Biyani's Think Tank

Concept based notes

Elements of Financial Management

(B. Com. Part-II (Pass))

Dr. Devika Agarwal

Associate Professor

Deptt. of Commerce and Management,

Biyani Girls College, Jaipur

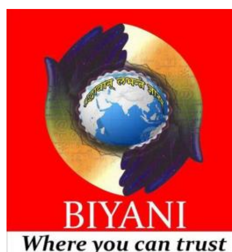
Mr. Mukul Sharma

Lecturer

Deptt. of Commerce and Management

Biyani Girls College, Jaipur

GURUKPO
Get Instant Access to Your Study Related Queries...



Published by :

Think Tanks

Biyani Group of Colleges

Concept & Copyright :

Biyani Shikshan Samiti, Sector-3, Vidhyadhar Nagar, Jaipur-302 023 (Rajasthan)

Ph : 0141-2338371, 2338591-95 | Fax : 0141-2338007

E-mail : acad@biyanicolleges.org

Website :www.gurukpo.com; www.biyanicolleges.org

ISBN :- 978 – 93 – 83462 – 89 – 6

Edition: 2012

Revised Edition 2023

GURUKPO
Get Instant Access to Your Study Related Queries...

While every effort is taken to avoid errors or omissions in this Publication, any mistake or omission that may have crept in is not intentional. It may be taken note of that neither the publisher nor the author will be responsible for any damage or loss of any kind arising to anyone in any manner on account of such errors and omissions.

Leaser Type Setted by :

Biyani College Printing Department

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 onscientific 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

□ □ □

Get Instant Access to Your Study Related Queries.

University of Rajasthan, Jaipur B.Com. Part II (P)

Paper-II – Elements of Financial Management

Minimum Pass Marks: 36 3 Hours duration

Unit-1

Meaning, scope, importance and limitation of Financial Management Tasks and responsibilities of a Modern finance manager. Financial Analysis: Financial statements - Income statement and Balance- Sheet. Techniques of financial analysis.

Unit-II

Ratio analysis, Liquidity, Activity, Profitability and Leverage Ratios, Funds flow analysis-Sources and uses of funds. Preparation of statement of changes in working capital and statement of source and uses of funds. Cash Flow Analysis: Source and uses of cash, Cash Flow Statement as per AS-3.

Unit-III

An introduction study of financial planning and forecasting. Break even analysis. Sources of short-term and long terms finance. Equity v/s debt.

Unit-IV

Working Capital management – concept and significance. Determinants and Estimation of Working Capital, Adequate working capital, Merits and demerits. And Estimation of Working Capital, Adequate working capitals, Merits and demerits. Management of cash and marketable securities.

Unit - V

Receivables and inventory management. Elementary study of capital budgeting including methods of evaluating capital expenditure proposal under certainty. Dividend policy.

GURUKPO Get Instant Access to Your Study Related Queries...

Contents

S. No.	Chapter Name
1	Meaning, Scope, Importance and Limitation of Financial Management
2	Ratio Analysis, Liquidity, Activity, Profitability and Leverage Ratios. Funds flow analysis-Sources and uses of funds. Preparation of statement of changes in working capital and statement of source and uses of funds Cash Flow Statement
3	Break Even analysis An Introduction Study of Financial Planning and Forecasting. Short term and Long term sources of Finance: Equity vs. Debt.
4	Working capital management Management of cash and Marketable Securities.
5	Receivables and Inventory management Elementary study of Capital Budgeting including methods of evaluating capital expenditure proposal under certainty. Dividend Policy
6	Multiple Choice Questions
7	Key Terminologies
8	Previous Year Question Paper

GURUKPO Get Instant Access to Your Study Related Queries...

Unit 1

Meaning, Scope, Importance and Limitation of Financial Management

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

Ans. Introduction: Financial management has emerged as an interesting and exciting area for academicians 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

<table>
<tr><td rowspan="4">Financial Management</td><td>Planning</td><td rowspan="4">of</td><td rowspan="2">Raising of funds</td><td rowspan="4">For Achieving Goals of an Organization</td></tr>
<tr><td>Organizing</td></tr>
<tr><td>Coordinating</td><td>Investment of Funds</td></tr>
<tr><td>Controlling</td><td>Distribution of Funds</td></tr>
</table>

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.

Q2. 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 school of thought
2. Modern school of thought

While Traditional 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.

GURUKPO Get Instant Access to Your Study Related Queries...

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 economist's concept of profit is different than 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 shareholder`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.
- It 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.

GURUKPO Get Instant Access to Your Study Related Queries...

Q3. 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

GURUKPO Get Instant Access to Your Study Related Queries...

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:

1. 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.

2. 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.

3. 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 lookin 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 andfor 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 arisingout of Internal & External factors

E) Other Functions of Modern Age

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

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

o 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.

o 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.

GURUKPO Get Instant Access to Your Study Related Queries...

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 andmore 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 financeis 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, increasein 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. such as Production Dept., Marketing Dept., Personnel Dept., Material/ Inventory Dept. and many more. 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.

FINANCIAL ANALYSIS TECHNIQUES

Q. What are Financial Analysis Techniques? 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.

GURUKPO Get Instant Access to your Study Related Queries.

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:

A) 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.

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.

B) 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.

GURUKPO Get Instant Access to Your Study Related Queries...

Unit 2

Ratio Analysis, Liquidity, Activity, Profitability and Leverage Ratios.

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

Cash Flow Statement

Q1. What are Financial Analysis techniques? 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:

i. Horizontal and Vertical Analysis ii. Ratios Analysis

1. Horizontal and Vertical Analysis: Same as Unit 1

2. Ratio 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.

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 obligation 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

GURUKPO Get Instant Access to Your Study Related Queries...

- 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.

GURUKPO Get Instant Access to your Study Related Queries...

Funds flow analysis

Q. 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 & 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

GURUKPO Get Instant Access to Your Study Related Queries...

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

Cash flow Statement

Q. What do you mean by Cash Flow Statement? Explain all the three activities under As-3?

- **Meaning of Cash Flow and Cash Flow Statement:**

o **Cash Flow:** A cash flow is the inflow (receipt) and the outflow (payment) of Cash and Cash equivalents, where cash and cash equivalents include Cash, Bank Balance, Marketable Securities, etc.(unless specified otherwise, Current Investments are considered as Marketable Securities).

o **Cash Flow Statement:** It is a statement that shows the inflows and the outflows of Cash and Cash Equivalents during the period. Inflows are those transactions that increase the Cash and Cash Equivalents and outflows are those transactions that decrease the Cash and Cash Equivalents. Such statement is prepared in accordance with the Accounting Standard-3(Revised) on Cash Flow Statement. As per this accounting standard, cash flows are showed under the following 3 heads:

- Cash Flow from Operating Activities;
- Cash Flow from Investing Activities; and
- Cash Flow from Financing Activities.

- **Cash Flow from Operating Activities:** Activities related to core or principal revenue generating activities of an enterprise.

Cash Inflows:	Cash Outflows:
i. from Cash Sales	i. Cash Purchases
ii. from Debtors	ii. Payment to creditors
iii. as Commission and Royalty	iii. Payment of wages

- **Cash Flow from Investing Activities:** Activities related to sale and purchase of long-term fixed assets and investments.

Cash Inflows:	Cash Outflows:
i. Proceeds from sale of Fixed Assets and Investments ii. Interest and dividend received	i. Purchase of long term fixed assets such as Land & Building, Plant & Machinery, Investments, etc.

- **Cash Flow from Financing Activities:** Activities related to capital or long term funds of an enterprise.

Cash Inflows:	Cash Outflows:
i. Proceeds from Issue of Shares and Debentures for Cash ii. Proceeds from Long-term Borrowings such as Bonds, Loans, etc.	i. Repayment of Loans ii. Redemption of Preference Shares and Debentures iii. Buy-back of Equity Shares iv. Payment of Dividend & Interest, etc.

- **Objectives of Cash Flow Statement:** It is prepared:

1. to determine the sources of Cash and Cash Equivalents under operating, investing and financing activities of the enterprise.
2. to determine the applications of Cash and Cash Equivalents for operating, investing and financing activities of the enterprise.
3. to determine the net change in Cash and Cash Equivalents due to cash inflows and outflows for operating, investing and financing activities of the enterprise that take place between the 2 balance sheet dates.

- **Importance or Uses of Cash Flow Statement:** Preparation of Cash Flow Statement is helpful for following reasons:

1. To facilitate Short-term Planning: It helps in planning investments and assessing the financial requirements of the enterprise based on information provided in the statement about the sources and applications of Cash and Cash Equivalents.
2. To manage Cash Efficiently: It provides information about the cash position by reflecting either a surplus of cash or a deficit of cash in the statement. This helps the enterprise to take decisions about the investment of surplus cash and the arrangement of deficit funds.
3. To facilitate Comparative Study: It facilitates the comparison of actual cash flows with the budgeted cash flows to identify whether the inflows and outflows of cash are moving as per the plan. Such comparison will also reflect deviations of the actual cash flows from the budgeted cash flows for which necessary actions are then taken by the enterprise.
4. To justify Cash Position: Cash flow statement is prepared to record all the cash inflows and outflows which result in the surplus or deficit of cash for an enterprise. Since, all the cash transactions are presented in

GURUKPO Get Instant Access to Your Study Related Queries...

the statement, it becomes easy to identify the items which increase or decrease the cash balances.

5. To assess Liquidity and Solvency: It helps in identifying the ability of the enterprise to meet its liabilities on time.
6. To evaluate Management Decisions: This statement classifies the cash transactions under 3 separate heads namely, operating, investing and financing. Such classification helps the users of the statement to evaluate whether the decisions taken by the management are appropriate from investing and financing point of view.
7. To take dividend decisions: In order to declare or approve the dividends, every enterprise should comply with the prescribed provisions e.g. depositing the amount of dividend in a separate bank, etc. Accordingly, to identify whether the enterprise has sufficient funds for such compliance cash flow statement is referred by the management. Also, it helps in deciding how much dividend the enterprise should pay during a particular year.

- **Limitations of Cash Flow Statement:**

1. Non-cash transactions are not shown: It takes into consideration only cash inflows and cash outflows. Non-cash transactions are not considered for preparation of cash flow statement.
2. Not a substitute for an Income Statement: Cash flow statement cannot be used as a substitute for an Income Statement because Income Statement is prepared on accrual basis of accounting whereas cash flow statement is prepared on cash basis. Also, it is not possible to compute net profit or loss from the cash flow statement.
3. Not a substitute for Balance Sheet: Cash flow statement do not show the financial position of the enterprise and therefore, cannot be used as a substitute for Balance Sheet.
4. Historical in Nature: Cash flow statement is prepared based on the cash inflows and outflows that have already taken place during the year and hence, it is historical in nature.
5. Assessment of Liquidity: Cash flow statement takes into consideration all the transactions of cash and cash equivalents. This cash and cash equivalents is just one of the components in the current assets which determine the liquidity position of the enterprise. Therefore, cash flow statement alone cannot help in determining the liquidity position of the enterprise.
6. Accuracy of Cash Flow Statement: Since, the cash flow statement is prepared from the financial statements of an enterprise, accuracy of the same shall depend upon how accurately the financial statements of the enterprise are prepared.

Unit 3

Break Even analysis

Q. 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:

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

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

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

GURUKPO Get Instant Access to Your Study Related Queries.

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:

1. Financial Resources (FR) 2. Financial Tools (FT)

3. 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.

GURUKPO Get Instant Access to your Study Related Queries...

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. 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

GURUKPO Got Insight Access to Your Study Related Queries...

- 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. 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 and profitability in concern.

GURUKPO Get Instant Access to Your Study Related Queries...

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

Q. 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 expenses 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, partly convertible debenture

(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.

GURUKPO Get Instant Access to Your Study Related Queries...

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

Unit 4

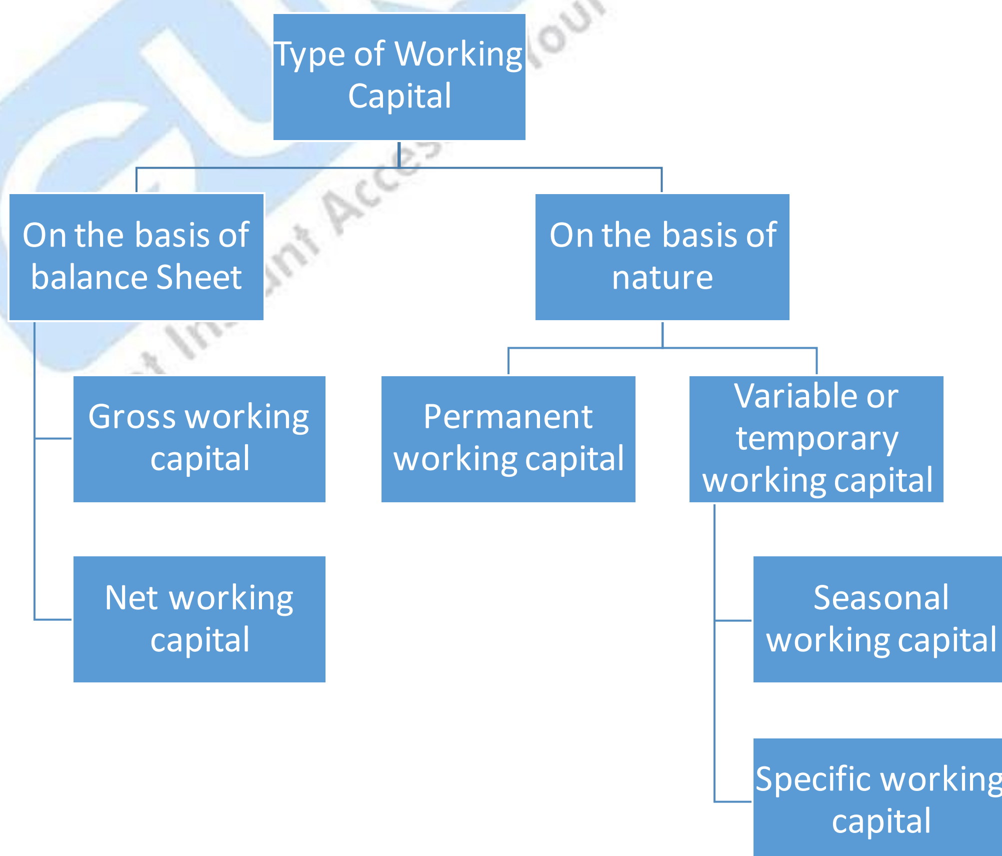
Working capital management

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 & cannot 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.

