# FACULTY OF COMMERCE
# ABM 801: FINANCIAL MANAGEMENT & ANALYSIS
# QUESTION BANK

## UNIT I: FINANCE FUNCTION

1. Define finance function. Discuss its nature and scope.
2. "The goal of profit maximization does not provide an operationally useful criterion for measuring the success of business operations." Explain the above statement in the context of the basic objectives of financial management.
3. What are the main characteristics of Financial Management? Why does finance area occupy key role in the overall management of the corporation?
4. "The concept of finance function has changed and keeps changing along with the evolution of the content of finance as a management activity." Elaborate.
5. "Sound financial management is the key to the progress of corporations". Discuss.
6. What are the objectives of financial management? Discuss important functions of financial management.
7. Write short notes on: (a) Investment Decisions, (b) Financing Decisions, and (c) Dividend Decisions.
8. What is the relevance of time value of money in financial decision making?
9. Explain the discounting and compounding techniques of time value of money.
10. Write detailed note on (a) Doubling period, (b) Effective vs. Nominal rate of interest, (c) Present value of Annuity, and (d) Future value of Annuity
11. (i) An investor deposited Rs. 1,000 in a scheme for 2 years. The scheme offers 10% interest with quarterly compounding. Find the maturity value of the scheme.
    (ii) The fixed deposit scheme of a bank offers 11% interest rate for 3 years. Find the maturity value of FD after 3 years.
    (iii) Find out the effective rate of interest if the nominal rate of interest is 12% and interest is quarterly compounded.
12. (i) A person is required to pay four equal annual payments of Rs. 5,000 each in his deposit account that pays 8% interest per year. Find out the future value of annuity at the end of 4 years.
    (ii) A company offers a bond for a period of 5 years having redemption value of Rs. 1,611. Prevailing rate of interest is 10%. Find the present value the bond.
    (iii) Suppose you deposit Rs.1, 000 annually in a bank for 5 years and your deposits earn a compound interest rate of 10%. What will be value of the deposit at the end of 5 years? Assuming each deposit occurs at the end of the year, the future value of this annuity?

## UNIT II: CAPITAL STRUCTURE AND COST OF CAPITAL

1. What do you mean by Capital Structure? Explain various determinants of capital structure.
2. What do you mean by optimal capital structure? Discuss qualities of a good capital structure?
3. Explain theories of capital structure based on relevance approach with suitable examples.
4. What is irrelevance approach of capital structure? Explain clearly MM Approach of capital structure decision.
5. What do you understand by Cost of Capital? How will you measure the following (a) Cost of equity capital (b) Cost of retained earnings (c) Cost of debt capital.
6. Explain the need and rationale of calculating cost of capital. How far it is relevant in (a) designing capital structure, and (b) allocation of financial resources?
7. (i) Discuss the relationship between Cost of Capital and Investment decisions. (ii) What is the impact of (a) Decline in Interest rate, and (b) Increase in Tax rate on cost of debt, cost of preference capital, and cost of equity capital?
8. What is meant by the term "Leverage"? What are its various types? With what type of risk is associated in leverage? Explain.
9. Give a note on financial leverage. How it is measured and what are its effects on the company?
10. What is meant by the term 'Firm's Break-Even Level'? What is the usefulness of BE Analysis in Leverages?
11. The capital structure of wood Art Ltd. included: (i) 2000, 8 percent debentures (first issue) of Rs. 100 each; (ii) 1000, 9 percent debentures (second issue) of Rs. 100 each; (iii) 2000, 10 percent preference shares of Rs. 100 each; (iv) 4000 Equity shares of Rs. 100 each; and (v) Retained earnings of Rs. 100000.

