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Financial Management

Question 1:

The cheapest source of finance is

(a) debenture

(b) equity share capital

(c) preference share

(d) retained earning

ANSWER:

The cheapest source of finance is retained earnings. Retained income refers to that portion of net income or profits of an organisation that it retains after paying off dividends. An organisation can reinvest its retained earnings or profits for the purpose expansion, modernisation, etc. It neither involves any fund raising cost nor any risk. Also, unlike other sources of finance it does not involve any obligation in terms of repayment.

Question 2:

A decision to acquire a new and modern plant to upgrade an old one is a

(a) financing decision

(b) working capital decision

(c) investment decision

(d) None of the above

ANSWER:

The decision to acquire a new and modern plant to upgrade an old one is an Investment decision. Investment decision refers to the decision regarding where the funds are to be invested so as to earn the highest possible return. The decision to acquire a new plant is a long term investment decision and affects long run working and earning capacity of the business.

On the other hand, working capital decisions refer to those investment decisions that influence the day to day working of the business. While, financing decision refers to the decisions regarding the sources from where the funds can be raised.

Question 3:

Other things remaining the same, an increase in the tax rate on corporate profit will

(a) make the debt relatively cheaper

(b) make the debt relatively the dearer

(c) have no impact on the cost of debt

(d) we can't say

ANSWER:

When there is an increase in the tax on corporate profit, the debt becomes relatively cheaper. This is because interest that is to be paid to the debtors is deducted from the total income before calculating the value of tax. Thus, as the value of tax increases, the debt becomes relatively cheaper.

Question 4:

Companies with a higher growth potential are likely to

(a) pay lower dividends

(b) pay higher dividends

(c) dividends are not affected

(d) none of the above

ANSWER:

Companies which have higher growth potential are likely to pay lower dividends. This is because the companies having higher growth potential have greater investment plans and require larger funds for investment. Thus, they retain a greater portion of their earnings to finance the required investment and thereby, pay lower dividends.

Question 5:

Financial leverage is called favourable if

(a) Return on investment is lower than the cost of debt

(b) ROI is higher than the cost of debt

(c) Debt is easily available

(d) If the degree of existing financial leverage is low

ANSWER:

Financial Leverage refers to the proportion of debt in the overall capital. It is said to be a favourable situation when the return on investment becomes higher than the cost of debt. In other words, as the Return on investment becomes greater, the earning per share also increases and the financial leverage is said to be favourable.

Question 6:

Higher debt-equity ratio results in

(a) lower financial risk

(b) higher degree of operating risk

(c) higher degree of financial risk

(d) higher EPS

ANSWER:

Higher debt- equity ratio refers to a situation where the proportion of debt in total capital is higher. This implies higher degree of financial risk. This is because in case of debt, it is obligatory for a business to make interest payments and the return of principal to the debtors. Thus, higher debt increases the financial risk for the business.

Question 7:

Higher working capital usually results in

(a) higher current ratio, higher risk and higher profits

(b) lower current ratio, higher risk and profits

(c) higher equity, lower risk and lower profits

(d) lower equity, lower risk and higher profits

ANSWER:

Working capital of a firm refers to the amount of current assets which are in excess over current liabilities. If a company has a higher working capital then there will be a higher current ratio (i.e. current assets over current liabilities), higher risk and higher profits.

Question 8:

Current assets are those assets which get converted into cash

(a) within six months

(b) within one year

(c) between one year and three years

(d) between three and five years

ANSWER:

Current assets are those assets which can be converted into cash or can be used to pay off liabilities within a time span of 12 months, i.e. one year. Some of the examples of current assets are cash, cash equivalents, inventories, debtors, bills receivables, etc.

Question 9:

Financial planning arrives at

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

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

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

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

ANSWER:

Financial Planning aims at ensuring that the firm faces neither a shortage nor a glut (excess) of unusable funds. If there is a shortage of funds then the firm will not be able to carry out its planned activities and commitments. On the other hand, if there are excess funds available then it adds to the cost of business and also encourages wastage of funds. Thus, financial planning focuses on ensuring the availability of just enough funds at the right time.

Question 10:

Higher dividend per share is associated with

(a) high earnings, high cash flows, unstable earnings and higher growth opportunities

(b) high earnings, high cash flows, stable earnings and high growth opportunities

(c) high earnings, high cash flows, stable earnings and lower growth opportunities

(d) high earnings, low cash flows, stable earnings and lower growth opportunities

ANSWER:

If a company gives higher dividend per share then it gets associated with high amount of earnings as only if they will earn higher, they will be able to give higher dividends; higher cash flow as the payment of dividend involves cash outflow; stable earnings as stable earnings means that the company is confident of its future earning potentials; and lower growth opportunities because it requires less requirement of retained earnings and their retained earnings while lowering the amount of dividends paid.

Question 11:

A fixed asset should be financed through

(a) a long term liability

(b) a short term liability

(c) a mix of long and short term liabilities

ANSWER:

Fixed assets are those assets which are invested in a company for a longer time period, generally more than one year. As these assets have long term implication on the business in terms of growth and profitability, they should be financed through long term liabilities such as long term loans, preference shares, retained earnings, etc.