Q2. 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.

GURUKPO Get Instant Access to Your Study Related Queries.

(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
- Political stability
- Availability of water, power nearly

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

Q3. Working capital is the lifeblood of any business.” Comment. (Significance/Importance of adequate working capital

Ans: **<u>Effects of Adequate capital</u>**

- 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

<u>Inadequate or short working capital</u>

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

GURUKPO Get Instant Access to Your Study Related Queries...

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)**				

GURUKPO Get Instant Access to Your Study Related Queries...

Q4. 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.

Q5. 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:

a. Commercial banks:- in the form of short term loan like short term credit limit, overdraft limit, pledge loan etc.
b. Indigenous bankers/private money lenders in case of small business organization
c. Trade credit :- Receiving goods on credit from suppliers
d. Installment credit :- goods/ assets are purchased and payment is made in installments.
e. Advances from customers/ agents :- against orders received for supplying goods
f. Deferred income :- i.e. incomes received in advance
g. Commercial paper :- issuing unsecured promissory note
h. Public deposits :- accepting deposit for short period i.e. 3 month, 6months etc.

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

GURUKPO Get Instant Access to Your Study Related Queries...

1. Shares – In the form of equity shares, preference shares, deferred shares etc.
2. Debentures – debentures may be of different type ie secured, unsecured, redeemable, unredeemable convertible, non-convertible etc.
3. Ploughing back of profit- retaining profit for growth. It is a internal source and a source which is cost free.
4. Public deposits – accepting fixed deposits from public for a period of one year and above.
5. 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.

Management of cash and Marketable Securities.

Q1. 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:-

1) Transaction motive: - Refers to cash required for making payments like wages, operating expenses, taxes, dividend, interest etc.
2) Precautionary motive:- To make payment for unpredictable contingencies like strike, lockout, fire, sharp rise in prices etc.
3) 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 and Ratio analysis
- Managing cash flows - Inflows and Outflows of cash
- 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:

(i) 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.

GURUKPO Get Instant Access to Your Study Related Queries...

(ii) 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 & all payments only through this centre. This would help in consolidating all funds in a single account & making a proper schedule of payments/handling fund
(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 & 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.

Q2. 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

GURUKPO Get Instant Access to Your Study Related Queries...

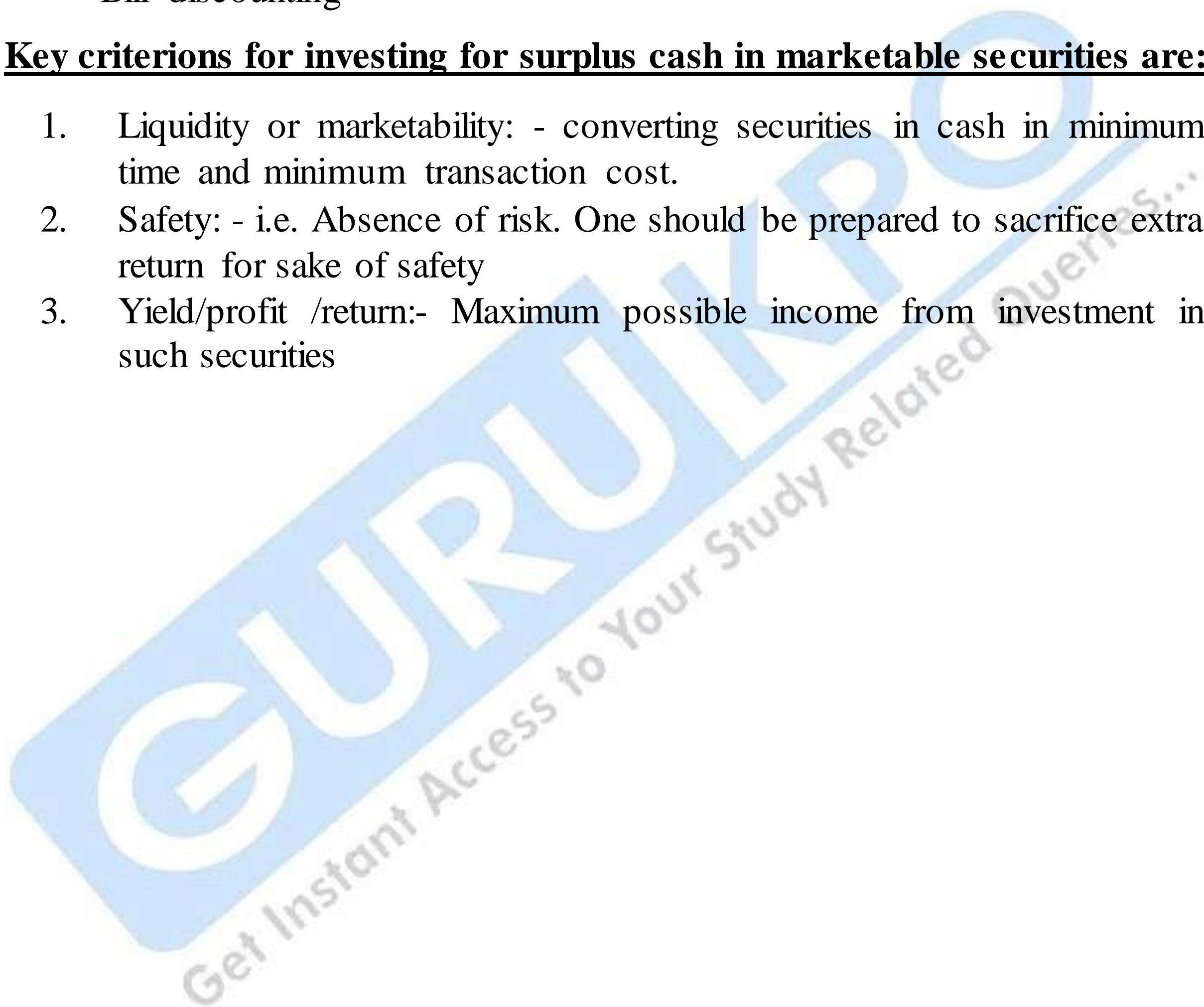
- to convert securities in cash as & when required
- increase return on excess cash through investments
- to maintain a proper mix of investments

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



Unit 5

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.

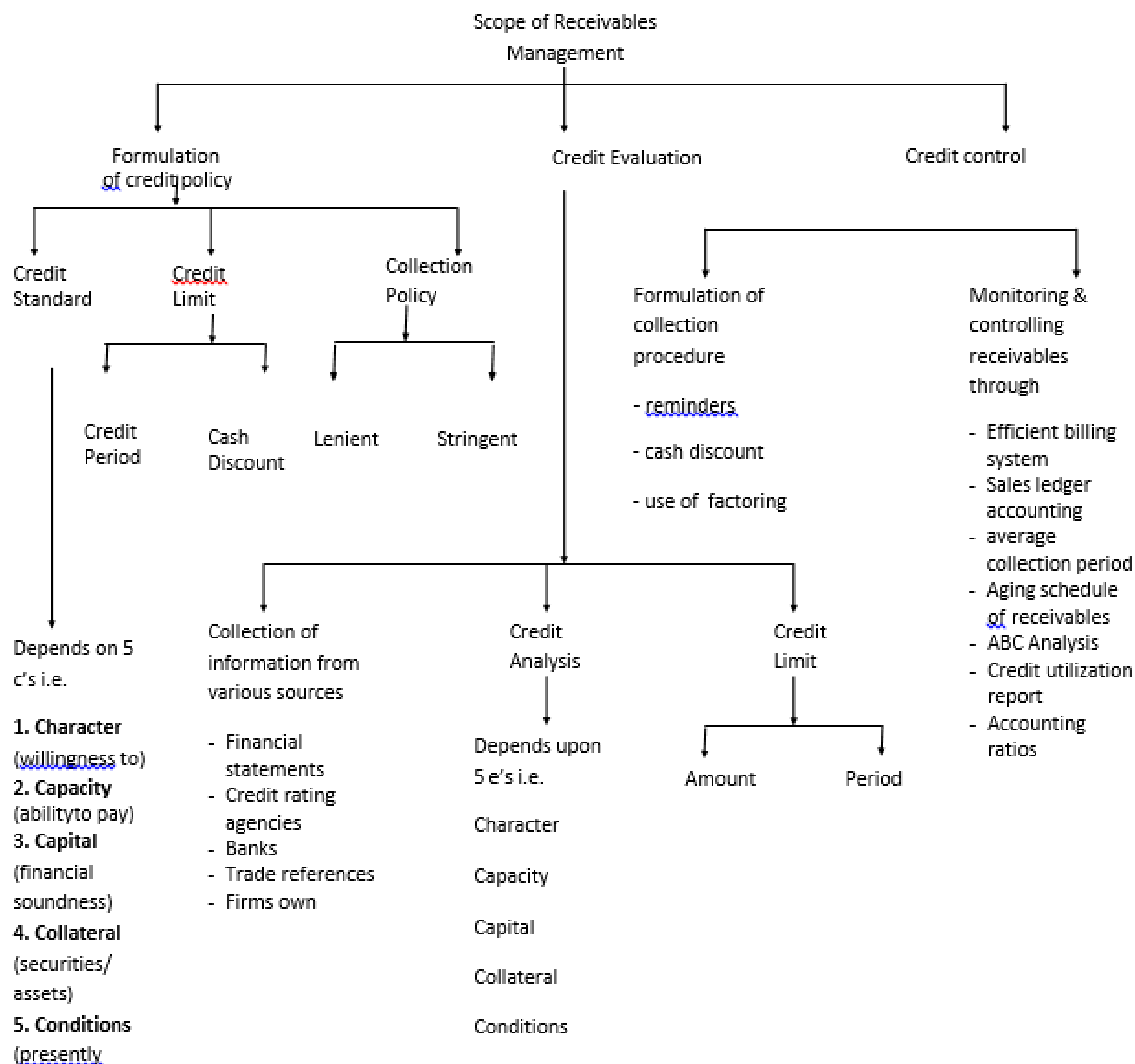
4. Default cost – cost of debtors becoming bad debts

Factors effecting investments in receivables

1. Level of sales – Higher the sales, high would be amount of credit sales & receivable would also be high
2. Nature and conditions of business – In competitive market, more credit sales in consumer durables like furniture, refrigerators etc.
3. Credit policy of firm – If credit policy is liberal, more would be amount of receivables
4. Terms of credit - Terms of cash & trade discount and period in which payment is expected from debtors.
5. 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.

GURUKPO Get Instant Access to Your Study Related Queries...



Q2. 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.

<u>Various types of risks associated with inventory are.</u>

- 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	Financial objective
(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	(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

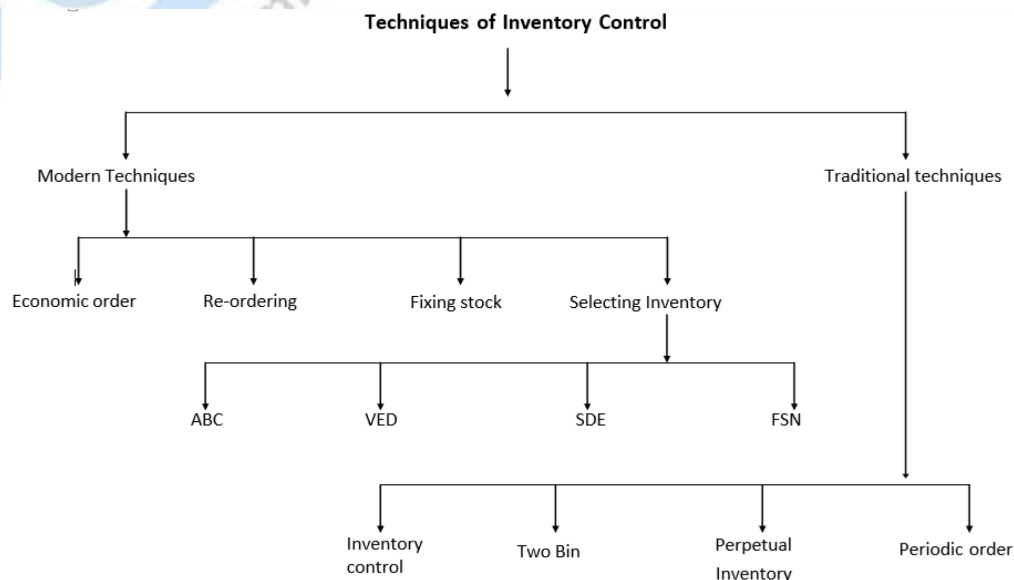
GURUKPO Get Instant Access to Your Study Related Queries...

