI approach, higher use of debt capital will result in reduction of WACC. As a consequence, value of firm will be increased.

  Value of firm = $\frac{\text{Earnings}}{\text{WACC}}$

- Earnings (EBIT) being constant and WACC is reduced, the value of a firm will always increase.
- Thus, as per NI approach, a firm will have maximum value at a point where WACC is minimum, i.e. when the firm is almost debt-financed.

Capital Structure Theories – B) Net Operating Income (NOI)

- Net Operating Income (NOI) approach is the exact opposite of the Net Income (NI) approach.
- As per NOI approach, value of a firm is not dependent upon its capital structure.
- Assumptions –
  - *WACC is always constant, and it depends on the business risk.*
  - *Value of the firm is calculated using the overall cost of capital i.e. the WACC only.*
  - *The cost of debt (K_d) is constant.*
  - *Corporate income taxes do not exist.*

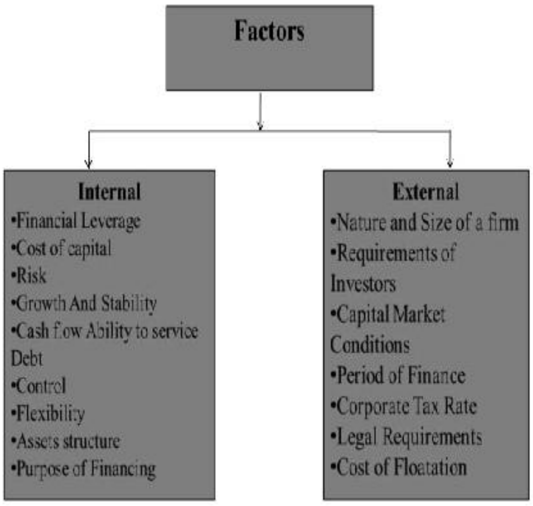
Capital Structure Theories – C) Modigliani – Miller Model (MM)

- MM approach supports the NOI approach, i.e. the capital structure (debt-equity mix) has no effect on value of a firm.
- Further, the MM model adds a behavioural justification in favour of the NOI approach (personal leverage)
- Assumptions –
  - ***Capital markets are perfect and investors are free to buy, sell, & switch between securities. Securities are infinitely divisible.***
  - ***Investors can borrow without restrictions at par with the firms.***
  - ***Investors are rational & informed of risk-return of all securities***
  - ***No corporate income tax, and no transaction costs.***
  - ***100 % dividend payout ratio, i.e. no profits retention***

Capital Structure Theories – D) Traditional Approach

- The NI approach and NOI approach hold extreme views on the relationship between capital structure, cost of capital and the value of a firm.
- Traditional approach (*'intermediate approach'*) is a compromise between these two extreme approaches.
- Traditional approach confirms the existence of an optimal capital structure; where WACC is minimum and value is the firm is maximum.
- As per this approach, a best possible mix of debt and equity will maximize the value of the firm.

Factors determining capital structure



Unit- 4:

6. What is capital Budgeting? Explain Capital Budgeting methods?

Ans: **Capital budgeting**, or **investment appraisal**, is the planning process used to determine whether an organization's long term investments such as new machinery, replacement machinery, new plants, new products, and research development projects are worth the funding of cash through the firm's capitalization structure (debt, equity or retained earnings). It is the process of allocating resources for major capital, or investment, expenditures.

Many formal methods are used in capital budgeting, including the techniques such as

- Accounting rate of return
- Payback period
- Net present value
- Profitability index
- Internal rate of return
- Modified internal rate of return
- Equivalent annual cost
- Real options valuation

The Importance of Capital Budgeting

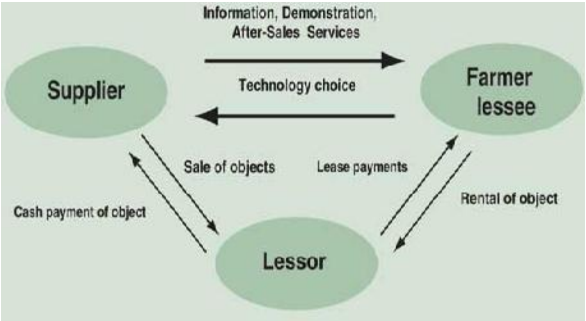
- Develop and formulate long-term strategic goals
- Seek out new investment projects
- Estimate and forecast future cash flows
- Facilitate the transfer of information
- Monitoring and Control of Expenditures
- Creation of Decision

7. Explain Leasing?

Ans: A **lease** is a contractual arrangement calling for the lessee (user) to pay the lessor (owner) for use of an asset.

Common elements of a lease agreement include:

- Names of the parties of the agreement.
- The starting date and duration of the agreement.
- Identifies the specific object (by street address, VIN, or make/model,serial number) being leased.
- Provides conditions for renewal or non-renewal.
- Has a specific consideration (a lump sum, or periodic payments) for granting the use of this object.
- Has provisions for a security deposit and terms for its return.
- May have a specific list of conditions which are therein described as Default Conditions and specific Remedies.
- May have other specific conditions placed upon the parties such as:
  - Need to provide insurance for loss.
  - Restrictive use.
  - Which party is responsible for maintenance.
- Termination clause (describing what will happen if the contract is ended early or cancelled, stating the rights of parties to terminate the lease, and their obligations)



Unit- 5:

8. What is dividend? Explain dividend policy in India?

Ans: A dividend is a distribution of a portion of a company's earnings, decided by the board of directors, to a class of its shareholders. Dividends can be issued as cash payments, as shares of stock, or other property.

Forms/Types of Dividend

- On the basis of Types of Share
  - Equity Dividend
  - Preference Dividend
- On the basis of Mode of Payment
  - Cash Dividend
  - Stock Dividend
  - Bond Dividend
  - Property Dividend
  - Composite Dividend

A Compromise Dividend Policy

This policy is based on five main goals: (in the order of importance)

1. Avoid cutting back on positive NPV projects to pay a dividend
2. Avoid dividend cuts
3. Avoid the need to sell equity
4. Maintain a target debt-equity ratio
5. Maintain a target dividend payout ratio.

- Debt-Equity ratio is viewed as long-range goal, it is allowed to vary in short run if necessary to avoid a dividend cut or the need to sell the new equity.
- One can minimize the problems of dividend instability by creating two types of dividends : regular and extra.

Factors Affecting Dividend Policy of A Firm

- Legal requirements
- Firm's liquidity position
- Repayment need
- Expected rate of return
- Stability of earning
- Access to the capital market

9. What is working capital? Explain the principles of working capital?

Ans: Working capital is the difference between the current assets and the current liabilities.

$$WorkingCapital = CurrentAssets - CurrentLiabilities$$

Figure 1:

A Typical Working Capital Cycle

Working Capital Cycle (in days) ≈ DIO + DSO – DPO

Principle of working capital management

1) Principle of equity position: as per this principle every investment in the current assets should contribute to the net worth of the firm. The position of current assets can be well judged by the two ratios; current assets to total asset and current asset to total sales.

2) Principle of cost of capital: different sources of working capital finance have different cost of capital. Generally there is –ve relationship between the risk and cost of capital, which means more the risk less will be the cost and less the risk more will be the cost. So there should be balance between the two.

3) Principle of maturity of payment: as per this principle the firm should make an every effort regarding the maturity of payment. In case the period to pay back the liabilities is short than it becomes difficult for the firm to meet it obligations in time.

4) Principle of risk variation: there is direct relationship between risk and profitability.