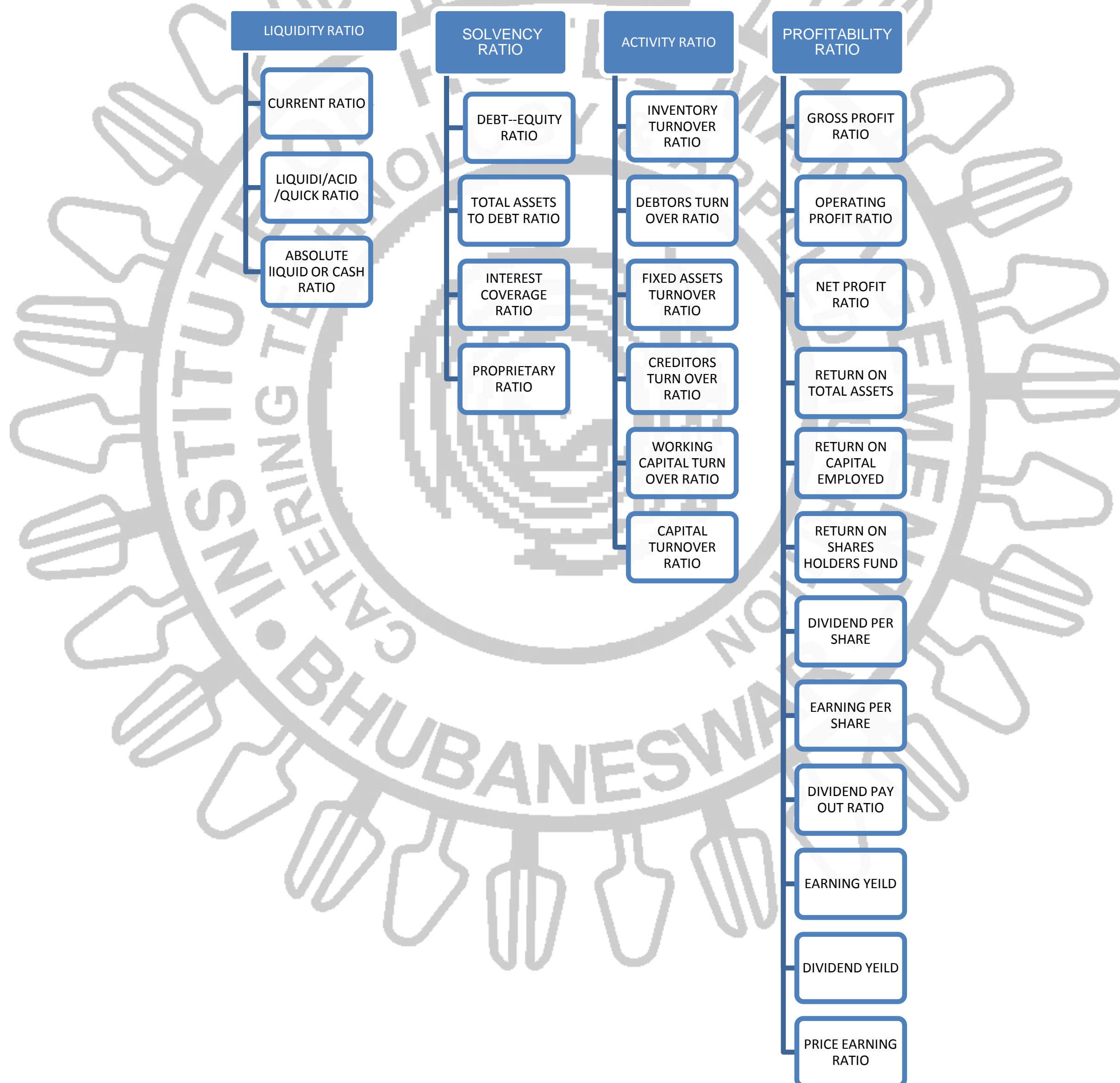
Previous Years Questions And Answers

Question 1 : What is meant by term ratio analysis in Financial Management ? Classify the different types of ratio with example.

A ratio is a simple arithmetical expression of the relationship of one number to another. It may be defined as the indicated quotient of two mathematical expressions. According to Kholer, a ratio is the relation, of the amount, a to another b, expressed as the ratio of a to b. a: b (a is to b) or as a simple fraction, integer, decimal, or percentage. For example , if the current assets of a firm on a given date are 5,00,000 and the current liabilities are Rs 2,50000 then the ratio of current assets to current liabilities will work out to be 500,000/2,50,000 or 2.



Question 2: What is mean by Working Capital? Discuss the factors which determines working capital needs of the firm.

Working Capital is the capital of a business which is used in its day-to-day trading operations, calculated as the current assets minus the current liabilities.

Factors

(1) Nature of Business:

The requirement of working capital depends on the nature of business. The nature of business is usually of two types: Manufacturing Business and Trading Business. In the case of manufacturing business it takes a lot of time in converting raw material into finished goods. Therefore, capital remains invested for a long time in raw material, semi-finished goods and the stocking of the finished goods. Consequently, more working capital is required. On the contrary, in case of trading business the goods are sold immediately after purchasing or sometimes the sale is affected even before the purchase itself. Therefore, very little working capital is required. Moreover, in case of service businesses, the working capital is almost nil since there is nothing in stock.

(2) Scale of Operations:

There is a direct link between the working capital and the scale of operations. In other words, more working capital is required in case of big organisations while less working capital is needed in case of small organisations.

(3) Business Cycle:

The need for the working capital is affected by various stages of the business cycle. During the boom period, the demand of a product increases and sales also increase. Therefore, more working capital is needed. On the contrary, during the period of depression, the demand declines and it affects both the production and sales of goods. Therefore, in such a situation less working capital is required.

(4) Seasonal Factors:

Some goods are demanded throughout the year while others have seasonal demand. Goods which have uniform demand the whole year their production and sale are continuous. Consequently, such enterprises need little working capital. On the other hand, some goods have seasonal demand but the same are produced almost the whole year so that their supply is available readily when demanded. Such enterprises have to maintain large stocks of raw material and finished products and so they need large amount of working capital for this purpose. Woolen mills are a good example of it.

(5) Production Cycle

Production cycle means the time involved in converting raw material into finished product. The longer this period, the more will be the time for which the capital remains blocked in raw material and semi-manufactured products. Thus, more working capital will be needed. On the contrary, where period of production cycle is little, less working capital will be needed.