- 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.

Q3. 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:

1. Material cost – Which include cost of purchasing material/ Goods including transportation cost, sales tax, octroi, handling cost (loading unloading) etc.
2. 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 recor purchase etc. setup costs when items are manufactured internally.
3. 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.
4. 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.



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%
Category "B"	value 20%	Where quantity is 20%
Category "C"	value 10%	Where quantity is 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)

GURUKPO Get Instant Access to Your Study Related Queries...

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

Q1. 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.

GURUKPO Get Instant Access to Your Study Related Queries.

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.

Q2. 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 (6) Other factors- Like fiscal policy (tax concessions, rebate on investments) political stability, global situation etc.

GURUKPO Get Instant Access to Your Study Related Queries...

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.

Ans.

Teachings of capital Budgeting	
Traditional	**Discounted**
Pay back period Post Pay back Profitability Average rate of return	Net present value Profitability index Internal rate of return.

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 cas h 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.

Q4. Which Method Is Better: NPV or 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.

GURUKPO Get Instant Access to Your Study Related Queries...

Q5. Explain the methods of time value of money.

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

1. Compounding/ future value :- 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. Discounting / present value -- 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.

$PV = \frac{FV}{(1+k)^n}$ or PV= FV* PVIF (k,n)

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

Dividend Policy

Q1. 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 -

1. Type of Security – Preference Dividend, - Equity Dividend
2. Timings of Dividends – Interim Dividend – Regular Dividend
3. 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.

GURUKPO Get Instant Access to Your Study Related Queries...

- **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

1. Legal requirements: As per companies Act, dividend only out of earned profit.
2. Liquidity position: In tight liquidity position, instead cash dividend, bonus shares or scripts/bonds are issued.
3. Trade Cycle: In boom conditions, higher profits are there and hence high dividend.
4. Expectations of share holders
5. Future Needs: If future needs are high, low dividend and high retained earnings.
6. Debt repayment: If heavy debt liability, low dividend.
7. Stability of Income: If income is stable, high dividend.
8. Public Opinion: High dividend to gain public confidence.
9. 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 (R) 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:

GURUKPO Get Instant Access to Your Study Related Queries...

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. $\frac{(opening + closing\ stock)}{2}$.

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 = $\frac{1}{360}$

3. Average stock of WIP = $\frac{\text{opening WIP + Closing WIP}}{2}$

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 = $\frac{1}{360}$

3. Average stock of finished goods = $\frac{\text{opening FG Stock + Closing FG Stock}}{2}$

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 = $\frac{1}{360}$

3. Average balance of sundry debtors = $\frac{\text{opening Balance + Closing Balance}}{2}$

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 = $\frac{1}{360}$

3. Average balance of sundry creditors = $\frac{\text{opening Balance + Closing Balance}}{2}$

4. Average payment period = 3/2 = n5 days.

Gross Operating Cycle = n1 + n2 + n3 + n4

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

GURUKPO Get Instant Access to Your Study Related Queries...

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	3454.84
o Work – in – Process	56.15
o Finished Goods	637.92
o Accounts Receivable	756.45
o Accounts Payable	504.18
2. Closing Balances of	
o Raw Materials, Stores and Spares, etc	4095.41
o Work – in – Process	72.50
o Finished Goods	1032.74
o Accounts Receivable	1166.32
o Accounts Payable	3087.47
3. Purchases of Raw Materials, Stores and Spares, etc.	10676.10
4. Manufacturing Expenses etc.	1146.76
5. Depreciation	247.72
6. Customs and Excise Duty	35025.56
7. Selling administration and financial expenses	4557.48
8. Sales	54210.65

Ans. **A. 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

GURUKPO Get Instant Access to Your Study Related Queries.

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.

$$EOQ = \sqrt{\frac{2RO}{C}}$$

Where, R= Annual Requirement, O= Ordering Cost and 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.

$$EOQ = \sqrt{\frac{2*10000*100}{2}} = 1000 \text{ units.}$$

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

GURUKPO Get Instant Access to Your Study Related Queries...

Multiple Choice Questions

1 What is Finance?

1. Getting things on loan
2. Study of money and its flow
3. Finance means money & 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`s
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

GURUKPO Get Instant Access to Your Study Related Queries...

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

GURUKPO Get Instant Access to Your Study Related Queries...

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)- 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. It is 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.

GURUKPO Get Instant Access to Your Study Related Queries.

Bibliography

Sr. No.	Name of the Book	Name of the Author
1	Financial Management	I.M. Pandey
2	Financial Management	M.R. Agrawal
3	Financial Management	Agrawal & Mishra
4	Financial Management	Rustagi
5	Indian Financial System	M.Y. Khan

Suggested Websites

www.wikipedia.com

www.managementstudyguide.com

www.eindiabooks.com

www.studyfinance.com

www.investopedia.com

wps.pearsoned.co.uk

B.Com. | Part II
EAFM - Paper II
(Elements of Financial Management)

2021

Unit I

Q. 1. What do you mean by Financial Management? Discuss the functions of Financial Management.

Ans.— Refer Page No. 6.1Q.No. 1 of the year 2018.

OR

Q. 2. What do you understand by Financial Analysis? Describe the various types of techniques of Financial Analysis.

Ans.—Meaning of Financial Analysis :-Refer Page No. 6.4 Q.No. 2 (or) of the year 2018.

Techniques of Financial Analysis :- Refer Q. No. 1 of the year 2017.

Unit II

Q. 3. What do you mean by Ratio Analysis? Describe the uses and limitations of the Ratio Analysis.

Ans.— Meaning of Ratio Analysis— A ratio is a simple arithmetical expression of the relationship of one number to another and is obtained by dividing the former by the later. In other words, ratios are simply a means of highlighting, in arithmetical terms, the relationship between figure drawn from financial statements; whereas ratio analysis is the process of determining and presenting the relationship of items or group of items in the financial statements. The relationship may be of two types : (i) associate relationship; and (ii) cause/effect relationship. For example, there is an associate relationship betwen cost of revenue from operations and cost of raw material, wheras, there is cause/effect relationship between revenue from operations and profits. Bother the relationships are expressed in terms of ratios. Thus ratio analysis is a device by which the retroactive size and importance of the relationship betwen strategic items or groups of items in the balance sheet and income statement are examined and compared by calculation of ratios.

J. Batty Stated that, "Ratio analysis is used to desribe significant relationship which exists between figures shown on a balance sheet, in a profit and loss account, in a budgetary control system or in any other part of the accounting organisations."

Wixon, Kell and **Bed Ford** states in Accounts Handbook, "Ratio ananlysis is the process of determining and presenting the relationship of items and group of item in the statement."

Thus, Ratio analysis is a multifarious tool for analysing the capital structure. It is the most important tool of evaluating and assessing the efficiency and effectiveness of a concern in various areas of operation. The tool of ratio analysis is not limited merely to the calculation of ratios but ratio analysis is the method of calculating and interpreting numerical relationship based on financial statements. The tool has been widely accepted in mathematical.

Objectives and Utility of Ratio Analysis- Financial ratios are useful because they summarise briefly the results of detailed and complicated computations. **Helfert, Erich A** states that, "The ratio analysis provides guide and clues especially in spotting trend towards better or poor performance and in finding out significant deviation from any average or relatively applicable standard."

As of **J. Batty** has said, "ratios can also assist management in its basic functions of forecasting, planning, co-ordination, control and communication." The following are some of the important objectives and utility or importance of Ratio Analysis :

(1) **Managerial Uses :** Ratio analysis is an invaluable aid to management in discharging its basic functions such as planning, control, communication and decision-making as discussed below:

(i) **Aid in Planning and Forecasting :** Ratios, derived after anlaysing the past results, help the management to prepare budgets and formulate future policies and plans of action. What is to be done in the immediate future is decided on the basis of trend analysis. Thus, ratios are of immense help in business planning and forecasting.

(ii) **Aid in Control :** Trend ratios are compared with standard ratios to measure the degree of variance with the actuals If comparison shows an adverse variance, it is reported to the management to take remedial action and excercise effective control. As such, ratio analysis helps in the effective control of the business affairs.

(iii) **Aid in Communication :** Ratios are effective means of communication. They play an important role in informing about the progress made by the firm to the owners and other parties interested therein. The communication by simplified and summarised ratios is more easy and understandable.

(iv) **Aid in Decision-making :** Ratio analysis highlights on the degree of efficiency of the management and utilisation of assets. This helps management in decision-making.

(2) **Measures Profitability :** The management as well as owners of a firm are primarily concerned with the overall profitability of the firm. Statement of profit and loss reveals the profit earned or loss incurred during a period, but fails to convey the capacity of the firm to earn in terms of per rupee invested or per rupee of sales. Profitability ratios help to measure this earning capacity of the firm. Return on investment, return on capital employed, net profit ratio etc. are the best measures of profitability.

(3) **Facilitates Inter-firm and Intra-firm Comparisons :** Ratio analysis is the basis for comparing the efficiency of various firms in the industry and various divisions of a business firm. Absolute figures are not suitable for this purpose, but accounting ratios are the best tools for inter firm and inter firm comparison.

(4) **Measures Long-term Solvency :** Ratio analysis is equally important in evaluating the long-term solvency of the firm. It is measured by capital structure or leverage ratios. These ratios are helpful to long-term trade payables, security analysts and present and prospective investors, as they reveal the financial soundness or weakness of the firm.

(5) **Expressing Trends :** Trend analysis of ratios reveals whethér financial position of the firm is improving or deteriorating over years because it enables a firm to take the time dimension into account. With the help of such analysis, one can ascertain whether the trend is favourable or adverse. For example, any particular ratio may be less than general ratio but the trend may be increasing. On the contrary, present level may be satisfactory but trend may be declining.

(6) **Measures Operational Efficiency :** Ratios are useful tools in the hands of management to evaluate the firm's performance over a period of time by comparing the present ratios with the past ratios. Various activity or turnover ratios measure the operational efficiency of the firm. These ratios are used, in general, by bankers, investors and other suppliers of credit.

(7) **Knowledge of Liquidity :** By evaluating liquidity the management can judge the operational efficiency of the concern. Liquidity ratios are also very advantageous for the bankers and short-term creditors.

(8) **Setting Standards :** Certain standards for the concern may be established for various economic activities on the basis of various financial ratios. The actual results are compared with the standards and preventive steps are taken by the management.

(9) **Measuring Efficiency :** Ratio analysis is used as a tool for mesuring the efficiency of the management. By comparing the financial results during various time periods of a concern, trends can be established for future forecasting.

(10) **Simplifies Accounting Figures :** Accounting figures in many cases fail to provide information in a desired way. Ratios simplify, summarise and systematise accounting figures which can easily be understood by those who do not know the language of accounting.

(11) **Showing Changes :** Financial ratios are useful in highlighting various changes in financial activities during different time periods. They also helps the management in effective communication and seedy implementation.

Limitations of Ratio Ananlysis

Ratio analysis, as already mentioned, is a useful tool of financial evaluation of business firms. But, it should be kept in view that ratios are only guide in analaysing the financial statements, and not conclusive end in themselves. If these ratios are misused, the results will be incorrect and misleading. Therefore, the analyst should be aware of the weaknesses and limitations of ratio analysis while analysing financial statements on the basis of these ratios. The important limitations are identified as follows:

(1) **It provides only a media of Interpretation :** Ratios are simply tools of analysing and interpretating the financial position of a concern, still a great deal of investigation is needed to be done. Hence more importance must be given to those items which require investigation.

(2) **Lack of Standard Ratios :** In practice, there is no uniformity in the definition of various terms used in ratio analysis. For example, some companies treat net current [assets (current assets) current liabilities] as working capital, while other only current assets. As such, the ratios of one firm cannot be compared with the ratios of other firm or whole industry. Comparison requires ideal ratios. But, in a dynamic financial and economic scenario, it is very difficult to evolve a standard ratio aceptable to all for all times.

(3) **Difference in Accounting Methods and Systems:** Comparability of financial statements is affected when various differences are traced out in accountng methods and systems followed by different firms. Lack of standard formulae for calculating ratios makes it more difficult to compare, as ratios are worked out on the basis of different items in different industries.

(4). **Limited Use of a Single Ratio :** A single ratio used without reference to other ratios gives a false picture of the situation while forming an opinion about the financial position or soundness of an enterprise. The combined effect of various ratios must be taken into account.

(5) **Lack of Qualitative analysis of the problem :** Ratios are arithmetical expressions, so that qualitative aspects cannot be presented through ratios. Normally, qualitative factors that may influence the conclusions drawn are ignored while computing ratios. For instance, a high current ratio may not necessarily mean sound liquid positions when current assets include large inventories consisting obsolete items or major part of debtors is bad. Therefore, in making decisions with the help of ratios, utmost care should be taken.

(6) **Inherent limitations of Accounting :** Ratios are calculated from accounting records which are subject to accounting principles, conventions, concepts and personal judgements. Any ratio based on the facts and figures of such financial statements suffers from inherent limitations. For example, ratio based on under recorded purchase by directors will provide misleading information about the profit and financial soundness of the business.

(7) **No substitute for Sound Judgement :** Ratio analysis is one of the methods of interpretation and drawing inferences. It only provides few information for decision-making. Conclusions drawn from ratio analysis are not sure indicators of bad or good management. They merely convey certain observations which need further investigations, otherwise wrong conclusions may be drawn. Therefore, computations of ratios is not useful unless they are interpreted.