    The earnings per share of the company for the current year are Rs. 15. The shares of the company are sold in the market at book value. The company tax rate is 50 percent. Find weighted average cost of capital.
12. A company's cost of capital for specific sources is: (i) Cost of debenture: 5%, (ii) Cost of preference shares: 10%, (iii) Cost of equity shares: 14%, and (iv) Cost of retained earnings: 13%

    The company wishes to raise Rs. 5, 00,000 for the expansion of its plant. It is estimated that Rs. 1, 00,000 will be available as retained earnings and the balance of additional funds will be raised through: (i) Debenture issue: Rs. 3 lakhs, and (ii) Preference shares issue: Rs. 1 Lakh.

    Using marginal weights, calculate weighted average cost of capital.

13. Jia Ltd. has obtained capital from the following sources: the specific costs are also noted done against them.

| Source of capital | Book value | Market value | Cost of capital |
|---|---|---|---|
| Debentures | 4,00,000 | 3,80,000 | 5% |
| Preference Shares | 1,00,000 | 1,10,000 | 8% |
| Equity Shares | 6,00,000 | 12,00,000 | 13% |
| Retained earnings | 2,00,000 | -- | 9% |

You are required to calculate weighted average cost of capital using (i) book value weights, (ii) Market value weights.

14. A company has the following components in capital structure.
9% Debentures: Rs. 6, 00,000, 7% Preference Shares: Rs. 2, 00,000, Equity Shares of Rs. 10 each: Rs. 5, 00,000, and Retained earnings: Rs. 3, 00,000.
In addition, the company has taken term loan of Rs. 4, 00,000 @10% for meeting financial needs of expansion program. The market price of equity shares is Rs. 40. A dividend of Rs. 4 per share is proposed. The company has a marginal tax rate of 50%. Compute the weighted average cost of capital.

15. A company was recently formed to manufacture a product. In its capital structure it has: (i) 9% Debentures: Rs. 6 Lakh, (ii) 7% Preference Shares: Rs. 2 Lakh, (iii) Equity Shares (24000): Rs. 6 Lakh, and (iv) Retained earnings: Rs. 4 Lakh.
The market price of equity shares is Rs. 40. A dividend of Rs. 4 per share is proposed. The company has a marginal tax rate of 50%. Compute the weighted average cost of capital.

16. Aerodynamics Limited has EBIT of Rs. 1, 00,000. The company makes use of debt and equity capital. The firm has 10% debentures of Rs. 5.00.000. The equity capitalization rate of the firm is 15%. Calculate (i) Current Value of the firm; and (ii) firm's Overall Cost of capital.

17. The selected financial data for A, B and C companies for the current year ended 31st March are as follows:

| | A | B | C |
|---|---|---|---|
| Variable expenses as a % of Sales | 66 2/3 | 75 | 50 |
| Interest Expenses | Rs. 200 | Rs. 300 | Rs. 1000 |
| Degree of operating leverage | 5 | 6 | 2 |
| Degree of financial leverage | 3 | 4 | 2 |
| Income Tax rate | 0.50 | 0.50 | 0.50 |

Prepare income statements for A, B, and C companies.

18. The capital structure of the progressive corporation consists of an ordinary share capital of Rs. 10, 00,000 (Shares of Rs. 100 per values) and Rs. 10, 00,000 of 10% debentures. Sales increased by 20% from 1,00,000 units to 1,20,000 units, the selling price is Rs. 10 per unit, variable costs amount to Rs. 6 per unit and fixed expenses amount to Rs. 2,00,000/- The income rate is assumed to be 50%. You are required to calculate: (i) The Percentage increase in earnings per share, (ii) The degree of financial leverage at 1,00,000 units and 1,20,000 units, and (iii) The degree of operating leverage at 1,00,000 units and 1,20,000 units.
19. The XYZ Company plans to expand assets by 50%. To finance the expansion it is choosing between a straight 6% debt issued and equity issue. Its current balance sheet and income statement are shown below:

| Liabilities | Amount (Rs.) | Assets | Amount (Rs.) |
|---|---|---|---|
| 5% Debt | 4,00,000 | Total Assets | 20,00,000 |
| Equity Shares (Rs. 10 per shares) | 10,00,000 | | |
| Earned surplus | 6,00,000 | | |
| | 20,00,000 | | 20,00,000 |