(6) Credit Allowed:

Those enterprises which sell goods on cash payment basis need little working capital but those who provide credit facilities to the customers need more working capital.

(7) Credit Availed:

If raw material and other inputs are easily available on credit, less working capital is needed. On the contrary, if these things are not available on credit then to make cash payment quickly large amount of working capital will be needed.

(8) Operating Efficiency:

Operating efficiency means efficiently completing the various business operations. Operating efficiency of every organisation happens to be different.

Some such examples are: (i) converting raw material into finished goods at the earliest, (ii) selling the finished goods quickly, and (iii) quickly getting payments from the debtors. A company which has a better operating efficiency has to invest less in stock and the debtors.

Therefore, it requires less working capital, while the case is different in respect of companies with less operating efficiency.

(9) Availability of Raw Material:

Availability of raw material also influences the amount of working capital. If the enterprise makes use of such raw material which is available easily throughout the year, then less working capital will be required, because there will be no need to stock it in large quantity.

On the contrary, if the enterprise makes use of such raw material which is available only in some particular months of the year whereas for continuous production it is needed all the year round, then large quantity of it will be stocked. Under the circumstances, more working capital will be required.

(10) Growth Prospects:

Growth means the development of the scale of business operations (production, sales, etc.). The organisations which have sufficient possibilities of growth require more working capital, while the case is different in respect of companies with less growth prospects.

(11) Level of Competition:

High level of competition increases the need for more working capital. In order to face competition, more stock is required for quick delivery and credit facility for a long period has to be made available.

(12) Inflation:

Inflation means rise in prices. In such a situation more capital is required than before in order to maintain the previous scale of production and sales. Therefore, with the increasing rate of inflation, there is a corresponding increase in the working capital.

Question 3: Objectives /goals of financial management:

1. To ensure regular and adequate supply of funds to the concern.
2. To ensure adequate returns to the shareholders which will depend upon the earning capacity, market price of the share, expectations of the shareholders.
3. To ensure optimum funds utilization. Once the funds are procured, they should be utilized in maximum possible way at least cost.
4. To ensure safety on investment, i.e, funds should be invested in safe ventures so that adequate rate of return can be achieved.
5. To plan a sound capital structure-There should be sound and fair composition of capital so that a balance is maintained between debt and equity capital

The following are the main characteristics/ features of the financial management-

- **Analytical Thinking-**Under financial management financial problems are analyzed and considered. Study of trend of actual figures is made and ratio analysis is done.
- **Continuous Process-**previously financial management was required rarely but now the financial manager remains busy throughout the year.
- **Basis of Managerial Decisions-** All managerial decisions relating to finance are taken after considering the report prepared by the finance manager. The financial management is the base of managerial decisions.
- **Maintaining Balance between Risk and Profitability-**Larger the risk in the business larger is the expectation of profits. Financial management maintains balance between the risk and profitability.
- **Coordination between Process-** There is always a coordination between various processed of the business.
- **Centralized Nature-** Financial management is of a centralized nature. Other activities can be decentralized but there is only one department for financial management.

QUESTION 4: Write short notes

1.Working Capital: Working Capital is the capital of a business which is used in its day-to-day trading operations, calculated as the current assets minus the current liabilities

2.Return On Capital Employed: Return on capital employed (ROCE) is a financial ratio that measures a company's profitability and the efficiency with which its capital is employed.

ROCE = Earnings Before Interest and Tax (EBIT) / Capital Employed.

Capital Employed= Which refers to the long term funds supplied by the long term creditors and shares holders. It comprises the long term debt and shares holders funds.

3.Net Profit Ratio: **Net Profit Ratio (NP ratio)** is a popular profitability ratio that shows relationship between net profit after tax and net sales.

It indicates the efficiency of the management in manufacturing, selling administrative and other activities of the firm.

Net Profit Ratio= Net profit after tax / Net sales

4.Return On Shares Holders Fund: **Return on shareholders**' investment ratio is a measure of overall profitability of the business and is computed by dividing the net income after interest and tax by average stockholders' equity. It is also known as **return** on equity (ROE) ratio and **return** on net worth ratio. The ratio is usually expressed in percentage.

5.Stock/Inventory Turn Over Ratio: Inventory turnover is a ratio showing how many times a company's inventory is sold and replaced over a period.

Inventory Turnover = Cost of Goods sold / Average Inventory

6.Trend Analysis: The trend analysis is a technique of studying several financial statements over a series of years. In this analysis, the trend percentages are calculated for each item over a series of years by taking the figure of that item for the base year. The base year's figure is taken as 100 and the trend percentages for other years are calculated in relation to the base year. Generally, the first year is taken as the base year. After calculating the trend percentages, the analyst becomes able to see the trend of figures, whether moving upward or downward.

7. Cash Budget: A cash budget is an estimation of the cash inflows and outflows for a business over a specific period of time, and this budget is used to assess whether the entity has sufficient cash to operate. Companies use sales and production forecasts to create a cash budget, along with assumptions about necessary spending and accounts receivable. If a company does not have enough liquidity to operate, it must raise more capital by issuing stock or by taking on debt.

8.Common Size Income Statement: The common size statements (Balance Sheet and Income Statement) are shown in analytical percentages. The figures of these statements are shown as percentages of total assets, total liabilities and total sales. In the balance sheet, the total assets are taken as 100 and different assets are expressed as a percentage of the total. Similarly, various liabilities are taken as a part of total liabilities. Practically, two financial statements are prepared in common-size form for analysis purposes. They are as follows:

a) Common-size Balance Sheet
b) Common-size Income statement

9.Cash Flow Statement:

The official name for the cash flow statement is the statement of cash flows. The statement of cash flows is one of the main financial statements. The cash flow statement reports the cash generated and used during the time interval specified in its heading. The period of time that the statement covers is chosen by the company.

The cash flow statement organizes and reports the cash generated and used in the following categories:

1.Operating activities	- converts the items reported on the income statement from the accrual basis of accounting to cash.
2. Investing activities	- reports the purchase and sale of long-term investments and property, plant and equipment.
3. Financing activities	- reports the issuance and repurchase of the company's own bonds and stock and the payment of dividends.
4. Supplemental information	- reports the exchange of significant items that did not involve cash and reports the amount of income taxes paid and interest paid.