(8) **Possibility of Window-dressing :** Window-dressing means manipulation of accounts in a way so as to present a better picture than what it actually is. By doing so, it is possible to cover up bad financial position. For instance, better liquid position by postponing purchase of desired fixed asset for some time; acceptance of deposits by banks from their customers for a week at the end of the year to show better deposit position etc. Threfore, ratios based on such figures are not realiable.

(9) **Need for Comparative Analysis :** A single ratio would not be able to convey anything, as the single ratio in itself is meaningless, it does not furnish a complete picture, Neither it can be explained, nor any decision can be taken on this basis. Hence it is essential to ponder over all relating ratios while drawing inferences. For example, current ratio alone is not a proper measure of liquidity unless it is supported by all liquidity ratios i.e. acid test ratio,inventory turnover ratio etc.

(10) **Lack of Proper Standards :** There is no single standard ratio against which the calculated (actual) ratio can be compared. This is because of change in nature and circumstances found in diferent firms. Unless they are compared with certain standard ratio they would be useless.

(11) **Effect of Price Level Changes:** Changes in price level affect the comparability of ratios. A change in price level can seriously affect the validity of comparison of ratios for different years. For instance, a firm which has purchased as asset during deflation at low price will show a higher return than the firm which has purchased the asset during inflation at a higher price.

(12) **Effect of Personal Ability and Bias of the Analyst :** Ratios have to be interpreted, but different people may interprete the same ratio in different ways. Ratios are only means of financial analysis, but not an end in themselves. It should be clearly noted that ratios are only tools and the personal judgement of the analysts is more important. If the analyst does not possess requisite qualifications or is biased in interpreting the ratios, the conclusions drawn will prove misleading.

(13) **Future Estimates on the Basis of Pasts :** Ratios are based on past records, hence they cannot be used in trend analysis.

OR

Q. 4. From the following Balance Sheet as on 31st March 2019 and 2020, you are required to prepare a fund flow statement.

Particulars	Note No.	31st March, 2020	31st March, 2019
I Equity and Liabilities :		₹	₹
(1) **Shareholders' Fund**			
(a) **Share Capital**		1,25,000	1,00,000
(b) **Reserve and Surplus**	1	45,300	40,250
(2) **Non-Current Liabilities (Bank Loan)**		67,600	35,000
(3) **Current Liabilities :**			
(a) **Trade Payable : Creditors**			75,000
(b) **Short-term Provision : Tax**		17,500	15,000
Total		2,55,400	2,65,250

			₹	₹
II. Assets :				
(1) Non-Current Assets :				
(a) Fixed Assets:				
(i) Tangible Assets	2		1,79,500	1,75,000
(ii) Intangible Assets : Goodwill			2,500	-
(2) Current Assets :				
(a) Inventories			37,000	50,000
(b) Trade Receivables			32,100	40,000
(c) Cash and Cash Equivalents	3		4,300	250
Total			2,55,400	2,65,250

Notes of Accounts :

		31st March, 2020	31st March, 2019
		₹	₹
(1)	Reserve and Surplus :		
	General Reserve	30,000	25,000
	Surplus	15,300	15,250
		45,300	40,250
(2)	Tangible Assets :		
	Plant	84,500	75,000
	Building	95,000	1,00,000
		1,79,500	1,75,000
(3)	Cash and Cash Equivalents :		
	Cash in Hand	4,000	-
	Cash at Bank	300	250
		4,300	250

Additional informations :

(1) Dividend of ₹11500 was paid

(2) Depreciation written off on plant ₹7000 and on Building ₹5000

(3) Income Tax provision was made during the year ₹16500

Ans.—

Schedule of Changes in Working Capital

(for the year ending 31st March, 2020)

Particulars	31 March, 2019	31 March, 2020	Increase in Working Capital	Decrease in Working Capital
	₹	₹	₹	₹
(A) Current Assets :				
Trade Receivables	40000	32100	-	7900
Inventories	50000	37000	-	13000
Cash in Hand	-	4000	4000	-
Cash at Bank	250	300	50	-
Total (A)	90250	73400		
(B) Current Liabilities :				
Creditors	75000	-	75000	-
Provision for Tax	15000	17500	-	2500
Total (B)	90000	17500		
Net Working Capital (A – B)	250	55900	79050	23400
Increase in Working Capital	55650	-	-	55650
	55900	55900	79050	79050

Fund Flow Statement

(for the year ending 31st March, 2020)

Source of Funds	₹	Uses of Funds	₹
Issue of Share Capital	25,000	Goodwill Purchased	2,500
Increase in Bank Loan	32,600	Plant Purchased	16,500
Funds from Operations	28,550	Dividend paid	11,500
		Increase in Working Capital	55,650
	86,150		86,150

Working Notes :

(i) Adjusted Profit and Loss Account

(for the year ending 31st March, 2020)

Particulars	₹	Particulars	₹
To Dividend paid	11,500	By Balance b/d	15,250
To Depreciation on Plant	7,000	By Fund from Operation (B/F)	28,550
To Depreciation on Building	5,000		
To Transfer to General Reserve	5,000		
To Balance c/d	15,300		
	43,800		43,800

(ii) Plant Acccount

Particulars	₹	Particulars	₹
To Balance b/d	75,000	By Depreciation a/c	7,000
To Cash a/c (Purchase)	16,500	By Balance c/d	84,500
	91,500		91,500

Unit III

Q. 5. Explain the various sources of long-term finance available to a public limited company.

Ans. Refer Page No. 6.32 Q. No. 6 of the year 2017

OR

Q. 6. The following figures relate to a manufacturing company.

	Year-I	Year-II
Sales	₹15,000	₹20,000
Profit	₹1,000	₹2,000

Calculate :

(i) **P/V Ratio**

(ii) **Fixed Cost**

(iii) **Profit on sales of ₹25,000**

(iv) **Variable cost for sales of ₹25,000**

Ans.

(i) $P/V\ Ratio = \frac{Change\ in\ Profits}{Change\ in\ Sales} \times 100 = \frac{2,000 - 1,000}{20,000 - 15,000} \times 100 = \frac{1,000}{5,000} \times 100 = 20\%$

(ii) Fixed Cost = (Sales x P/V Ratio) - Profit

Year I = (15,000 × 20%) - 1,000 = ₹ 2,000

Year II = (20,000 × 20%) - 2,000 = ₹ 2,000

(iii) Profit when Sales are ₹25,000

Profit = (Sales × P/V Ratio) - Fixed Cost

= (25,000 × 20%) - 2,000 = ₹3,000

(iv) Variable Costs for Sales of ₹25,000

Variable Cost = Sales (1-P/V Ratio)

= 25,000 (1-0.20) = ₹ 20,000

Unit IV

Q. 7. Explain "Working Capital". What factors determine the need of working capital?

Ans. Refer Page No. 6.45 Q.No. 8 of the year 2017.

OR

Q. 8. On the basis of the data given below, prepare a cash budget, for the quarter ending June, 2017 and estimate its cash requirements for June, 2017

(i) Sales : February, 2017 ₹25,000

March, 2017 ₹20,000

April to June, 2017 ₹30,000 P.M.

Roughly half the sales are for cash 90% of credit sales are collected in the month following the month of sales and the balance one month later.

(ii) Goods always bought for cash to avail the cash discount of 5%. The purchases for the 2nd quarter (April-June) was 15,000 units per month @₹1 per unit.

(iii) Wages and salaries for 2nd quarter were budgeted at ₹5,000 per month.

(iv) Manufacturing and other expenses for the quarter are as follows :

Cash manufacturing expenses	**₹ 45,00**
Depreciation	**₹ 7,500**
Selling Expenses	**₹ 3,000**

Administrative Expenses ₹2,000 (in April and May only)

Ans.—

Cash Budget

Period-Three months ending June, 2017

Particulars	**April**	**May**	**June**
	₹	₹	₹
Receipts:			
(i) Opening Balance	-	2500	9250
(ii) Cash Sales [1/2 of Sales]	15000	15000	15000

	₹	₹	₹
(iii) Cash collected from Debtors	10,250	14,500	15,000
Total (A)	25,250	32,000	39,250
Payments:			
(i) Cash Purchases (*Less* Cash discount)	14,250	14,250	14,250
(ii) Wages and Salaries	5,000	5,000	5,000
(iii) Cash Manufacturing Expenses (1/3 of ₹4,500)	1,500	1,500	1,500
(iv) Selling Expenses (1/3 of ₹3,000)	1,000	1,000	1,000
(v) Administration Expenses (1/3 of ₹2,000 for April and May only)	1,000	1,000	-
Total (B)	22,750	22,750	21,750
Closing Balance (A-B)	2,500	9,250	17,500

Cash requirement for June 2017 :- ₹21750

Working Note :

1. In absence of information, it has been assumed that there is no cash balance in April.
2. Collection from debtors has been calculated as below :

Particualars	April	May	June
	₹	₹	₹
90% of the credit sales made one month ago	9,000	13,500	13,500
10% of the credit sales made two months ago	1,250	1,000	1,500
Total Collection	10,250	14,500	15,000

3. The amount of depreciation has not been included because of non-cash item.

Unit V

Q. 9. A company uses annual 24000 kg of a material which cost ₹1.25 per kg. Placing each order cost ₹22.50 and the carrying cost is 15% p.a. of the average inventory. Find EOQ and the total inventory cost (including the purchase cost of material).

If procurement time is 12 day and safety stock is 500 kg. Find maximum inventory, re-order point and average inventory. Assume 300 working days in a year.

Ans.—

(i) $EOQ = \sqrt{\frac{2CO}{I}} = \sqrt{\frac{2 \times 24,000 \times 22.50}{15\% \text{ of } ₹1.25}}$

$= \sqrt{\frac{10,80,000}{0.1875}} = 2400$ Units

C= Annual Consumption

O=Ordering cost per order

I= Inventory carrying cost per unit per annum

(ii) Total Cost = Purchases Cost + Ordering Cost + Carrying Cost

$= C \times \text{Price Per unit} + \frac{C}{EOQ} \times O + \frac{EOQ}{2} \times I$

$$= 24{,}000 \times 1.25 + \frac{24{,}000}{2{,}400} \times 22.5 + \frac{2{,}400}{2} \times 0.1875$$

$$= 30{,}000 + 225 + 225 = ₹30{,}450$$

(iii) Maximum Stock Level = EOQ + Safety Stock

= 2,400 + 500 = 2,900 Units.

(iv) Re-order Level (RoL) :

= (Units Consumed per day × Lead time) + Safety Stock

= (24,000/300 × 12) + 500

= 960 + 500 = 1,460 Units.

$$— \quad \frac{\text{Maximum Stock Level} + \text{Minimum Stock Level}}{2}$$

$$\frac{2{,}900 + 500}{2}$$

Note = Minimum Stock Level = Safety Stock

OR

Q. 10. Describe Dividend Policy. Explain the factors determining the divided policy of a company.

Ans. **Meaning of Dividend Policy : Refer Page No. 6.71 Q.No. 10 of the Year 2016.**

Factors Affecting Dividend Policy :

The dividend policy plays and important role in the financial decisions. Therefore it should be properly framed. Time to time dividend policy should be reviewed and necessary changes can be made. Here we can discuss some of the important factors which affect the dividend policy of a company. Some of the important factors are as under :

(1) **Firm's Access to Capital Market :** A company can pay dividend, despite of its weak liquidity position, provided it can sell its debentures or shares in the capital market. Hence, well established and large companies like Videocon International Ltd., Reliance Industries Ltd. etc. can pay dividend at higher rate than new and small companies because of their better access to capital market. The new companies find it difficult to borrow from the market and hence they cannot afford to pay dividends at the higher rates. Therefore, the greater the capacity of the company to raise funds from the capital market, the more will be the dividend paying capacity even in absence of liquid funds.

(2) **Shareholders' Expectations :** The dividend policy should be framed in accordance to the expectations of shareholders. If company's dividend policy does not fulfil the expectations of the shareholders then in future company will not be able to mobilise additional resources from the capital market.

(3) **Past Dividend Policies :** The company should keep its past policies while deciding divident rate and new dividend policy. Usually a company should not deviate from its past dividend policy. If dividend rates are abruptly raised or lowered, then speculation in the share prices starts which is harmful and it should be avoided.

(4) **Taxation Policy :** The taxation policy of the government also plays a vital role in dividend policy. Sometimes Govt. levy tax on higher payment of dividend so that profit can be retained by the companies resulting acceleration of capitalisation.

(5) **Position of Profit :** The dividends are paid only out of the profits. Therefore the company should see whether profits of that year are sufficient or not. Profits are less or more as compared to last year or compared to other firms in the same industry. It should also be noted that whether company is in a position to earn the same profit in future or not.

(6) **Composition of Ownership :** If a company is closely held then it can follow for a number of years a policy of low dividend but when it is a widely held company then it has to follow the prevalent industry norms and customs and has to pay adequate or reasonable dividend.

(7) **Liquidity Position and Working Capital Requirements :** A company may have earned sufficient profits but there may not be enough liquid resources for dividend distribution. Company may be in need of additional resources for its working capital. In such a situation either no dividend should be declared or the rate of dividend should be low.

(8) **Future Needs :** If the company will need more and more resources in future for expansion and diversification then low rates of dividend will suit the company. Company will have sufficient internal resources and it can further mobilise resources from the capital market. it also gets support from financial institutions.

(9) **Age of the Company :** Age of the company also have a critical role in deciding dividend. Newly established companies generally are not in condition to pay dividend in initial year since in initial yer each company needs funds for its expansion which cannot be mobilised from open market easily. Therefore, newly established companies are dependent on their internal resourcess. On the other hand well establish companies can get loans from the bank easily and even their requirement of fund is less. Therefore they can follow a liberal policy.

