

## Model Answers

### Subject –Financial Management

#### Paper code-AS-2639

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*(Note-These models answers are only depiction of important points, in order to secure high marks examinees are require to explain all the points and give proper notes to the practical question. The length of answer may vary as per interpretation and presentation of subject matter.)*

No.1. (i) Financial management is management of financial resources of a company with a aim to maximize the profit and value of the organization. It deals with how to arrange the estimated fund and how we will utilize this. Its objective includes:

- i. Procurement of funds
- ii. Effective utiliasation of funds

(ii) Two objectives of financial management are as follows:

(a) Profit maximization

(b) Wealth maximization

(iii) Debenture is one type of debt instrument which gives right to its holder to get a fixed rate of return and the principal amount at the time of maturity. Debenture holders do not have voting rights, but they will get interest irrespective profit or loss of the company.

(iv) Leverage indicates the company's ability to use the fixed interest bearing debt to diversify its risk or to maximize its profit by taking tax advantage. According to S.C. Kuchchal, "Leverage may be defined as meeting a fixed cost or paying a fixed return for employing resources or funds."

It may be classified into following types

- (a) Operating leverage
- (b) Financial leverage
- (c) Combined leverage

(v) NPV means net present value. This indicates the difference between P.V of cash inflows and P.V of cash outflows. This is one of the method of capital budgeting. In this method all the stream of future cash flows are discounted at given rate of discount or cost of capital.

$NPV = P.V \text{ of cash inflows} - P.V \text{ of cash out flows}$

(vi) Composite cost of capital is also known as overall cost of capital. It is weighted average of all specific cost of capital. First we calculate all specific cost of capital like  $K_d$ ,  $K_p$ ,  $K_e$  etc. after tax then these costs are multiplied by their proportionate weight according to total capital amount, the resultant amount is divided with total amount of weight to find out composite cost of capital.

(vii) Dividend decision is the decision making process regarding amount of profit to be distributed as dividend and amount to be ploughed back for reinvestment. It can be also defined as the determination of Dividend payout ratio. \* Example is required.

(viii)  $K_d = I/NP$ , here  $I = 150 * 11/100 = 16.5$  and  $NP = Rs.150 - 3 = Rs.147$

$K_d(\text{before tax}) = 16.5/147 = 0.11$  or 11%

$K_d \text{ after Tax} = K_d(BT)(1-T) = 11(1-0.30) = 7.7\%$

(IX) Stable policy gives importance to company's future requirement and share holders current expectation and tries to balance the both. It is done for long term period and remains constant for a long period. In this company's pays a stable rate of dividend and does not change. In other word it can be said dividend payout ratio remains stable in every year.

(X)  $FL = EBIT/EBT$ , here  $EBIT = RS.400000$  Interest = Rs.200000, so  $EBT = 400000 - 200000$

= Rs.200000

$$FL=400000/200000=2$$

No.2. In these answer students are expected to write the meaning of profit maximization objective, then they have explain all the merit and demerits with examples.

Merits:

- (a) Rationality
- (b) Maximization of social benefit.
- (c) Efficient allocation and uses of resources.
- (d) Source of incentive.
- (e) Measurement of success decisions

Demerits:

- (a) Ambiguity
- (b) It ignores time value of money
- (c) Ignores risk factor or quality of profit

Note- Examinees are required to explain all the points with suitable examples.

No-3. Capital structure theories means the decision making process regarding the selection of components of total capital of a company. Generally a company has option to finance its whole capital from various sources like owned capital or borrowed capital. So in this company decides from which Source Company will arrange its finance so that the value of firm will be maximized and overall cost of capital will be minimized.

Capital structure theories are:

- (a) Net Income approach
- (b) Net operating income approach
- (c) Traditional approach
- (d) Modigliani and miller approach

Note- Students are required to explain all above theories with suitable examples.