8.Fund From Operation:

Funds from operation refer to those funds which are **generated in the business** as a result of carrying out the operation during the normal course of the business and are **computed** by **taking out difference between**

Operating revenue that provide funds during the accounting period and

Operating expenses that involved an outflow of funds during the accounting period.

Fund From Operation Adjusted Profit & Loss	
To Depreciation	By Opening Balance
To Loss on sale of Non Current Assets or fixed assets	By gain on sale of noncurrent assets or fixed assets.
To Goodwill /Patent/ Trade Mark/other intangible assets amortized.	By Transfer fee
To discount on issue of shares /Debentures, Written off	By dividend and interest on investment
To transfer to reserve	By rent received
To Reserve for doubt ful debt	By Compensation on acquisition of non -current assets
To interim Dividend(current year)	By Refund of taxes.
To Proposed Dividend (for current year)if not taken as current liability	By profit revaluation of assets
To Provision for taxation(for current year)if not taken as current liability *	By Appreciation in the value of fixed assets
To Preliminary Expenses*	
To Net Profit	By fund from operation(Balancing figure)
To Closing Balance of P/La/c	
to fund lost in operation(in case cr side exceeds debit sides	

10.Financial Planning:

Financial planning can refer to the three primary financial statements (balance sheet, income statement, and cash flow statement) created within a business plan. **Financial forecast** or financial plan can also refer to an annual projection of income and expenses for a company, division or department.[2] A financial plan can also be an estimation of cash needs and a decision on how to raise the cash, such as through borrowing or issuing additional shares in a company.

Its Characteristics are:

(1) Simplicity:

A sound financial structure should provide simple financial structure which could be managed easily and understandable even to a layman. "

(2) Foresight:

Foresight must be used in planning the scope of operation in order that the needs for capital may be estimated as accurately as possible. A plan visualised without foresight spells disaster for the company, if it fails to meet the needs for both fixed and working capital. In simple words, the canon of foresight means that besides the needs of 'today' the requirements of 'tomorrow' should also be kept in view.

(3) Flexibility:

Financial readjustments become necessary often. The financial plan must be easily adaptable to them. There should be a degree of flexibility so that financial plan can be adopted with a minimum of delay to meet changing conditions in the future.

(4) Optimum use of funds:

Capital should not only be adequate but should also be productively employed. Financial plan should prevent wasteful use of capital, avoid idle capacity and ensure proper utilisation of funds to build up earning capacity of the enterprise. There should be optimum utilisation of available financial resources. If this is not done, the profitability will decline. There should be a proper balance between the fixed capital and the working capital.

(5) Liquidity:

It means that a reasonable percentage of the current assets must be kept in the form of liquid cash. Cash is required to finance purchases, to pay salaries, wages and other incidental expenses. The degree of liquidity to be maintained is determined by the size of the company, its age, its credit status, the nature of its operations, the rate of turnover etc.

(6) Anticipation of contingencies:

The planners should visualise contingencies or emergency situations in designing their financial plan. This may lead to keeping of some surplus capital for meeting the unforeseen events. It would be better if these contingencies are anticipated in advance.

(7) Economy:

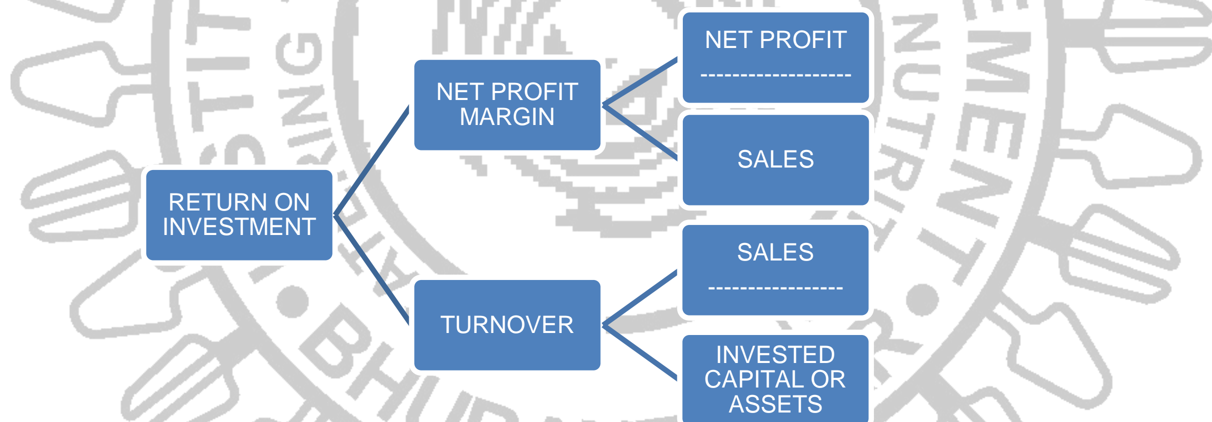
Last but not the least, the financial open be made in such a manner that the cost of capital procurement should be minimum. The capital mobilised should not impose disproportionate burden on the company. The fixed dividend on preference shares, the interest on loans and debentures should be related to the earning capacity. The fixed interest payments should not reduce the profits of the company and hamper its sustained growth.

11.Cost Of Capital: Cost of capital refers to the opportunity **cost** of making a specific investment. It is the rate of return that could have been earned by putting the same money into a different investment with equal risk. Thus, the **cost of capital** is the rate of return required to persuade the investor to make a given investment. Since the cost of capital represents a hurdle rate that a company must overcome before it can generate value, it is extensively used in the capital budgeting process to determine whether the company should proceed with a project.

12. Budgetary control: is a system of controlling costs which includes the preparation of budgets, coordinating the departments and establishing responsibilities, comparing actual performance with the budgeted and acting upon results to achieve maximum profitability."

13. Du Pent Control Chart:

The Du Pont control chart also known as Du Pont analysis is **named after the first user of Ratio** i.e. The DuPont Company of the United States.



According to this chart ROI represent the earning power of a firm. It depends on two ratio:

A) Net Profit Margin

B) Capital Turnover Ratio

A change in any one of the two ratio will change the firms earning power i.e ROI and is affected by many factors.

The financial ratio of a company in a given year may not help in the complete assessment of its performance. To interpret the financial health of a company , it is crucial to analyse and compare the ratio for a given year with the ratios in the previous year and the industry ratio.