(10) **Debt Repayment :** If the firm has borrowed money through debt insturments those are to be repayed. This is possible either by creating debt redemption fund out of the profits or new debentures can be issued and out of proceeds of those new debentures old debentures could be paid. Dividend policy will depend on the decision of management how to repay debt.

(11) **Legal Requirement :** Legal requirement play an important role in the formulation of dividend policy. These requirements are necessarily be fulfilled. As per Indian Companies Act dividends can be paid only out of earned profits and before declaration of dividends if there are any losses, these should be set-off. Sometimes government may impose restrictions on dividend rate or on bonus shares. These should be kept in mind.

(12) **Governement Control :** The dividend should be declared keeping in view of various statutory provisions like Article of Association of company, Company Act, 2013, Income Tax Act, 1961 etc. The Company Act, 2013 provides that dividend should not be paid out of capital under Income tax provisions in this regard have been given in Section 104-109. So each company has to follow these rules while declaring and paying dividends.

(13) **Trade cycle Position :** If there are boom conditions in the economy then earnings of the company may be rising therefore high rate of dividend payment be opted and if recessionary conditions are there then either no dividend or low rate of dividend be followed.

(14) **Stability of Income :** If the earnings of company are stable then it can easily follow stable dividend policy. But when income is uncertain then companies have to conserve major part of earnings and declare low rates of dividend.

(15) **Public Opinion :** The companies have to keep public opinion into consideration in formulation of dividend policy. Very high dividends are against the public policy because there is sharp criticism of such companies. Workers demand more wages and bonus and consumers demand reduction in prices.

□□□

B.Com. | Part II
EAFM - Paper II
ELEMENTS OF FINANCIAL MANAGEMENT

2020

Unit I

Q.1 Define financial management. Discuss the importance and limitations of financial management.

Ans. Meaning of Financial Management:

'Financial Management' is the composition of two words - 'Financial' and 'Management'. Financial means procuring sources of money supply and allocation of these sources on the basis of forecasting monetary requirements of the business. The word 'Management' refers to planning, organization, co-ordination and control of human activities and physical resources for achieving the objectives of an enterprise.

Thus, Financial management is that part of business management which is concerned with the planning and controlling of a firm's financial resources i.e. management of finance function. In other words, financial management is the ways and means of managing money.

Definition of Financial Management :

According to Josph L. Massie - "Financial Management is the operational activity of a business that is responsible for obtaining and effectively utilizing the funds necessary for efficient operations."

According to Ezra soloman - "Financial Management is concerned with the efficient use of an important economic resource, namely capital fund."

According to Wheeler - "Financial Management is the activity which is concerned with the acquisition and administration of Capital funds in meeting the financial needs and overall objective of business enterprise."

Conclusion : Financial management is a functional area of business management. Financial management is the planning, organising, directing and controlling of the procurement and utilisation of funds and safe disposal of profit to the end that individual, organisational and social objectives are accomplished.

Importance of Financial Management :

1. Basis of business success: Finance infuses life in business and the finance function keeps it alive. Development and stability of business depend on efficient working of finance function. If any business is running in a loss, it indicates that there is some lacuna in the carrying out of finance function. It is finance manager who ensures that finances of the enterprise are being utilised in the most efficient manners. according to Solomon " Financial management is not only viewed as a fund raising operation but a part of enterprise success."

2. Optimum use of resources : Finance function ensures optimum allocation and effective use of funds besides collection of funds. It is the duty of finance manager that each segment of the business get adequate finances as and when its needs so that their activities go on without any lindrances. Thus the effective use of funds is possible only when finance functions are carried out efficiently.

3. Financial control : The financial manager, by following different techniques such as budgetary control, cost control, variance analysis, internal audit, exercises financial control over the various activities of business. This indirectly leads to increase in the profitability of the enterprise. Thus finance functions play on important role in controlling the finance of the concern.

4. Helpful in Decision making : The main objective of finance function is to take important decision such as investment decision, financing decision, dividend decision and liquidity decision. The financial lanager with the help of expert knowledge arrives at judicious decisions regarding procurement and allocation of funds and also in framing different financial policies.

5. Helpful in maintaining liquidity : The finance functions like maintaining balance between cash - in - flows and outflows, management of working capital, availability of funds at the due date, all help in maintaining liquidity of the enterprise so that the firm may fulfill all its short term obligations.

6. Helpful in Financial Analysis: Various financial problems are analysed by using different techniques such as variance analysis, ratio analysis, inter firm comparison, cost volume profit analysis, comparison of results on the basis of time. By analysing cost volume profits relationship of different projects, it can be ascertained as to which source of finance is appropriate and which project is profitable and which is not.

7. Importance to Investors and Shareholders: The investors and shareholders keep an eye on the financial policies and activities of the firm. They have interest in the firm's income and they want a regular and adequate return on the capital employed by them and their capital should remain intact. They, from time to time analyse the performance of the firm on the basis of final accounts. Hence it is the responsibility of the management to inform them about the financial position of the firm.

8. Importance to Financial Institutions: Financial institutions such as banks, insurance companies, financial incorporations, underwriters, and discount houses, want to have a correct knowledge about the financial working of the enterprise, as they will like to invest their funds in profitable securities and in concerns which are financially strong. Generally the managers of such institutions are those, who are experts in the field of finance and they completely analyse the financial position of a concern before investing their funds.

9. Importance to businessmen and citizens: Businessmen have to face financial problems at every state. Hence he should also have a working knowledge of principles and methods of finance so that they may esily win over the difficulties and problems in the way of finance.

10. Importance to Nation : Every country invests huge amounts for its economic development. The success of the investments depend upon the effective use and management of the resources. Hence the economists and social workers should also have knowledge of various finance functions so that they can also contribute towards the development of the country by their valuable guidance and advice minimum possible cost.

Limitations of Financial Management :-

Financial management, as any other branch of knowledge is not without limitations. Though the emergence of financial management has greatly improved the managerial performance, yet it has to face certain challenges and constraints. These have curtailed the effectiveness of financial management and these limitations are identified below:

1. Lack of Objectivity : Financial management is absolutely subjective. The decisions taken by financial managers are affected by their personal prejudices, views and opinions which sometimes bring adverse results to the firm.

2. Expensive or Uneconomical : The installation of effective financial management needs a very elaborate organisation and a myriad of numerous rules and regulations. This results in heavy investments which only large concerns can afford. Hence, it is very costly.

3. Lack of Knowledge of Related Subjects : Financial management is related to other subjects such as economics, statistics, management etc. The full benefits of financial management can only be derived when financial manager is fully acquainted with all these related subjects. But, today in the age of specialisation, it seems very difficult to possess knowledge of all such subjects by a single person.

4. Evolutionary Stage : Financial management is in a developing state and has not reached to its final stage. Its conventions are not as exact and established as of other sciences. Thus, beings an inexact science, its results depend to a very great extent upon the intelligent interpretation of date for managerial uses.

5. Based on Accounting Records : Most of the information used in financial management is derived from financial accounting, cost accounting and other similar records and documents. The techniques such as analysis and interpretation of financial statements, cost - volume profit analysis, budgetary control etc. used in financial management are based on these accounting records. Therefore, how far the decisions taken on the basis of this information are correct, depends upon the correctness and accuracy of these informations.

6. No Alternate of Administration : Financial management presents duly analysed and interpreted information regarding financial position and performance of various functions of the enterprise before the top management. He also suggests the best possible alternative, but ultimate decision and connective steps or measures are being taken by management and not by financial manger, Therefore, financial management is no alternate of administration.

7. It is difficult to know the financial effects of various managerial decisions : In an organization there are so many areas of functions and all their decisions have effect on finance. So it is quite difficult for finance manager to know those effects and co - ordinate all decisions.

OR

Q.2 What do you understand by financial analysis? Give the names of various techniques of financial analysis and explain any one technique in detail.

Ans. Refer Q.No.2 of the Year 2018.

Unit II

Q.3 What is Fund flow Statement ? Give its advantages and limitations.

Ans. Meaning of Funds flow Statements:

Funds flow statements is a summary report financial operations of a business firm which brings into light the changes in financial items of balance sheets prepared at two different dates. In other words, funds flow statement reveals the sources from which funds were obtained by the firm and the specific uses to which such funds were applied. The effectiveness of financial management in procuring funds from various sources and using them effectively for generating income without sacrificing the financial health of the firm is reflected in this statement.

A few definitions of funds flow statement are given below:

According to **Roy A. Foulke** "a statement of source and application of funds is a technical device designed to analysed the changes in the financial conditions of business enterprises between tow dates.

According to **Robert N. Anthony,** Funds flow statement is a statement prepared to indicate the increase in the cash resources and the utilization of such resources of a business during the accounting period.

According to **Almond Coleman,** "the funds flow statement is a statement summarising the significant financial changes which were occurred between the beginning and the end of a company's accounting period."

According to **Accounting Standard Board of ICAI,** " a statement which summarises for the period covered by it the changes in financial position including the sources from which the funds were obtained by the enterprise and the specific used to which the funds were applied."

Thus, funds flow statements is not a statement of financial position at a particular date, but it is report of financial operations, changes, flows and movement of funds. It is not a subsidiary schedule of balance sheet like-statement of profit and loss or appropriations of earnings, but a supplementary statement and provides such information which are not available in other statements.

Advantages or Importance of Funds Flow Statement

The funds flow statement provides important information regarding changes occurred in working capital during a given period. This statement focuses on changes occurred in capital structure and assets combination between two

balance sheet dates and managerial policy decisions in this regard. It contains those information also, which generally not found in balance sheet and profit & loss account. Hence this statement is very useful for management of the organisation, shareholders, loan providers, researchers, other firms in the same industry and government. It is being further explained under following heads:

1. For Shareholders :

As we are aware that shareholders of a limited liability company are actually the owners of the company and the board of directors manages the company on behalf of shareholders. The shareholders get the following information from the fund flow statement :

(i) Whether their interests in the organisation are safe or not.

(ii) How the financial management of an organisation is done.

(iii) What is the trend of profit in the organisation.

(iv) Whether burden of loan on the company is increasing or decreasing.

(v) Whether funds are generated from its main operation or otherwise, if funds are generated from other operations, it is more beneficial.

(vi) Whether there is proper coordination between various financial resources of the organisation.

On the basis of above information the shareholders can analysed the performance of managerial efficiency.

2. For - Creditors and Investors:

The primary interest of the creditors and investors are in the financial soundness of the organisation. The creditors, loan providers and investors can get the following information with the help of funds flow statement:

(i) They can also take decision regarding whether their existing credit is safe or not on the basis of current position.

(ii) They can also project the earning capacity of the organisation from their normal operations.

(iii) The creditors and investors can project the future requirement of working capital on the basis of fund flow statement.

(iv) Whether their investments are safe or not.

(v) On the basis of utilisation of funds, it can be judged whether application of funds are profitable or not. Is there any reverse effect over the earning capacity of the firm.

(vi) Whether the organisation is in condition to pay interest regularly.

On the basis of the above analysis the creditors and investors can take decision of investment. Now a days every organisation analyses the financial statement of the company before releasing any fund to that company. They need various information relating to financial and liquidity position. The funds flow statement provides them all desired information. Therefore in other words, it helps the organization to get the loans.

3. For Management :

Fund Flow statement is very important managerial tool for management of any organisatior. The Financial manager get the following information:

(i) Helpful in planning : The planning for the future can be done after due analysis of sources and application of working capital.

(ii) Dividend Policy : The determination of dividend policy depends upon the availability of funds and future requirement of funds and this can not be done without the help of funds flow statement.

(iii) Analysis of working capital : The funds flow statement provides an analytical picture of working capital before the management. The manager from the help of this statement can know from which sources working capital obtained and for what purposes it is utilised.

(iv) comparative study : The comparison of funds flow statement with balance sheet and profit & loss account can provide very crucial information's to the management.

(v) The effect of sources of fund on external parties: The Funds flow statement tell the management about effect on economic condition of business of various sources of funds and how it will affect the external parties.

(vi) Arrangement of fixed assets : Arrangement of funds for expansion of fixed assets can be done after the due study and analysis of funds flow statement. Because of depreciating the fixed assets, the balance sheet does not provide completed information about fixed assets however the funds flow statement provides necessary information which are generally required by the management while taking the decision regarding fixed assets.

(vii) Reasons for shortage or working capital : Inspire of huge protest if there is any shortage of working capital, reasons for the same can be known with the help of funds Flow statement.

(viii) Analysis of earnings : How business profit were utilised. Why are the fundsshort instead of huge profit? Reply of all these questionsare found in funds flow statement.

(c) Analysis of earnings: How business profit were utilised . Why are the funds short instead of huge profit ? Reply of all these questions are found in funds flow statement.

From the above, its is clear that funds flow statement is a very helpful managerial tool for management of any organisation. Only after the due study of fund flow statement the management comes to know from where the funds should be arranged and how the management of funds should be done.

4. For Government : Government takes various decisions regarding industries. Particularly finance and price decisions are the main concern. On the basis of fund flow statement the Govt. can know the sources of funds in various industries and can control the flow of capital. The Govt. can also make decision regarding price policy after due analysis of operational profit of the firms.

5. For Researchers :

The financial researches are also found interested in fund flow statement of various companies. They can concluded the financial position of the company after in depth analysis of sources and application of funds. They have to do comparative study also. The fund flow statement helps them in this regard.

6. For other Firms : The other firms in the same industry can compare his firm with other firms. With the help of fund flow statement and after due study and analysis they can take necessary steps to improve their managerial efficiency.