Income Statement for the year ending December

| | |
|---|---|
| Sales | 3,40,000 |
| Operating expenses (including Rs. 60,000 depreciation) | -1,20,000 |
| EBIT | 2,20,000 |
| Interest | -60,000 |
| Earnings before Tax | 1,60,000 |
| Taxes at 50% | 80,000 |
| Net earnings (EAT) | 80,000 |

Determine the degree of operating, financial and combined leverages at the current sales level, if all operating expenses, other than depreciation, are variable costs. If total assets remain at the same level, but sales (a) increase by 20% and (b) decrease by 20%, what will be the earnings per share in the new situation?

20. The well-Established company's most recent balance sheet is as follows:

| Liabilities | Amount (Rs.) | Assets | Amount (Rs.) |
|---|---|---|---|
| Equity Capital (Rs. 10 per share) | 60,000 | Net fixed assets | 1,50,000 |
| 10% long term debt | 80,000 | Current assets | 50,000 |
| Retained earnings | 20,000 | | |
| Current liabilities | 40,000 | | |
| | 2,00,000 | | 2,00,000 |

The company's total assets turnover ratio is 3:0, its fixed operating cost are Rs. 1, 00,000 and its variable operating costs ratio is 40%. The income tax rate is 50%. Calculate for the company all the three types of leverages. Also determine the likely level of EBIT if EPS is (a) Re. 1, (b) Rs. 3, (c) Zero

**UNIT III: CAPITAL BUDGETING**

1. What is Capital Budgeting? Explain various techniques of Capital Budgeting decisions.
2. What is Capital Budgeting? In what manner is the discounted cash flow technique useful in capital budgeting decisions?
3. What do you understand by Internal Rate of Return? How is it different from the present value method? Explain.
4. What do you understand by internal rate of return (IRR)? How is it different from the required rate of return (RRR)? Explain by giving suitable examples.
5. The following particulars relate to a project number.
   Cost of project Rs. 50,000. Operating savings (Expected in five years): Rs. 5000, 20000, 30000, 30,000, and 10000.
   Calculate payback period: (i) Ignoring interest factor, and (ii) Taking into account interest factor at 10%. Present value factors at 10% are: 0.909, 0.826, 0.751, 0.683, and 0.621
6. A company is having following two options regarding purchase of machine –

| | A | B |
|---|---|---|
| Cost of Machine | 6,00,000 | 10,00,000 |
| Estimated Life | 10 | 10 |
| Estimated savings in scrap p.a. | 40,000 | 60,000 |
| Additional cost of supervision p.a. | 48,000 | 64,000 |
| Additional cost of maintenance p.a. | 28,000 | 44,000 |
| Cost of indirect materials p.a. | 24,000 | 32,000 |

| | | |
|---|---|---|
| Estimated savings in wages p.a. | | |
| (i) Wages per worker p.a. | 2,400 | 2,400 |
| (ii) No. of workers not required | 150 | 200 |

Using the method of payback period, suggest as which model should be purchased. Ignore tax.

7. X Ltd. is considering 3 projects X, Y, Z. Following are the particulars in respect of them:

| | Project X | Project Y | Project Z |
|---|---|---|---|
| Cost (in Rs.) | 1,00,000 | 1,40,000 | 1,40,000 |
| Economic life (in years) | 10 | 10 | 10 |
| Estimated scrap (in Rs.) | 5,000 | 10,000 | 14,000 |
| Annual savings (in Rs.) | 16,000 | 25,000 | 20,000 |

Ignoring income tax recommend the best of these projects using: (i) Payback period, (ii) Post pay back profit, (iii) Index of Post pay back profit.