13. Over Capitalizing: When a company has issued more debt and equity than its assets are worth. An overcapitalized company might be paying more than it needs to in interest and dividends. Reducing debt, buying back shares and restructuring the company are possible solutions to this problem.

14. Financial Analysis: Financial analysis is a process which involves reclassification and summarization of information through the establishment of ratios and trends. Analysis of financial statement refers to the examination of the statements for the purpose of acquiring additional information regarding the activities of the business. The users of the financial information often find analysis desirable for the interpretation of the firm's activities.

Financial statement analysis can be referred as a process of understanding the risk and profitability of a company by analyzing reported financial info, especially annual and quarterly reports. Putting another way, financial statement analysis is a study about accounting ratios among various items included in the balance sheet. These ratios include asset utilization ratios, profitability ratios, leverage ratios, liquidity ratios, and valuation ratios. Moreover, financial statement analysis is a quantifying method for determining the past, current, and prospective performance of a company.

15. Over Trading and Under Trading:

Over-trading arises only when the capital employed is inadequate in comparison with the volume of business. In other words, it is an expansion of sales without adequate support from capital. That is to say, the company with limited resources tries to increase the volume of business which, ultimately, suffers from acute shortage of liquid funds.

The symptoms of over-trading are discernible when:

(a) A company takes a comparatively long time to pay-off its creditors or the amount of creditors increases in comparison with debtors, or creditors increase more rapidly or fall more slowly than debtors.

(b) The amount of profit declines.

(c) The company increases the rate of borrowings in a way which is quite excessive in relation to the assets owned by the shareholders.

(d) A company is buying fixed or non-current assets out of short-term funds.

(e) Bills Payable are recorded which is not customary, and unaccounted reduction is made in Bills Receivable which indicates discounting.

Under-Trading:

Under-trading is a condition contrary to over-trading. It is an application of idle funds. Too much investment in current assets and smaller amount of current liabilities results in under-trading. **The symptoms of under-trading, however, are to show:**

(a) A very high Current Ratio and Liquid Ratio.

(b) Lower Turnover Ratios.

The consequence of under-trading are:

(a) Reduction in profits.

(b) Reduction in the rates of return on capital employed.

(c) Loss of Goodwill.

(d) Fall in the prices of the shares in the market.

Difference between Over Capitalization and Under Capitalization of Company

Over Capitalization:

A company is said to be overcapitalized when the aggregate of the par value of its shares and debentures exceeds the true value of its fixed assets. In other words, over capitalisation takes place when the stock is watered or diluted.

It is wrong to identify over capitalisation with excess of capital, for there is every possibility that an over capitalised concern may be confronted with problems of liquidity. The current indicator of over capitalisation is the earnings of the company .If the earnings are lower than

the expected returns, it is overcapitalised. Overcapitalisation does not mean surplus of funds. It is quite possible that a company may have more funds and yet to have low earnings. Often, funds may be inadequate, and the earnings may also be relatively low. In both the situations there is over capitalisation.

Over capitalisation may take place due to – exorbitant promotion expenses, inflation, shortage of capital, inadequate provision of depreciation, high corporation tax, liberalised dividend policy etc. Over capitalisation shows negative impact on the company, owners, consumers and society.

Factors responsible for over capitalization

Over-issue of capital:

Defective financial planning may lead to excessive issue of shares or debentures. The issue would be superfluous and a constant burden on the earnings of the company.

2. Acquiring assets at inflated prices:

Assets may be acquired at inflated prices or at a time when the prices were at their peak. In both the cases, the real value of the company is below its book value and the earnings are very low.

3. Formation during the boom period:

If the establishment of a new company or the expansion of an existing concern takes place during the boom period, it may be a victim of over- capitalisation. The assets are acquired at fabulous prices. But when boom conditions cease prices of products decline resulting in lower earnings. The original value of assets remains in books while earning capacity dwindles due to depression. Such a state of affairs results in over- capitalisation.

4. Over estimation of earnings:

The promoters or the directors of the company may over-estimate the earnings of the company and raise capital accordingly. If the company is not in a position to invest these funds profitably, the company will have more capital than required. Consequently, the rate of earnings per share will be less.

5. Inadequate depreciation:

Absence of suitable depreciation policy would make the asset-values superfluous. If the depreciation or replacement provision is not adequately made, the productive worth of the assets is diminished which will definitely depress the earnings. Lowered earnings bring about fall in share values, which represents over-capitalisation.

6. Liberal dividend policy:

The company may follow a liberal dividend policy and may not retain sufficient funds for self-financing. It is not a prudent policy as it leads to over-capitalisation in the long run, when the book value of the shares falls below their real value.

7. Lack of reserves:

Certain companies do not believe in making adequate provision for various types of reserves and distribute the entire profit in the form of dividends. Such a policy reduces the real profit of the company and the book value of the shares lags much behind its real value. It represents over-capitalisation.

8. Heavy promotion and organisation expenses:

"A certain degree of overcapitalisation ,"says Beacham, "may be caused by heavy issue expenses". If expenses incurred for promotion, issue and underwriting of shares, promoters' remuneration etc., prove to be higher compared to the benefits they provide, the enterprise will find itself over-capitalised.

9. Shortage of capital:

If a company has small share capital it will be forced to raise loans at heavy rate of interest. This would reduce the net earnings available for dividends to shareholders. Lower earnings bring down the value of shares leading to over-capitalisation.

10. Taxation policy:

High rates of taxation may leave little in the hands of the company to provide for depreciation and replacement and dividends to shareholders. This may adversely affect its earning capacity and lead to over-capitalisation

Under capitalization:

Under capitalisation is just the reverse of over capitalisation, a company is said to be undercapitalized when its actual capitalisation is lower than its proper capitalisation as warranted by its earning capacity. This happens in case of well established companies, which have insufficient capital but, large secret reserves in the form of considerable appreciation in the values of fixed assets not brought into books.

In case of such companies, the dividend rate will be high and the market value of their shares will be higher than the value of shares of other similar companies.

The state of under capitalisation of a company can easily be ascertained by comparing of a book value of equity shares of the company with their real value. In case real value is more than the book value, the company is said to be undercapitalized.

Under capitalisation may take place due to – under estimation of initial earnings, under estimation of funds, conservative dividend policy, windfall gains etc. Under-capitalisation has some evil consequences like creation of power competition, labour unrest, consumer dissatisfaction, possibility of manipulating share value etc..