Limitations of the Fund Flow Statement

As discussed, above fund flow statement is very important tool for financial analysis, still it also has some limitations.While using fund flow statement or taking, decisions on the basis of this statement, we should know its limitations discussed as below:

1. Misleading Conclusion : As already discussed fund flow statement cover not only cash funds but non - cash funds also, so this statement does not provide the exact information regarding changes in cash funds, which sometimes are more useful and relevant. It provides the misleading presentation on the basis of only funds flow resulting wrong decision - making.

2. Historical analysis : Fund flow statement is prepared after the finalisation of accounts. Therefore it is historic in nature and provides the information of past. So we analyses only those things which had been happened in the past.

However, projected fund flow statements are also prepared now - a - days by modern managers but still it can not be prepared with higher accuracy.

3. Ignore non - found items: The main limitation of funds flow statement is that it does not provided the information relating to non - found (i.e. non - current transactions) items. Hence, It does not provide the entire information. However, as compared to balance sheet and profit & Loss account it provides more meaningful information.

4. Unable to provide item wise analysis of working capital: Under fund flow statement changes in working capital are shown in total It does not provide the changes in individual items of working capital.

5. Lack of Original Information : This statement is not original in nature. The accounting data given in financial statements are presented in systematic and re - arranged form.

OR

Q.4 Following is the Balance Sheet of Jay Ltd. as on 31st March 2020 :

Balance Sheet of Jay Ltd, as on 31st March, 2020

Particulars	Current Year 2019-20
I. EQUITY AND LIABILTIES:	
(1) Shareholder's Funds:	40,000
(a) Paid up Share Capital	
(b) Reserve and Reserve Surplus	6,000
(i) General and Surplus	14,000
(ii) Surplus for the years	
(2) Non – current liabilities	20,000
10% Loan on mortgage	
(3) Current Liabilities	14,000
(a) Trade payables	2,000
(b) Bank Overdrafts	
(c) Other current liabilities	2,000
(i) Proposed Dividend	2,000
(ii) Current Taxation	
Total	**1,00,000**
II. ASSETS:	
(1) Non – Current Assets	
(a) Faxed Assets	
(i) Tangible	48,000
(ii) Intangible (Good will at cost)	12,000
(2) Current Assets	
(a) Short term investments	2,000
(b) Inventories (Stock)	16,000
(c) Trade Receivables	16,000
(d) Cash and Equivalents	6,000
Total	**1,00,000**

Sales amounted to ₹ 1,20,000.

Calculate the following ratios:

(i) Current Ratio

(ii) Quick Ratio

(iii) Net Profit Ratio

(iv) Return on Net Capital Employed

Ans. (i) Current Ratio $\frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{40,000}{20,000} = 2:1$

Current Assets = Inventories + Trade Receivables + Investments + Cash

= ₹ 16,000 + ₹ 16,000 + ₹ 2,000 + ₹ 6,000 = ₹ 40,000

Current Liabilities

= Trade Payables + Bank Overdraft + Proposed Dividend + Taxation

= ₹ 14,000 + ₹ 2,000 + ₹ 2,000 + ₹ 2,000 = ₹ 20,000

(ii) **Quick Ratio** $= \dfrac{\text{Quick Assets}}{\text{Current Liabilities}} = \dfrac{₹24,000}{₹20,000} = 1:2:1$

Quick Assets = Current Assets – Inventories

= ₹ 40,000 – ₹ 16,000 = ₹ 24,000

(iii) Net Profit Ratio $= \dfrac{\text{Net Profit after Tax}}{\text{Sales}} \times 100$

$\dfrac{₹14,000}{₹1,20,000} \times 100 = 11.67\%$

(iv) **Returns of Net Capital Employed**

$= \dfrac{\text{Net Profit (before Interest and Tax)}}{\text{Net Capital Employed}} \times 100$

$= \dfrac{₹14,000 + ₹2,000 + ₹2,000}{₹80,000} \times 100$

$= \dfrac{₹18,000}{₹80,000} \times 100 = 22.5\%$

Net Capital Employed = Total Assets – Current Liabilities

= ₹ 1,00,000 – ₹ 20,000 = ₹ 80,000

Net Profit before Interest & Tax = Net Profit after Tax and Interest + Taxation (current) + Interest

= ₹ 14,000 + ₹ 2,000 + ₹ 2,000 = ₹ 18,000

Unit III

Q.5 Explain the meaning of financial forecasting and describes the tools unused for financial forcasting.

Ans. Meaning of Financial Forecasting

Financial Forecasting is that process in which the future financial condition of the firm is shown on the basis of past accounts, funds flow statements, financial ratios and economics conditions of the firm and industry. The projection of future plan of management in terms of finance is financial forecasting. The financial forecasting shows the financial planning activates of the firm for specific period of time.

Financial forecasting provides the basic information on which systematic planning is based on. Therefore, forecasting of financial results is an integral part of business planning, where in the management expresses the planning of activities in finance of a particular period keeping in view the competitive, technical and social environment, Sometimes the financial forecasting is used as a control device to set the way for firm's future course of action.

A 'Forecast' is a prediction of what is going to happen as a result of a given set of circumstances. It is an assessment of future conditions such as future demand for products, sales, costs, fund requirements.

Financial forecasting means estimating the future financial requirements of the enterprise using the past data and information pertaining to items contained in profit and loss account and balance sheet of the firm. In other words, financial forecasting means a systematic projection of the expected action of finance through financial statements. It is process in which future financial position of a firm is explained on the basis of past records, cash flows and funds flow behaviour, financial ratios and expected economic conditions of the industry and enterprise. It is a kind of plan. Which will be formmulated at a future date for a specified period.

Financial forecasting has been described as an integral part of the financial manager's job, is an act of deciding in advance the quantum of fund requirements of the enterprise and the time pattern of such requirement."

Tools or Techniques of Financial Forecasting

Some of the important techniques that are employed in financial forecasting given below.

1. Proforma or Projected Financial Statement
2. Cash Budge or Cash Flow forecast
3. Linear or Multiple Regression
4. Sensitivity Analysis
5. Simulation

1. Proforma or Projected Financial Statements:-

Those financial statements which are prepared to show future results are called proforma or projected Financial Statements. These proforma present an important basis about financial forecasting and planning. The preparation of these statements are m1ade on the basis of certain assumptions and conditions and these statement present a right estimation about receipts, costs, tax, dividends and funds. There are no fixed rules for preparation of these proforma statements because their objective of making, these proforma statement determines their form and size.

The 'Projected Income Statement'. and 'Projected Balance Sheet' are included in these projected financial statements, the method of their preparation is explained below:

I. Proforma or Projected Income Statement:-

Projected income statement is a projection of income for a period of time in future that will provide a fair and reasonable estimate of expected revenues, costs, profits, taxes, dividends and other financial items. The format of projected income statement is similar to that which the firm use in the regular financial reports to facilitate the review process at a later stage. The following information or steps are required to prepare the projected income statement:

(i) Sales : This statement is prepared on the basis of estimates of the expected sales for the future period. The sales may be estimated on the basis of "rule of thumb' or market research or economics survey.

(ii) Cost of Goods Sold : Estimates of cost of goods sold may be made by preparing production schedules. The most accurate forecast may be made with the help of a detailed analysis of purchase, productive wages and overhead costs. Generally, cost of goods sold are estimated on the basis of past ratio of goods sold to sales i.e. a certain percentage say 60% or 70% of sales This is based on the analysis of past operating data and future tern in prices.

(iii) Selling Costs - The selling costs are calculated for a future period of time only. The estimation of future selling costs are done and it is shown in projected income statements. The past ratios of selling costs are used to calculate future selling costs.

(iv) General and administrative expenses - According to some financial experts these expenses are estimated as some percentage of sales. But this method is not right because these expenses are to some extend fixed and variable to certain extent. Therefore these should be properly estimated.

(v) Other items - The expenses on other items can also be estimated. For the estimation of interest, the size of loan can be the basis. The estimation of income tax is made on basis of known tax rate and estimated profit. The payment of dividend and distribution of income should be fixed by top management..

Thus, projected income statement is the best method for the estimation of profits, but it fails to control the expenses For this purpose, various methods of cost accounting may be used.

II. Proforma or Projected Balance Sheet :-

Profroma balance sheet is forecasting of flow of funds and according to this the estimation of every item should be made and checked. The preparation of proforma balance sheet is made on the basis of proforma income statement and supporting schedules and budgets. There are four steps in preparing proforma balance sheet. First, calculation of gross

investment amount should be done to run the business at planned production level. Second, List of liabilities should be prepared on which we can rely without negotiations. Third, the net worth of the company should be adjusted with net income at the time of estimations. In the end, the projected assets are compared with total funds for that period. (Net Worth + Liabilities)

If the assets are more than total funds, then the difference shows, requirement of excess funds for which negotiation has to be made. If funds are more than assets, then the excess shows surplus cash than the minimum required cash, for which the loan and advances should be reduced in the liabilities side. The estimations of assets and liabilities in projected balance sheet are made in the following way:

(i) Fixed Assets : In order to acquire, replace or dispose of fitted assets like plants, machinery, building etc. over a number of years, capital budget plan is to be drawn up and adjustments have to be made therein by adding additional assets purchased and deducting assets sold in the existing amount of fixed asset. Depreciation on assets should also be considered before arriving at the values of fixed assets for preparing the projected balance sheet. Other assets will reaming as they are useless if is specifically mentioned. Intangible Assets like goodwill, patent licence etc. are to be valued at the exiting figure until and unless there are some special information about this.

(ii) Current Assets: The value of various current assets are estimated as follows:

(a) ***Accounts Receivable or Debtors*** is the main amount included in current assets to be estimated on the date of forecast'. This amount can be ascertained on the basis of debtors turnover or number of days credit allowed to debtors using the following formulae:

$$\frac{\text{Credit Sales}}{\text{Average Debtors}} \text{ or } \frac{\text{Debtors}}{\text{Credit Sales}} \times 365$$

(b) ***Inventory level*** in relation to production programmed which is to be maintained is an important item in this regard. As soon as this level is fixed by the management, the same will be an of the proforma balance sheet. The amount may be ascertained as under:

$$\text{Inventory Turnover Ratio} = \frac{\text{Cost of Goods Sold}}{\text{Average Inventory}}$$

Or

$$= \text{Opening Stock} + \text{Purchase} + \text{Mfg. Costs} - \text{Cost of goods sold.}$$

(c) ***Minimum balance of cash*** is to be maintained in hand for various purpose. But, when the flexible bank borrowing is available, the cash balance will represent the difference between the assets and the liabilities.

(iii) Liabilities : The amount of various items of liabilities are estimated as

(a) ***Accounts Payable or Creditors*** are to be estimated on the basis of purchase schedules or creditors turnover ratio or the number of days credit allowed by suppliers using the following :

$$\frac{\text{Credit Purchases}}{\text{Average Creditors}} \text{ Or } \frac{\text{Creditors}}{\text{Credit Purchase}} \times 365$$

(b) ***Outstanding Liabilities*** such as accrued wages and other expenses are ascertained on the basis of the pattern of wage payments or with the help of production schedules or time lag in payments. For this purpose past and future data relating to them, are also to be taken in consideration while preparing a proforma balance sheet.

(c) ***Provision for Tax and Dividend*** should be made properly for the proforma balance sheet. The amount may be estimated by adding additional provisions made during the year and deducting actual payment in the opening balance. These provisions also depend upon past and future data and the rate of tax and dividend.

(d) Long- term Liabilities can be estimated easily as their amount depends on the raising of and paying off long - term loans in the financial plan.

(iv) Net worth or Shareholder's Funds : It represents the amount of share capital and reserve and surplus (fixed assets + current assets – current liabilities and long - term liabilities). But for this purpose, fresh issue of shares, redemption of preference shares, buy - back of shares, retained earning from profits should also be taken into consideration.

(v) Balancing the Projected Balance Sheet : Once we have estimated or ascertained all the components of proforma balance sheet. they are combined and presented in a balance sheet. Each item of balance sheet is estimated independently with reference to future policies and expected conditions. Therefore , the total of assets and liabilities should be equal. If assets exceeds total sources, the difference represents additional sources that must be negotiated if the planned operations are to be carried out. If the expected sources are more than required assets. investment the excess indicates the additional cash over and above the desired minimum level.

2. Cash Budget or Cash Flow Forecasting :-

Cash budgeting is the principal tool of planning and controlling the use of cash. ***A cash budget is a statement showing the estimates or forecasts of cash receipts, cash disbursements and net cash balance for a future period of time.*** Thus, a cash budget forecasts the estimated cash flows over a period of time and indicates the cash requirements at various time and anticipated cash receipts. It show the cash position of the enterprise during the budget period.

Meaning of Cash Budget : Cash Budget is a table in which we know the cash inflow and outflow in specified period of time so that the surplus of cash or deficit of cash can be known beforehand. In reality, it is seen that cash budget is forecast of cash flow for a definite period. According to **Guthaman** and **Dougal** " Cash budget is an estimate of cash receipts and disbursement for a future period ot time." According To **Mealchman** and **Slavin,** "Tha cash budgets are plans for financing the budgeted activates of the company."

Budget Period : Cash budget is a time - phased schedule. It covers a specific period. Coverage of time depends upon the firm's planning horizon. It means that if a firm wants to plan for 3 months, its cash budget should cover a period of 3 months. Generally, firms prepare monthly cash budget.