Question 12:

Current assets of a business firm should be financed through

(a) current liability only

(b) long-term liability only

(c) both types (i.e. Long and short liabilities)

ANSWER:

Current assets are those assets which get converted in cash or cash equivalents within a short span of time and provide liquidity to a business. For financing the current assets of a business, both types of liabilities (short and long) can be used.

Question 1:

What is meant by capital structure?
ANSWER:

Capital structure refers to the combination of borrowed funds and owners' fund that a firm uses for financing its fund requirements. Herein, borrowed funds comprise of loans, public deposits, debentures, etc. and owners' fund comprise of preference share capital, equity share capital, retained earning etc. Generally, capital structure is simply referred as the combination of debt and equity that a firm uses for financing its funds. It is calculated as the ratio of debt and equity or the proportion of debt in the total capital used by the firm. Algebraically,

$$\text{Capital Structure is } \frac{\text{Debt}}{\text{Equity}} \text{ or, } \frac{\text{Debt}}{\text{Debt} + \text{Equity}}$$

The proportion of the debt and equity used by the firm affects its financial risk and profitability. While on one hand, debt is a cheaper source of finance than equity and lowers the overall cost of capital but on the other hand, higher use of debt, increases the financial risk for the firm. Thus, the decision regarding the capital structure should be taken with utmost care. Capital structure is said to be optimal when the proportion of debt and equity used is such that the earnings per share increases.

Question 2:

Discuss the two objective of Financial Planning.
ANSWER:

Financial Planning involves designing the blueprint of the financial operations of a firm. It ensures that just the right amount of funds are available for the organisational operations at the right time. Thereby, it ensures smooth functioning. Taking into consideration the growth and performance, through financial planning, firms tend to forecast what amount of fund would be required at what time. The following are the two highlighted objectives of financial planning.

i) ***Ensure Availability of Funds***

Ensuring that the right amount of funds are available at the right time is one of the main objectives of financial planning. It involves estimating the right amount of funds that are required for various business operations in the long term as well for day to day operations. In addition, it also involves estimating the time at which the funds would be required. Thus, financial planning ensures that right amount of funds are available at the right time. Financial planning also points out the probable sources of funds.

ii) ***Proper Utilisation of Funds***

Financial Planning aims at full utilisation of funds. It ensures that both inadequate funds as well as excess funds are avoided. Inadequate funds hinders the smooth operations and the firm is unable to carry its commitments. On the other hand, excess funds add to the cost of business and encourage unnecessary wasteful expenditure. Thus, financial planning ensures that the funds are properly and optimally utilised.

Question 3:

What is financial risk? Why does it arise?

ANSWER:

Financial risk refers to a situation when a company is not able to meet its fixed financial charges such as interest payment, preference dividend and repayment obligations. In other words, it refers to the probability that the company would not be able to meet its fixed financial obligations. It arises when the proportion of debt in the capital structure increases. This is because it is obligatory for the company to pay the interest charges on debt along with the principle amount. Thus, higher the debt, higher will be its payment obligations and thereby higher would be the chances of default on payment. Hence, higher use of debt leads to higher financial risk for the company.

Question 4:

Define a 'current asset'. Give four examples of such assets.

ANSWER:

Current asset of a firm refers to those assets which can be converted into cash or cash equivalents in a short period of time, i.e. less than one year. Such assets are used to facilitate the day to day business operations. As they can be easily converted into cash or cash equivalents, these assets provide liquidity to the company. Firms acquire such assets to meet its various payment obligations. However, such assets provide very little return and are thereby, less profitable. Current assets can be financed through short-term as well as long term sources.

Some of the examples of current assets are short term investment, debtors, stocks and cash equivalents.

Question 5:

Financial management is based on three broad financial decisions. What are these?
ANSWER:

Financial management refers to the efficient acquisition, allocation and usage of funds of the company. It deals in three main dimensions of financial decisions namely, Investment decisions, Financial decisions and Dividend decisions.

Investment Decisions

Investment decisions refer to the decisions regarding where to invest so as to earn the highest possible returns on investment. Investment decisions can be taken for both long term as well as short term.

Long term investment decisions also known as Capital Budgeting decisions affect a business' long term earning capacity and profitability. For example, investment in a new machine, purchase of a new building, etc. are long term investment decisions.

Short term investment decisions also known as working capital decisions affect a business' day to day working operations. For example, decisions regarding cash or bill receivables are short term investment decisions.

Financial Decisions

Such decisions involve identifying various sources of funds and deciding the best combination for raising the funds. The main sources for raising funds are shareholders' funds (referred as equity) and borrowed funds (referred as debt). Based on the cost involved, risk and profitability a company must judiciously decide the combination of debt and equity to be used. For example, while debt is considered to be the cheapest source of finance, higher debt increases the financial risk. Financial decisions taken by a company affects its overall cost of capital and the financial risk.

Dividend Decisions

The decision involves the decision regarding the distribution of profit or surplus of the company. A company can distribute its profit to the equity share holders in the form of dividends or retain it with itself. Under dividend decision, a company decides what proportion of the surplus to distribute as dividends and what proportion to keep as retained earnings. It is aimed at maximising the shareholders' wealth while keeping in view the requirement of retained earnings that are needed for re-investment.