Comparison Chart

BASIS FOR COMPARISON	PROFIT MAXIMIZATION	WEALTH MAXIMIZATION
Concept	The main objective of a concern is to earn a larger amount of profit.	The ultimate goal of the concern is to improve the market value of its shares.
Emphasizes on	Achieving short term objectives.	Achieving long term objectives.
Consideration of Risks and Uncertainty	No	Yes
Advantage	Acts as a yardstick for computing the operational efficiency of the entity.	Gaining a large market share.
Recognition of Time Pattern of Returns	No	Yes

15.Objectives of financial analysis

1. Assessment of Past Performance and Current Position:

Past performance is often a good indicator of future performance. Therefore, an investor or creditor is interested in the trend of past sales, expenses, net income, cast flow and return on investment. These trends offer a means for judging management's past performance and are possible indicators of future performance.

Similarly, the analysis of current position indicates where the business stands today.

2. Prediction of Net Income and Growth Prospects:

The financial statement analysis helps in predicting the earning prospects and growth rates in the earnings which are used by investors while comparing investment alternatives and other users interested in judging the earning potential of business enterprises. Investors also consider the risk or uncertainty associated with the expected return.

The decision makers are futuristic and are always concerned with the future. Financial statements which contain information on past performances are analysed and interpreted as a basis for forecasting future rates of return and for assessing risk.

3. Prediction of Bankruptcy and Failure:

Financial statement analysis is a significant tool in predicting the bankruptcy and failure probability of business enterprises. After being aware about probable failure, both managers and investors can take preventive measures to avoid/minimise losses. Corporate managements can effect changes in operating policy, reorganise financial structure or even go for voluntary liquidation to shorten the length of time losses.

Investors and shareholder can use the model to make the optimum portfolio selection and to bring changes in the investment strategy in accordance with their investment goals. Similarly, creditors can apply the prediction model while evaluating the creditworthiness of business enterprises.

4. Loan Decision by Financial Institutions and Banks:

Financial statement analysis is used by financial institutions, loaning agencies, banks and others to make sound loan or credit decision. In this way, they can make proper allocation of credit among the different borrowers. Financial statement analysis helps in determining credit risk, deciding terms and conditions of loan if sanctioned, interest rate, maturity date etc.

14. Pay -Back period Method: Payback period in capital budgeting refers to the **period** of time required to recoup the funds expended in an investment, or to reach the break-even point. For example, a $1000 investment made at the start of year 1 which returned $500 at the end of year 1 and year 2 respectively would have a two-year **payback period**.

15. Business Finance: Business finance is a term that encompasses a wide range of activities and disciplines revolving around the management of money and other valuable assets. Business finance programs in universities familiarize students with accounting methodologies, investing strategies and effective debt management. Small business owners must have a solid understanding of the principles of finance to keep their companies profitable.

16.Net working capital is the aggregate amount of all current assets and current liabilities. It is used to measure the short-term liquidity of a business, and can also be used to obtain a general impression of the ability of company management to utilize assets in an efficient manner.

17. ROI is usually expressed as a percentage and is typically used for personal financial decisions, to compare a company's profitability or to compare the efficiency of different **investments**. The **return on investment** formula is: **ROI** = (Net Profit / Cost of **Investment**) x 100.

18.Net Present Value (NPV) is the difference between the present value of cash inflows and the present value of cash outflows. NPV is used in capital budgeting to analyze the profitability of a projected investment or project.

19.The quick ratio or **acid test ratio** is a liquidity **ratio** that measures the ability of a company to pay its current liabilities when they come due with only quick assets. Quick assets are current assets that can be converted to cash within 90 days or in the short-term.

20.Retained earnings refer to the percentage of net **earnings** not paid out as dividends, but **retained** by the company to be reinvested in its core business, or to pay debt. It is recorded under shareholders' equity on the balance sheet.

21 .Redemption is the process of repaying an obligation at predetermined amount. The redeemable **preference shares** are issued on the terms that the shareholders will be repaid the amount which they invested at future date.

22.Internal Rate of Return: Internal rate of return (IRR) is a metric used in capital budgeting measuring the profitability of potential investments. Internal rate of return is a discount rate that makes the net present value (NPV) of all cash flows from a particular project equal to zero. IRR calculations rely on the same formula as NPV does.

23.Wealth Maximization: Wealth maximization is the concept of increasing the value of a business in order to increase the value of the shares held by stockholders. Wealth maximization simply means maximization of shareholder’s wealth. It is a combination of two words viz. wealth and maximization. A wealth of a shareholder maximizes when the net worth of a company maximizes. To be even more meticulous, a shareholder holds share in the company /business and his wealth will improve if the share price in the market increases which in turn is a function of net worth. This is because wealth maximization is also known as net worth maximization.

24. Debentures: A debenture is a type of debt instrument that is not secured by physical assets or collateral. Debentures are backed only by the general creditworthiness and reputation of the issuer. Both corporations and governments frequently issue this type of bond to secure capital

25. Preference shares: Preference shares, more commonly referred to as preferred stock, are shares of a company’s stock with dividends that are paid out to shareholders before common stock dividends are issued. If the company enters bankruptcy, the shareholders with preferred stock are entitled to be paid from company assets first. Most preference shares have a fixed dividend, while common stocks generally do not. Preferred stock shareholders also typically do not hold any voting rights, but common shareholders usually do.

26.Deferred Revenue Expenditure: Deferred Revenue Expenditure is an expenditure which is revenue in nature and incurred during an accounting period, but its benefits are to be derived over a number of following accounting periods.

27.Balance Sheet (Liquidity Format): Order of **liquidity** is the presentation of assets in the **balance sheet** in the order of the amount of time it would usually take to convert them into cash. Thus, cash is always presented first, followed by marketable securities, then accounts receivable, then inventory, and then fixed assets. Goodwill is listed last.

QUESTION 5: FILL IN THE BLANKS

1.Capital Budgeting is also known as INVESTMENT APPRAISAL.