I. Cash Budget For short period:

Ordinarily, the period of cash budget is of one year which is dividend in three months, one month and a week according to convenience. The cash budget can be prepared quite easily. In it (i) estimation of cash receipts, (ii) estimation of cash payments, and (iii) estimation of financial requirements are made. In the preparation of cash budget all the receipts and payments of the budget period are shown. So the cash budget is divided into two parts. In the first part of cash budget, the receipt of cash and in the second part, cash payments are shown. The calculation of cash receipts and payments are made in the following manner :

(A) Cash Receipts :

The following are the main sources of cash receipts:

(i) Cash receipts a arising from operations - Advances from customers, cash collection from debtors and B/R, and cash from sale of goods and services are called cash receipts from operations. The cash sale can quite easily be estimated because some part of sale is always cash sale. The estimation of credit sale, debtors and B/R is quite difficult because it depends on the terms of sale, credit and collection policy of the firm, financial condition of customers, business customs etc. So the estimation is done on the basis of information and data collected and analysed by credit and collection department.

(ii) Non - operating cash receipts - If an organization obtains cash receipts from non - operating functions, then it is included in this section. Dividend, interest, rent, royalty, commission, refund of tax etc. are included in non - operating cash receipts.

(iii) Cash Receipts from capital transactions- Receipts from issue of shares and debentures and sale of fixed assets and investments are known as cash receipts from capital transactions. Short - term loans are also included in it.

(B) Cash Payment:

Cash payments are made for the following:

(i) Cash payment for business operations: For this following business operating payments have to be made:

(ii) Cash purchases and accounts payables- Payments at the time of purchase, advances to suppliers and payments to creditors are very essential and those are included in this head.

(iii) Payment for labourers :- The payment of wages to workers are included in this head. Usually weekly or monthly payments are made to workers.

(iv) Overheads: Factory overheads, Administrative, and other general overheads and selling and distribution overheads are necessary and these are estimated on the basis of time lag in their payment.

(v) Cash Payments for Non - business Operations : In this payments for interest, rent, income - tax, charity etc are included. They should be estimated on the basis of time lag.

(vi) payments for capital transactions: Redemption of Debentures and preference shares, purchase of fixed assets and long - term investment and payment of bank overdraft are included in this head.

II. Long-Term Cash Budget : Long - term cash forecasts are prepared to give an idea of the financial requirements of the firm. The cash budget for long - term forecasts is like projected cash flow statement based on proforma financial statements. Under this method, profit and loss account is adjusted to know the cash estimates. Cash Increases on account of income from operations (after adjusting non - cash items like deprecation , outstanding expenses, write off of intangible assets etc.), reduction in current assets (except cash), sale of fixed assets; increase in liabilities and sale of shares and debentures. Decrease in cash occurs due to increase in current assets (excepts cash): decrease in liabilities; purchase of fixed assets, payments of dividend; tax etc. This method of preparing cash budget is also called **'Adjusted Net Income Method'** or **'Adjusted profit and Loss Method'**. It is because the profit forecasts of the budget period are converted into cash by adjusting the items which do not affect cash inflows and outflows. It is based on the principle that profits of a business are equal to cash. If there are no credit transactions, capital transaction, accruates, provisions, appropriations etc., the balance of profit as shown by profit and loss account should be equal to the balance in the cash book. A specimen of such budget

3. Regression Analysis : Regression analysis is a statistical technique of financial forecasting that discloses the relative movements of two or more inter - related series. It is used to estimate the changes in one variable as a result of specified changes in other variable or variables. In economic and business situations, a number of factors affect a business phenomenon simultaneously. Regression helps in isolating the effects of such factors to a great extend. For example, if we know that three is a positive relationship between the advertisement expenditure and volume of sales or between sales and profit, it is possible to have estimates of sales on the basis of advertisement expenditure or profit on projected sales provided other things remaining the same.

4.Sensitivity Analysis : In this modern world of uncertainty and risk, forecasts made on the basis of projected financial statements and cash flow estimates are inclined to errors. It would be, therefore, meaningful to estimate the range of possible capital needs along with the best estimates provided by the forecast. It is in this context that the sensitivity analysis in undertaken. In sensitivity analysis, value of uncertain variables in changed and a revised outcome is calculated. This is how the sensitivity of answers changes in uncertain input variables.

In this analysis, the finance manager determines the sensitivity of firm's requirements for external capital to change in the values of uncertain input variables viz. sales, receivables, inventories etc. That is why, a new proforma balance sheet and income statement at various sales levels is constructed. If reveals capital needs of the enterprise. This sort of information received in advance can be very helpful in planning the firm's future financing.

Thus, sensitivity analysis is always a valuable exercise when input variable are subject to uncertainty. However, the major weakness of this analysis is that only one uncertain variable can be tested at a time.

5. Simulation : Simulation is one of the recently introduced technique in business decision which has gained wider acceptance among business executives in diverse areas including cash planning. Simulation is a mathematical model with equalities and probability distribution which describes the important variables in a risky decisions.

Q.6 The profit-volume ratio of a firm dealing in drugs manufacturing is 50% and the margin of safety is 40%. Calculate the breakeven point and the net profit if the sales are ₹ 30,00,000. Also find out sales to earn a profit of ₹ 7,50,000.

Ans.(i) Calculation of B.E. P

$$M/S = \frac{S - B.E.P}{S} \times 100 \qquad 40 = \frac{30,00,000 - B.E.P}{30,00,000} \times 100$$

or $12,00,000 = 30,00,000 - B.E.P.$

$B.E.P. = 30,00,000 - 12,00,000$

$\therefore$ $B.E.P. = ₹\ 18,00,000$

(ii) Calculation of Profit:

$$M/S = \frac{Profit}{P/V\ Ratio}\ ;\ 12,00,000 = \frac{P}{50\%}$$

$$P = 12,00,000 \times \frac{50}{100} = ₹6,00,000$$

(iii) Sales to earn a profit of ₹ 7,50,000 :

$$Sales = \frac{F + P}{P/V\ Ratio}$$

$$F = B.E.P \times P/V\ Ratio = ₹\ 18,00,000 \times \frac{50}{100} = ₹9,00,000$$

$$Sales = \frac{9,00,000 + 7,50,000}{50\%} = 16,50,000 \times \frac{100}{50} = ₹33,00,000$$

Unit IV

Q.7 From the following information prepare a statement showing the estimated working capital requirements:

(a) in total, and

(b) as regards each constituent part of working capital, budgeted sales are ₹ 2,60,000 per annum. Analysis of cost of each unit :

	₹
Raw Materials	**3**
Labour	**4**
Overheads	**2**
Profit	**1**
Selling Price	**10**

It is estimated that :

(i) Pending use of raw materials are carried in stock for three weeks and finished goods for two weeks.

(ii) Factory processing will take three weeks.

(iii) Suppliers will give five week credit and customers will require eight weeks credit.

It may be assumed that production and overheads accure evenly throughout the year.

Ans. Statement of Working Capital Requirements :-

	₹	₹
(A) Current Assets :		
1. Stock of Raw Materials (500 × ₹ 3 × 3)		4,500
2. Stock of Work-in-Progress :		
Raw Materials (500 × ₹ 3 × 3)	4,500	
Labour $(500 \times ₹3 \times 4 \times \frac{1}{2})$	3,000	
Overheads $(500 \times ₹2 \times 3 \times \frac{1}{2})$	1,500	9,000
3. Stock of Finished Goods :		
Raw Materials (500 × ₹ 3 × 2)	3,000	
Labour (500 × ₹ 4 × 2)	4,000	
Overheads (500 × ₹ 2 × 3)	2,000	9,000
4. Sundry Debtors (500 × ₹ 9 × 8)		36,000
Total Current Assets (A)		58,500
(B) Current Liabilities :		
Sundry Creditors : (500 × ₹ 3 × 5)		7,500
Total Current Liabilities (B)		
(C) Net Working Capital Required (A-B)		51,000

Note - (i) Budgeted Sales are ₹ 2,60,000 and per unit price is ₹ 10, therefore 26,000 units will be sold. Per week units sold $= \frac{26,000}{52} = 500$ units.

(ii) Work-in-process values at 100% material fed in the beginning and 50% labour and overheads for three weeks.

OR

Q.8 Explain the meaning of cash management. Discuss advantages and limitations of cash management.

Ans. Refer Q.No. 8 of the Year 2018.

Unit V

Q.9 Jareda Ltd., is considering the purchase of machine. Two machines A and B are available at the cost of ₹ 60,000 each. Earning after taxes but before depreciation are expected as follows:

Year	Cash Inflows	
	Machine A ₹	Machine B ₹
1	25,000	10,000
2	20,000	15,000
3	15,000	25,000
4	10,000	20,000
5	10,000	20,000

Evaluate the two alternatives by using :

(i) Pay - back Period Method and

(ii) Post Pay - back Profitability Method.

Ans. (i) Pay - black Method

Initial Investment = ₹ 60,000

Year	Machine A		Machine B	
	Yearly Cash Inflow	Cumulative Cash Inflow	Yearly Cash Inflow	Cumulative Cash Inflow
	₹	₹	₹	₹
1	25,000	25,000	10,000	10,000
2	20,000	45,000	15,000	25,000
3	15,000	60,000	25,000	50,000
4	10,000	70,000	20,000	70,000
5	10,000	80,000	20,000	90,000

Pay Back Period =

$$\text{Completed years before pay back year} + \frac{\text{Initial investment} - \text{Cash Inflows in Completed years}}{\text{Cash inflows in pay back year}}$$

Machine A :

Pay - back period of Machine 'A' = 3 yrs.

$$\text{Pay -back Period of Machine 'B'} = 3 \text{ yrs.} + \frac{₹10,000}{₹20,000} \times 12 \text{ months}$$

= 3 yrs. 6 months.

Decision : The pay - back period of machine 'A' is shorter than the pay - back period of machine 'B' therefore, machine 'A' will be selected.

(ii) Post Pay- back Period Profitability Method:

Post pay - back Profitability = Total Cash Inflow – Initial Investment

Machine 'A' = ₹ 80,000 – ₹ 60,000 = ₹ 20,000

Machine 'B' = ₹ 90,000 – ₹ 60,000 = ₹ 30,000

Decision : On the basis of Post Pay - back period profitability method machine 'B' will be selected.

Q.10 What do you mean by 'Economics Order Quantity'? How it is determined?

Ans. Refer Q.No. 9(a) of the Year 2018.

□□□

B.Com. | Part II
EAFM - Paper II
ELEMENTS OF FINANCIAL MANAGEMENT

2019

Unit-I

Q.1. Discuss the tasks and responsibilites of a Modern Finance Manager.

Ans- Refer Q.No.1 of the year 2015

OR

Q.2. What do you mean by common-size statements? Discuss its utility for management.

Ans. Meaning of Common size Statements:- Refer Q.No.1 of the year 2017

Utility of common size statement for management:-

(i) **To present the change in various items in relation in revenue from Operations, total assets or total liabilities**: One of the major drawbacks of comparative financial statements is that they do not present the change in various items in relation to revenue from operations, total assets or total equity & liabilities. This drawback is removed through the preparation of common size statements.

(ii) **To establish a relationship**: over a period, a relationship is established between various items of the statement of profit & loss to revenue from operations and various items of balance sheet to total assets or total equity & liabilities. Significant conclusions can be drawn by studying the change in such a relationship. For example, if over the years it is established that cost of materials consumed constitute 40% of revenue from operations, an increase **in this percentage** will need immediate attention.

(iii) **To provide for a common base for comparison**: Common size statements provide for a common base for comparison. Financial statements of different firms can be converted into uniform common-size format irrespective of the size of individual items. Hence, they facilitate the comparison of profitability and financial position of two or more businesses over a period of time.

Utility of Common Size Balance Sheet for Management

(i) To analyse changes in individual items of balance sheet.

(ii) To establish the trend in various items of assets and liabilities.

(iii) To judge the relative financial soundness for different enterprises belonging to the same industry by preparing their common size balance sheets for different periods.

(iv) To assess the financial strategy adopted by different enterprises belonging to the same industry.

Utility of Common Size Statement of Profit & Loss for management:

(i) To establish a relationship between individual items of statement of profit & loss and revenue from operations: Since each item in a common size statement of profit & luss is shown as percentage of revenue from operations, a relationship can be established between each item of statement of profit&loss and volume of revenue from operations. The increase in revenue from operations will certainly increase selling expenses and not the administrative expenses. Administrative expenses may go up only if the revenue from Operations

increase to a considerable extent. In case the revenue from operations decline, the selling expenses should be reduced at once. Hence, a relationship is established between revenue from operations and other items of the statement of profit & loss and such a relationship is helpful in analysing the increase or decrease in the percentage of each item.

(ii) To analyse changes in individual items of statement of profit & loss in relationship to revenue from operations.

(iii) To judge the relative efficiency of cost items of the two or more firms belonging to the same industry.

Unit-II

Q.3. The Balance sheets of Nisha Ltd. as at 31-3-2016 and 31-3-2016 and 31-3-2017 are as follows.

Balance sheets asat 31st March, 2016 and 2017

	Particular	Note No.	2016 ₹	2017 ₹
1	**Equity and Liabilities**			
	(1) Shareholder's Fund			
	(a) Paid up Share capital		50,000	60,000
	(b) Reserve and Surplus			
	(i) General Reserve		5,000	8000
	(j) Statement of Profit and loss		41,000	33,000
	(2) Non-Current Liabilities			
	Secured Loan		20,000	25,000
	(3) Current Liabilities			
	(a) Trade Payables		10,000	12,000
	Income Tax Provision		20,000	17,000
	Total		1,46,000	1,55,000
2	**Assets**			
	(1) Non- Current Assets			
	(a) Fixed Assets		90,000	1,00,000
	(b) Other Non-Current Assets			
	Preliminary Expenses		2,000	1,000
	(2) Current Assets			
	(a) Inventories		20,000	24,000
	(b) Trade Receivables		30,000	25,000
	(c) Cash and Cash Equivalents		4,000	5,000
	Total		1,46,000	1,55,000

Additional Information:

(i) Depreciation Written off on fixed assests ₹ 20,000

(ii) Income Tax paid during the year ₹ 1800

Prepare a cash flow statement.