No.4. Computation of payback period

				Camelex	Shrilex	
Estimated savings						
(i) Scrap				40000	60000	
(ii) Wages				360000	480000	
Total				400000	540000	
Additional cost:						
(i) Cost of supervision				48000	64000	
(ii) cost of maintenance				28000	44000	
(iii) Indirect material				24000	32000	
Total				100000	140000	
Net savings p.a.				300000	400000	
Payback period				600000/300000	1000000/400000	
				=2	=2.5	
Conclusion : Camelex should be purchased as P.B period is less						

\*proper notes required

N0-5. (i) Issued at a discount of 10%

$$\text{Here } I = 150 * 9 / 100 = 13.5$$

$$NP = 150 - (150 * 10 / 100) - (150 * 4 / 100) = 129$$

$$RV = 150 + 9\% = 168, N = 5 \text{ years}$$

$$Kd(\text{ Before tax}) = \frac{I + \frac{RV - NP}{N}}{RV + NP/2} * 100$$

$$= \frac{13.5 + \frac{168 - 129}{5}}{168 + 129/2} * 100$$

$$= 14.3\%$$

$$Kd(\text{after tax})=Kd(\text{BT})(1-T)$$

$$=14.3(1-0.50)$$

$$=7.15\%$$

(ii) If issued at par

$$\text{Here } I= 150*9/100=13.5$$

$$NP=150-(150*4/100)=144$$

$$RV=150+9\%=168, N=5 \text{ years}$$

$$Kd(\text{ Before tax})= \frac{I + \frac{RV-NP}{N}}{RV+NP/2} * 100$$

$$= \frac{13.5 + \frac{168-144}{5}}{168+144/2} * 100$$

$$=11.73\%$$

$$Kd(\text{after tax})=Kd(\text{BT})(1-T)$$

$$=11.73(1-0.50)$$

$$=5.86\%$$

(iii) If issued at premium of 8%

$$\text{Here } I= 150*9/100=13.5$$

$$NP=150+(150*8/100)-(150*4/100)=156$$

$$RV=150+9\%=168, N=5 \text{ years}$$

$$Kd(\text{ Before tax})= \frac{I + \frac{RV-NP}{N}}{RV+NP/2} * 100$$

$$= \frac{13.5 + \frac{168-156}{5}}{168+156/2} * 100$$

$$=9.8\%$$

$$Kd(\text{after tax})=Kd(\text{BT})(1-T)$$

$$=9.8(1-0.50)$$

=4.9%

No-6. . Dividend decision is the important financial decision which involves the decision making process, whether the whole profit should be distributed as dividend or some amount should be kept as retained earnings for reinvestment purpose. Company should carefully carefully decide its dividend policy because it affects behavior and response of investor and also stock prices.

Factors affecting dividend decision:

**(A) Ownership factors**

- (i) Current income requirements of share holders
- (ii) Alternative uses of funds by share holders
- (iii) Tax consideration for shareholders

**(B) Company oriented factors**

- (i) Legal restrictions
- (ii) Liquidity and working capital requirement
- (iii) Need for expansion
- (iv) Business cycle
- (v) Availability of external capital
- (vi) Inflation

**(C) Other factors**

- (i) Nature of business
- (ii) Objective of management
- (iii) Composition of shareholders
- (iv) Restriction by financial institutions
- (v) Age of company
- (vi) Corporate tax policy
- (vii) Public opinion

- Proper explanation is required

No.7.

Estimate of working capital requirements			
(a) Current Assets		amount	
Debtors	1920000*1/12	160000	
Raw materials	900000*1/12	75000	
Finished goods	1920000*1/12	160000	
Cash & bank balance		40000	
Total(a)		435000	
(b) current liabilities			
Creditors	900000*2/12	150000	
Manufacturing expenses	1080000*1/12	90000	
Wages	720000*1/24	30000	
Admn expenses	240000*1/12	20000	
Total(b)		290000	
Working capital(a-b)		145000	
Add: 20% for contingencies		29000	
Total working capital		174000	
Working note:			
Cost of sales			
Sales	2400000		
Less: 20% gross profit	480000		
	1920000		

Note- Proper working note and assumptions ( if any taken) are required to be shown.

No-8. (a) Cost of Debt: it means minimum rate of return expected by the debenture holder. It is denoted by  $K_d$ . Debenture.

(b) Cost of preference share: it means the minimum rate of return expected by the preference share holder. It is denoted by  $K_p$ .

(c) Cost of equity: it means the minimum rate of return expected by the equity share holder.

It is denoted by  $K_e$ .

Note- Along with above meaning Examinees is required to write the formula for calculation of different cost before and after tax (redeemable and irredeemable) with suitable example.