2.There is a time gap between cash inflow and CASH OUTFLOW

3.Budgetary control is a system of controlling COST

4.The cost of capital is the minimum rate of return expected by its INVESTORS

5. Capital gearing refers to the relationship between equity capital and FIXED COST BEARING SECURITIES

6.The ratio between the cost of good sold and average inventory is known as STOCK TURN OVER RATIO

7.When absolute rupee amounts in financial statement are converted into percentage the financial statement is known as COMMON SIZE STATEMENT

8. An INTRIM FIRM COMPARISON would demonstrate the firms position via-a -vis its competitors

9.An INCREASE in current assets causes an increase in working capital

10.Redumption of debentures is a APPLICATION

11.The number of years cash benefits take to recover the original cost of investment is the PAYBACK PERIOD of investment appraisal

12.The discount rate which equates the aggregate present value of the net cash inflow with the aggregate present value of cash outflow of a project is known as INTERNAL RATE OF RETURN

13.The phrase under capitalization signifies INADEQUANCY OF CAPITAL in an enterprise.

14.The mix of long term sources of funds and owners equity is known as CAPITAL STRUCTURE of a firm

15.The term gross working capital refers to the aggregate of CURRENT ASSETS

QUESTION 6:

State and explain the difference between Cash Flow Statement and Fund Flow Statement.

	Basis of Difference	Funds Flow Statement	Cash Flow Statement
1.	**Basis of Analysis**	Funds flow statement is based on broader concept i.e. working capital.	Cash flow statement is based on narrow concept i.e. cash, which is only one of the elements of working capital.
2.	**Source**	Funds flow statement tells about the various sources from where the funds generated with various uses to which they are put.	Cash flow statement stars with the opening balance of cash and reaches to the closing balance of cash by proceeding through sources and uses.
3.	**Usage**	Funds flow statement is more useful in assessing the long-range financial strategy.	Cash flow statement is useful in understanding the short-term phenomena affecting the liquidity of the business.
4.	**Schedule of Changes in Working Capital**	In funds flow statement changes in current assets and current liabilities are shown through the schedule of changes in working capital.	In cash flow statement changes in current assets and current liabilities are shown in the cash flow statement itself.
5.	**End Result**	Funds flow statement shows the causes of changes in net working capital.	Cash flow statement shows the causes the changes in cash.
6.	**Principal of Accounting**	Funds flow statement is in alignment with the accrual basis of accounting.	In cash flow statement data obtained on accrual basis are converted into cash basis.

QUESTION 7:
Define capital structure. What are the major determinants of capital structure:

The **capital structure** is how a firm finances its overall operations and growth by using different sources of funds. Debt comes in the form of bond issues or long-term notes payable, while equity is classified as common stock, preferred stock or retained earnings.
Major Determinants

- **Trading on Equity**
- **Degree of control**
- **Flexibility of financial plan**
- **Choice of investors**
- **Capital market condition-**
- **Period of financing**
- **Cost of financing**
- **Stability of sales**
- **Sizes of a company**

Question 8.What is capital budgeting? What are its need and importance. Write shorts notes on any two capital budgeting appraisal methods

Capital budgeting, or investment appraisal, is the planning process used to determine whether an organization's long term investments such as new machinery, replacement of machinery, new plants, new products, and research development projects are worth the funding of cash through the firm's capitalization structure

- **Develop and formulate long-term strategic goals** – the ability to set long-term goals is essential to the growth and prosperity of any business. The ability to appraise/value investment projects via capital budgeting creates a framework for businesses to plan out future long-term direction.

- **Seek out new investment projects** – knowing how to evaluate investment projects gives a business the model to seek and evaluate new projects, an important function for all businesses as they seek to compete and profit in their industry.

- **Estimate and forecast future cash flows** – future cash flows are what create value for businesses overtime. Capital budgeting enables executives to take a potential project and estimate its future cash flows, which then helps determine if such a project should be accepted.

- **Facilitate the transfer of information** – from the time that a project starts off as an idea to the time it is accepted or rejected, numerous decisions have to be made at various levels of authority. The capital budgeting process facilitates the transfer of information to the appropriate decision makers within a company.

- **Monitoring and Control of Expenditures** – by definition a budget carefully identifies the necessary expenditures and R&D required for an investment project. Since a good project can turn bad if expenditures aren't carefully controlled or monitored, this step is a crucial benefit of the capital budgeting process

- **Creation of Decision** – when a capital budgeting process is in place, a company is then able to create a set of decision rules that can categorize which projects are acceptable and which projects are unacceptable. The result is a more efficiently run business that is better equipped to quickly ascertain whether or not to proceed further with a project or shut it down early in the process, thereby saving a company both time and mon

METHODS

PAY BACK PERIOD METHOD

- It refers to the period in which the project will generate the necessary cash to recover the initial investment.
- For E.g. If a project requires Rs 20000 as initial investment and it will generate annual cash flow of Rs 5000 for ten years, the pay back period will be 4 years as follows
- Pay Back Period = $\frac{\text{Initial Investment}}{\text{Annual Cash Flow}}$

AVERAGE RATE OF RETURN METHOD

Under this method average profit after tax and depreciation is calculated and then it is divided by the total capital outlay or total investment in the project

Average Rate Of Return= $\frac{\text{Average Annual Profit}}{\text{Net Investment}} \times 100$

Question 9 True and false

1.Liquidity ratio measures long term solvency of a concern F
2.Inventory is a part of asset T
3.The term financial analysis includes both analysis and interpretation T
4.Funds is difference between Fixed assets and current assets F
5.Cash flow statement is based upon accrual basis of accounting T
6.Finance Function is one of the most important function of business management T
7.Capital structure is a mix of presence and equity share capital T
8.Net working capital is the excess of current liabilities over current assets F
9.Pay back period method measures the true profitability of a project T
10.Capital rationing and capital budgeting means the same thing. F
11.Gross profit is sales minus cost of goods sold T
12..Average stock is calculated $\frac{\text{opening stock plus closing stock}}{2}$ T
14.Equity share capital is also known as risk capital T
15.Retaining of huge cash balance is a sound policy F
16.Ratio analysis helps in decision making process T
17.Debt equity ratio is to measures outsiders funds to shareholders fund. T
18.Non fund items are added back to profits and loss account in order to know funds from operation. T
19.Net present value method recognizes the time value of money T
20.Pay back method is not a simple method to calculate. F
21.Depreciation is calculated on fixed assets as well as on current assets. F
22.Equity shares holder and preference share holders shares profit equally. F
23.Gross Profit Ratio = $\frac{\text{Gross Profit}}{\text{Nett Profit}} \times 100$ F
24.Cuerrent Ratio is =$\frac{\text{Current Assets}}{\text{current Liabilities}} \times 100$ T

Question 10

State the importance of financial statement analysis. Explain any one technique of financial statement analysis

Financial Analysis: Financial analysis is a process which involves reclassification and summarization of information through the establishment of ratios and trends. Analysis of financial statement refers to the examination of the statements for the purpose of acquiring additional information regarding the activities of the business. The users of the financial information often find analysis desirable for the interpretation of the firm's activities. Financial analysis can be referred as a process of understanding the risk and profitability of a company by analyzing reported financial info, especially annual and quarterly reports. Putting another way, financial statement analysis is a study about accounting ratios among various items included in the balance sheet. These ratios include asset utilization ratios, profitability ratios, leverage ratios, liquidity ratios, and valuation ratios. Moreover, financial statement analysis is a quantifying method for determining the past, current, and prospective performance of a company.