Ans. Solution:

Cash Flow Statement

For the year ending 31st march, 2017

	₹	₹
(A) Cash flow from Operation Activities:		
Net Profit before tax		
Add: Non Cash and non-operating Expenses:	20,000	10,000
Depreciation	1,000	21,000
Preliminary Expenses		31,000
Operating Profit before working capital changes		
Decrease in Trade Receivables	5,000	
Increase in Trade Payables	2,000	
Increase in Inventories	(4,000)	3,000
Cash Generated from Operating Activities		34,000
Less: Income Tax Paid		18,000
Net Cash From Investing Activities:		16,000
(B) Cash flow from Investing Activities	(30,000)	
Purchases of Fixed Assets		
Net Cash used in Investing Activities		(30,000)
(C) Cash Flow from Financing Activities:		
Issue of share capital	10,000	
Raising of Secured Loans	5,000	15,000
Net Cash Flows From Financing Activities		
Net Increase in Cash & Cash Equivalents (A+B+C)		
Add: Cash & Cash Equivalents at the Beginning		1,000
Cash & Cash Equivalents at the End		4,000
		5,000

Working Notes: (1) Calculation of Net Profit before Tax

	₹
Closing Balance of Statement of P & L	33,000
Less: Opening Balance of Statement of P &L	41,000
Net Loss after Appropriation	(8,000)
Add:- Transfer to General Reserve	3,000
Income Tax Provision	15,000
Net Profit before Tax	10,000

(2) Fixed Assets A/c

Particulars	₹	Particulars	₹
To Balance B/d	90,000	By Depreciation	20,000
To bank (Purchase) (Balancing figure)	30,000	By Balance C/d	1,00,000
	1,20,000		1,20,000

(3) Provision For Income Tax A/c

Particulars	₹	Particulars	₹
To Balance	18,000	By Balance b/d	20,000
To- Balance c/d	17,000	By P & L A/c (b/f)	15,000
	35,000		35,000

OR

Q.4. Discuss the following Ratios:-

(a) Current Ratio

(b) Quick Ratio

(c) Average Collection Period

(d) Debt-Equity Ratio

Ans. (a) Current Ratio:-

Meaning and computation : Current ratio may be defined as the relationship between current assests and current liabilities. It is also known as working capital ration or 2:1 ratio, it is calculated by dividing the current assets by current liablities. Expressed as formula, the current ratio is as follows:

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

Components: Current assets of a firm represent those assets which can be, in the ordinary course of business, converted into cash within a period not exceeding one year. Current liabilities mean those obiigations which are to be paid within a period of one year out of current assets or by creation of current liabilities. Long-term debts or debentures payale within a year from the date of balance sheet should be included in current liabilities.

Interpretation- A current ratio of 2:1 is considered as ideal, i.e. if current ratio is 2 or more it means that the concern has the ability to meet its current obligations but if this ratio is less than 2 it indicates that the concern has difficulty in meeting its current obligations. However the ratio above the ideal ratio shows the managerial deficiency of the concern to profitably and productively manage the current assets.

If the current ratio is higher, it is good from the trade payables (Crs. + B/P) point of view but extremely high current ratio is not good from the management's point of view. In such a case, (i) more funds of the firm would be employed in unproductive uses (like inventory) which do not fetch any return; (ii) it is the indicator of a firm's poor investment policy, and (iii) poor credit management due to over extended accounts receivable. Similarly, a low and declining current ratio would indicate: (i) an inadequate margin of safety to the trade payables (Crs, + B/P), i.e. firm has no sufficient cash to pay its liabilities, (ii) shortage of working capital in the business i.e. firm is trading out of its resources. Therefore, current ratio shall not be taken as a conclusive proof of financial soundness and real liquidity of a firm. It is a quantitative index, rather than qualitative, of

the liquidity of a firm because it considers only on total current assets. It does not consider the composition of various assets.

Ans. (b) Quick Ratio:

Meaning- This ratio reveals the relationship between quick assets and current liabilities. This ratio is Called Liquid Ratio Acid test Ratio.

Objective- The main objcctive of computing this ratio is to measure the ability of the firm to meet its short-term obligations as and when due without relying upon the realization of stock.

Components- Ouick Assets are those assets which can be converted into cash within a short notice without any loss, ie. Quick Asscts = Current Assets - (Closing Stock + Prepaid Expenses)

Stock is not considered as a quick asset as there is uncertainty about its selling price, socondly time is required to convert the raw material and work-in-progress into finished goods. Prepaid expanses usually cannot be converted into cash, hence they are not considered as quick or Liquid Assets. In order to ascertain the realizable value of Debtors the 'Provision for bad and doubtful debts' is deducted from the total amount of debtors.

Computation Formula :

$$\text{Quick or Liquid Ratio} = \frac{\text{Quick Assets or Liquid Assets}}{\text{Current Liabilities}}$$

Interpretation-This ratio shows the liquidity position of a firm. Generally a quick ratio of 1:1 is considered to be ideal. Although the quick ratio is more penetrating test of liquidity than the current ratio, yet it should be used more cautiously. A concern having a quick ratio of more than 1 May not be meeting its short term obligations in time if its current assets include doubtful and slow paying debtors while a concern having a quick ratio of less than 1, May be able to meet its short-term obligations in time because of its very effective inventory management. However if current liabilities are in excess of quick assets then it will be implied that short term solvency of business is not satisfactory.

Ans. (c) Average Collection Period :

This ratio is, inter-related with and dependent upon trade receivables turnover ratio. Average collection period or trade receivables velocity means the number of days over which trade receivables remain uncollected. This period can be calculated by any of the following formulae:

(a) $$\text{Average Collection Period} = \frac{\text{Average Trade Receivables (Drs. +B/R)}}{\text{Credit Revenue from Operations per day}}$$

$$\text{Credit Revenue from Operations per Day} = \frac{\text{Net Credit Revenue from Operations}}{365 \text{(or 360)}}$$

OR

(b) $$\text{Average Collection Period} = \frac{\text{Average Trade Receivables}}{\text{Net Credit Revenue from Operations}} \times \text{No. of months / Weeks/Days in a year}$$

OR

(c) $$\text{Average Collection Period} = \frac{\text{Months (or days) in a year}}{\text{Trade Receivables Turnover}}$$

Interpretation and Significance : An average collection period or trade receivables velocity, say. of 2 months, implies that trade receivables are collected in 60 days. It measures the quality of trade receivables because it indicates the rapidity or slowness in the collection process. A shorter collection period implies prompt payment by the trade receivables while a larger period reflects delay in payments by trade receivables. Fast recovery is the indication of good trade receivables and less probability of bad and unrecoverable trade receivables. On the other hand, delay in recovery of trade receivables in a business indicates increase in the amount of bad trade receivables, negligence and inefficiency of management or relaxation in credit terms. In order to measure the efficiency of the credit collection department, this period should be compared with the average of the industry or with the credit period normaily allowed by other firms.

(d) **Debt- Equity Ratio:**

Meaning- This ratio indicates the relationship between long term debts and shareholder's fund.

Objective- The objective of calculating this ratio is to measure the relative proportion of debt and equity in financing the assets of a firm.

Components- There are two components of this ratio which are as under -

(i) **Outsiders Fund-** This means long term loan whether secured or unsecured). e.g. debentures, bonds, loans from financial institutions.

(ii) **Shareholders Fund** – Which means equity share capital plus preference share capital plus reserves and surplus minus fictitious assets.

Computation- In the form of formulae this ratio can be expressed as-

$$\text{Debt} - \text{Equity Ratio}\left(\text{D/E Ratio}\right) = \frac{\text{Debt}}{\text{Equity}} \text{ or } \frac{\text{External Equities}}{\text{Internal Equities}}$$

OR

$$\text{Debt} - \text{Equity Ratio} = \frac{\text{Outsider's Funds}}{\text{Share holder's or Propietor's Funds or worth}}$$

OR

$$= \frac{\text{Long} - \text{term Borrowing} + \text{Short} - \text{term Borrowing}}{\text{Equity Share capital} + \text{Preference Share capital}}$$

Interpretation- A high D/E Ratio shows that the claims of creditors are greater than those of owners. A very high ratio is unfavourable from the owacr's point of view. This causes hinderence in the firm's operations due to the increasing pressure and interference of creditor in management. A high debt company finds difficulty in raising additional debt. During the periods of low profits a highly debts company suffers great strain, it cannot earn sufficient profits even to pay the interest charges of creditors. In this case the firm enjoys the benefits of trading on cquity when it earn a rate higher than the interest rate on borrowed funds.

A low debt equity ratio shows a greater claim of owners than creditors. From the creditors point of view it represents a larger margin of safety since owners equity is treated as margin of safety by creditors. During the periods of low probits the debt surviving will prove to be less burdensome for a firm with low debt-equity ratio. However there will be no benefits of trading on equity when the firm earns a rate higher than the interest rate on borrowed funds.

Unit-III

Q.5. Explain the meaning of equity shares and discuss their merits and demertis in company finance.

Ans. Refer Q.No.6 of the year 2017

OR

Q.6. Naresh Trading and Manufacturing Company manufactures prodcut 'A' The following figures are available for two successive years:

	Year 1	Year II
Sales	2,00,000	3,00,000
Fixed Cost	40,000	50,000
Variable Cost	1,10,000	1,80,000

The management of the company is interested to know the Profit-Volume- Ratio, Break-even Point and Margin of safety.

Ans. Solution:

Marginal Cost Statement

	Year I	Year II
Sales	₹	₹
Less- Variable Cost	2,00,000	3,00,000
Contribution Margin	1,10,000	1,80,000
Less: Fixed Costs	90,000	1,20,000
Profit	40,000	50,000
	50,000	70,000

(i) P/V Ratio= $\frac{C}{S} \times 100$

Year I Year II

$= \frac{90,000}{2,00,000} \times 100 = 45\%$ $= \frac{1,20,000}{3,00,000} \times 100 = 40\%$

(ii) B.E.P. $= \frac{F}{P/V\ Ratio} = \frac{40,000}{45\%}$ $= \frac{50,000}{40\%}$

$= \frac{40,000 \times 100}{45}$ $= \frac{50,000 \times 100}{40}$

= ₹ 88,889 = ₹ 1,25,000

(iii) Margin of Safety = = $\frac{\text{Profit}}{\text{P/V Ratio}}$

$= \frac{50,000}{45\%} = ₹1,11,111$ $= \frac{70,000}{40\%} = ₹1,75,000$

Unit-IV

Q.7. Explain the concept and determinants of working capital.

Ans. Refer Q No.8 of the year 2017

OR

Q.8. Krishna and Co. requires ₹ 15 lakhs to meet its transaction needs during next 6 months planning period. It holds short-term marketable securities of an equal amount at 20 per cent. ₹ 1,500 is required to convert the securities into cash. Determine economic lot size by using Baumol Model.

Ans. $C = \sqrt{\frac{2bT}{i}}$

Where,

b= Fixed cost on Transaction Cost associated with selling of securities

T= Requirement of cash for a given period of time.

I= Interest rate on securities for a specified period. (it has been assumed that interest rates are fixe)

C= That amount of cash balance where cost of selling securities (i.e. transaction cost) is less than the cost incurred due to loss of interested on securities sold.

$C = \sqrt{\frac{2 \times 15,00,000}{(0.20 \div 2)}} = ₹2,12,132$

UNIT- V

Q.9. For one of the A class items, the purchases manager spent Rs. 500 in procuring 1,000 units in a single lot in a year and thereby availed a discount of 5% on the price of Rs. 10 per unit. No discount will be given for any other order quantity. Inventory carrying cost worked out to be 40%. If he follows EOQ policy, what would be the gain or loss to the organisation.

Ans.

(i) **Total Cost if EOQ system is not followed:**

Existing order size = 1,000 average inventory = 1000 ÷ 2 = 500

Discounted cost per unit = ₹ 9.5 (Given ₹ 10-5% discount)

Cost of Carrying one unit for one year (C)= 9.5 X 0.4 = ₹ 3.8

Overall cost as per the current practice of the manager

	₹
(a) Ordering cost as given	500
(b) Inventory carrying cost (1000/2) X 3.8	1,900
(c) Material Purchased cost (1,000 X 9.5)	9,500
Total Cost	11,900

(ii) Total Cost if EOQ system is followed:

Annual demand (C)= 1,000

Cost per order (O)= ₹ 500 (As given)

Cost of Carrying one unit for one year (I) = 10.00 X 0.4 = ₹ 4

$$EOQ = \sqrt{\frac{2CO}{I}} \qquad EOQ = \frac{\sqrt{2 \times 1,000 \times 500}}{4} = 500$$

No. of Order= 1,000 ÷ 500= 2

Overall Cost if EOQ system is followed

	₹
Ordering cost (2 orders × ₹ 500)	1,000
Inventory carrying (500 ÷ 2) × 4	1,000
Material Purchased cost (1,000 × 10)	10,000
Total Cost	12,000

Decision: If we follow EOQ, we will incur a loss of Rs. 100 (i.e., 12,000-11,900)

OR

Q.10. What is 'Dividend Policy'? Examine the essentials of a sound dividend policy.

Ans. Refer Q-No.6 of the year 2014