Tools/Techniques/Methods of Financial Analysis

A number of tools or methods or devices are used to study the relationship between financial statements. However, the following are the important tools which are commonly used for analyzing and interpreting financial statements:

- Comparative Financial Statements/Horizontal Analysis
- Common-size Statements/Vertical Analysis/Cross-Sectional Analysis
- Trend Analysis
- Ratio Analysis
- Funds Flow Analysis
- Cash Flow Analysis

1. Comparative Financial Statements/Horizontal Analysis:

In brief, comparative study of financial statements is the comparison of the financial statements of the business with the previous year's financial statements. It enables identification of weak points and applying corrective measures. Practically, two financial statements are prepared in comparative form for analysis purposes. They are as follows:

a) Comparative Balance Sheet
b) Comparative Income statement

The analysis and interpretation of income statement will involve the following:

- The increase or decrease in sales should be compared with the increase or decrease in cost of goods sold.
- To study the operating profits.
- The increase or decrease in net profit is calculated that will give an idea about the overall profitability of the concern.

2. Common-size Statements/Vertical Analysis/Cross-Sectional Analysis:

The common size statements (Balance Sheet and Income Statement) are shown in analytical percentages. The figures of these statements are shown as percentages of total assets, total liabilities and total sales. In the balance sheet, the total assets are taken as 100 and different assets are expressed as a percentage of the total. Similarly, various liabilities are taken as a part of total liabilities. Practically, two financial statements are prepared in common-size form for analysis purposes.

3. Trend Analysis/Trend Percentage Analysis (TPA)

The trend analysis is a technique of studying several financial statements over a series of years. In this analysis, the trend percentages are calculated for each item over a series of years by taking the figure of that item for the base year. The base year's figure is taken as 100 and the trend percentages for other years are calculated in relation to the base year. Generally, the first year is taken as the base year. After calculating the trend percentages, the analyst becomes able to see the trend of figures, whether moving upward or downward.

Trend analysis is the type of analysis in which the information for a single company is compared over time. Over the course of the business cycle, sales and profitability of a company may expand and contract. So the ratio analysis for one year may not present an accurate picture of the firm. Therefore we look at trend analysis of performance over a number of years. However, without industry comparisons even trend analysis may not present a complete picture.

4. Ratio Analysis:

Ratio analysis is essentially concerned with the calculation of relationships which after proper identification and interpretation may provide information about the operations and state of affairs of a business enterprise. The analysis is used to provide indicators of past performance in terms of critical success factors of a business. This assistance in decision-making reduces reliance on

guesswork and intuition and establishes a basis for sound judgment.The significance of a ratio can be appreciated only when:

- It is compared with other ratios in the same set of financial statements.
- It is compared with the same ratio in previous financial statements (trend analysis).
- It is compared with a standard of performance (industry average).Such a standard may be either the ratio which represents the typical performance of the trade or industry, or the ratio which represents the target set by management as desirable for the business.

Limitation of Ratio Analysis

- **Historical.** All of the information used in ratio analysis is derived from actual historical results. This does not mean that the same results will carry forward into the future. However, you can use ratio analysis on pro forma information and compare it to historical results for consistency.
- **Historical versus current cost**. The information on the income statement is stated in current costs (or close to it), whereas some elements of the balance sheet may be stated at historical cost (which could vary substantially from current costs). This disparity can result in unusual ratio results.
- **Inflation.** If the rate of inflation has changed in any of the periods under review, this can mean that the numbers are not comparable across periods. For example, if the inflation rate was 100% in one year, sales would appear to have doubled over the preceding year, when in fact sales did not change at all.
- **Aggregation.** The information in a financial statement line item that you are using for a ratio analysis may have been aggregated differently in the past, so that running the ratio analysis on a trend line does not compare the same information through the entire trend period.
- **Operational changes.** A company may change its underlying operational structure to such an extent that a ratio calculated several years ago and compared to the same ratio today would yield a misleading conclusion. For example, if you implemented a constraint analysis system, this might lead to a reduced investment in fixed assets, whereas a ratio analysis might conclude that the company is letting its fixed asset base become too old.

1. **Scope of financial management:**
2. The scope of financial management includes three groups.
3. First – relating to finance and cash,
4. second – rising of fund and their administration,
5. third – along with the activities of rising funds, .

    1. Liquidity:

6. Liquidity can be ascertained through the three important considerations.

    i) Forecasting of cash flow:

7. Cash inflows and outflows should be equalized for the purpose of liquidity.
8. ii) Rising of funds:
9. Finance manager should try to identify the requirements and increase of fund
10. iii) Managing the flow of internal funds:

Liquidity at higher degree can be maintained by keeping accounts in many banks. Then there will be no need to depend on external loans.

2. Profitability:

While ascertaining the profitability the following aspects should be taken into consideration:

1) Cost of control:

For the purpose of controlling costs, various activities of the firm should be analyzed through proper cost accounting system,

ii) Pricing:

Pricing policy has great importance in deciding sales level in company's marketing. Pricing policy should be evolved in such a way that the image of the firm should not be affected.

iii) Forecasting of future profits:

Often estimated profits should be ascertained and assessed to strengthen the firm and to ascertain the profit levels.

iv) Measuring the cost of capital:

Each fund source has different cost of capital. As the profit of the firm is directly related to cost of capital, each cost of capital should be measured.

3. Management:

It is the duty of the financial manager to keep the sources of the assets in maintaining the business. Asset management plays an important role in financial management. Besides, the financial manager should see that the required sources are available for smooth running of the firm without any interruptions. A business may fail without financial failures. Financial failures also lead to business failure. Because of this peculiar condition the responsibility of

financial management increased. It can be divided into the management of long run funds and short run funds. Long run management of funds relates to the development and extensive plans. Short run management of funds relates to the total business cycle activities. It is also the responsibility of financial management to coordinate different activities in the business. Thus, for the success of any firm or organization financial management is said to be a must.

What Is Financial Management? What major decision are required to be taken in finance ?

Financial management refers to the efficient and effective management of money (funds) in such a manner as to accomplish the objectives of the organization. It is the specialized function directly associated with the top management. The significance of this function is not seen in the 'Line' but also in the capacity of 'Staff' in overall of a company. It has been defined differently by different experts in the field.

The term typically applies to an organization or company's financial strategy, while personal finance or financial life management refers to an individual's management strategy. It includes how to raise the capital and how to allocate capital, i.e. capital budgeting. Not only for long term budgeting, but also how to allocate the short term resources like current liabilities. It also deals with the dividend policies of the share holders.

Investment Decision

One of the most important finance functions is to intelligently allocate capital to long term assets. This activity is also known as capital budgeting. It is important to allocate capital in those long term assets so as to get maximum yield in future.

Investment decision not only involves allocating capital to long term assets but also involves decisions of using funds which are obtained by selling those assets which become less profitable and less productive

Financial Decision

Financial decision is yet another important function which a financial manger must perform. It is important to make wise decisions about when, where and how should a business acquire funds. Funds can be acquired through many ways and channels. Broadly speaking a correct ratio of an equity and debt has to be maintained. This mix of equity capital and debt is known as a firm's capital structure.

Dividend Decision

Earning profit or a positive return is a common aim of all the businesses. But the key function a financial manger performs in case of profitability is to decide whether to distribute all the profits to the shareholder or retain all the profits or distribute part of the profits to the shareholder and retain the other half in the business.

Liquidity Decision

It is very important to maintain a liquidity position of a firm to avoid insolvency. Firm's profitability, liquidity and risk all are associated with the investment in current assets. In order to maintain a trade off between profitability and liquidity it is important to invest sufficient funds in current assets. But since current assets do not earn anything for business therefore a proper calculation must be done before investing in current assets.

Question: Explain in what ways the wealth maxima ion objective of financial management is superior to the profit maximisation?

- Wealth maximization is a clear term. Here, the present value of cash flow is taken into consideration. The net effect of investment and benefits can be measured clearly (i.e. quantitatively).
- It considers the concept of time value of money. The present values of cash inflows and outflows help the management to achieve the overall objectives of a company.
- The concept of wealth maximization is universally accepted, because, it takes care of interests of financial institution, owners, employees and society at large.
- Wealth maximization guides the management in framing consistent strong dividend policy, to earn maximum returns to the equity holders.
- The concept of wealth maximization considers the impact of risk factor, while calculating the Net Present Value at a particular discount rate; adjustment is made to cover the risk that is associated with the investments.

Question : What are different sources of raising finance for a large organisation?

Sources of financing a business are classified based on the time period for which the money is required. Time period is commonly classified into following three:

- Long Term Sources of Finance: Long-term financing means capital requirements for a period of more than 5 years to 10, 15, 20 years or maybe more depending on other factors. Capital expenditures in fixed assets like plant and machinery, land and building etc of a business are funded using long-term sources of finance. Part of working capital which permanently stays with the business is also financed with long-term sources of finance. Long term financing sources can be in form of any of them:
  - Share Capital or Equity Shares
  - Preference Capital or Preference Shares
  - Retained Earnings or Internal Accruals
  - Debenture / Bonds
  - Term Loans from Financial Institutes, Government, and Commercial Banks
  - Venture Funding

- Asset Securitization
- International Financing by way of Euro Issue, Foreign Currency Loans, ADR, GDR etc.

- Medium Term Sources of Finance: Medium term financing means financing for a period of 3 to 5 years. Medium term financing is used generally for two reasons. One, when long-term capital is not available for the time being and second, when deferred revenue expenditures like advertisements are made which are to be written off over a period of 3 to 5 years. Medium term financing sources can in the form of one of them:
  - Preference Capital or Preference Shares
  - Debenture / Bonds
  - Medium Term Loans from
    - Financial Institutes
    - Government, and
    - Commercial Banks
  - Lease Finance
  - Hire Purchase Finance

- Short Term Sources of Finance: Short term financing means financing for a period of less than 1 year. Need for short term finance arises to finance the current assets of a business like an inventory of raw material and finished goods, debtors, minimum cash and bank balance etc. Short term financing is also named as working capital financing. Short term finances are available in the form of:
  - Trade Credit
  - Short Term Loans like Working Capital Loans from Commercial Banks
  - Fixed Deposits for a period of 1 year or less
  - Advances received from customers
  - Creditors
  - Payables
  - Factoring Services
  - Bill Discounting etc.

"**Return On Investment is considered to be the master ratio which reflect the overall performance of a company" Explain**

Return on investment or ROI is a profitability ratio that calculates the profits of an investment as a percentage of the original cost. In other words, it measures how much money was made on the investment as a percentage of the purchase price. It shows investors how efficiently each dollar invested in a project is at producing a profit. Investors not only use this ratio to measure how well an investment performed, they also use it to compare the performance of different investments of all types and sizes.

For example, an investment in stock can be compared to one in equipment. It doesn't matter what the type of investment because the return on investment calculation only looks that the profits and the costs associated with the investment.

That being said, the ROI calculation is one of the most common investment ratios because it’s simple and extremely versatile. Managers can use it to compare performance rates on capital equipment purchases while investors can calculate what stock purchases performed better.

Generally, any positive ROI is considered a good return. This means that the total cost of the investment was recouped in addition to some profits left over. A negative return on investment means that the revenues weren’t even enough to cover the total costs. That being said, higher return rates are always better than lower return rates. The ROI calculation is extremely versatile and can be used for any investment. Managers can use it to measure the return on invested capital. Investors can use it to measure the performance of their stock and individuals can use it to measure their return on assets like their homes. One thing to remember is that it does not take into consideration the time value of money. For a simple purchase and sale of stock, this fact doesn’t matter all that much, but it does for calculation of a fixed asset like a building or house that appreciates over many years. This is why the original simplistic earnings portion of the formula is usually altered with a present value calculation.

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