8. Two projects A and B are before consideration of the management of a company. The particulars available are:

| | Project A | Project B |
|---|---|---|
| Cost (in Rs.) | 10,000 | 10,000 |
| Economic life (in years) | 4 | 6 |
| Earnings before depreciation: Year 1 | 5,000 | 1,000 |
| Year 2 | 4,000 | 2,000 |
| Year 3 | 3,000 | 3,000 |
| Year 4 | 1,000 | 4,000 |
| Year 5 | -- | 5,000 |
| Year 6 | -- | 6,000 |

Which project should be preferred? Use unadjusted return on investment method.

9. A Company has to select one of the following two projects:

| | Project A | Project B |
|---|---|---|
| Cost | 11,000 | 10,000 |
| Cash inflows: Year 1 | 6,000 | 1,000 |
| Year 2 | 2,000 | 1,000 |
| Year 3 | 1,000 | 2,000 |
| Year 4 | 5,000 | 10,000 |

Using the internal rate of return method, suggest which project is preferable.

10. The following details relate to the two machines X and Y

| | Machine X | Machine Y |
|---|---|---|
| Cost | 56,125 | 56,125 |
| Estimated life (in years) | 5 | 5 |
| Estimated salvage value | 3,000 | 3,000 |
| Annual income after tax and depreciation | | |
| Year I | 3,375 | 11,375 |
| Year II | 5,375 | 9,375 |
| Year III | 7,375 | 7,375 |
| Year IV | 9,375 | 5,375 |
| Year V | 11,375 | 3,375 |

Overhauling charges at the end of the third year Rs. 25000 incase of machine X. Depreciation has been charged at straight-line method. Discounting rate is 10%. P.V.F at 10% for five years is: 0.909, 0.826, 0.751, 0.683, and 0.621 Using present value method, suggest which machine should be chosen.

11. The following particulars relate to two projects:

| | Project I | Project II |
|---|---|---|
| Cost (in Rs.) | 90,000 | 1,00,000 |
| Estimated savings (in Rs.) | 15,000 | 20,000 |
| Economic life (in years) | 10 | 8 |

Compute time-adjusted rate of return and state which of the two projects is better.

12. A choice is to be made between two competing projects, which require an equal investment of Rs. 50000 each and are expected to generate net cashes as under:

| End of year | Project A | Project B |
|---|---|---|
| 1 | 25,000 | 10,000 |
| 2 | 15,000 | 12,000 |
| 3 | 10,000 | 18,000 |
| 4 | Nil | 25,000 |
| 5 | 12,000 | 8,000 |
| 6 | 6,000 | 4,000 |

The cost of capital is 10%. Using discounted cash flow method, recommend which project is to be preferred. Use P.V.F. as given in the previous example.

13. An operation which is presently done entirely by manual methods has a labor cost of Rs. 46,000 a year. It is proposed to install a machine to do the job, which involves an investment of Rs. 80,000 and an annual operating cost of Rs. 10,000. Assume the machine can be written off in 5 years on straight line depreciation basis for tax purposes. Salvage value at the end of its economic life is zero. The tax rate is 55%. Analyze the economic implications of the proposal by the internal rate of return method.
14. The capital budgeting department of a company has suggested three investment proposals. The after-tax cash flows for each are tabulated below. If the company's cost of capital is 12% rank them in the order of profitability.

| Year | Project A | Project B | Project C |
|---|---|---|---|
| 0 | -20,000 | -60,000 | -36,000 |
| 1 | 5,600 | 12,000 | 13,000 |
| 2 | 6,000 | 20,000 | 13,000 |
| 3 | 8,000 | 24,000 | 13,000 |
| 4 | 8,000 | 32,000 | 13,000 |

P.V.F. at 12% is: 0.893, 0.797, 0.712, and 0.636

15. The following particulars are available in respect on three investment proposals:

| | Proposal X | Proposal Y | Proposal Z |
|---|---|---|---|
| Cost (in Rs.) | 50,000 | 60,000 | 70,000 |
| Annual savings (in Rs.) | 15,000 | 16,000 | 17,000 |
| Estimated scrap (in Rs.) | 8,000 | 10,000 | 15,000 |
| Life (in Years) | 12 | 10 | 9 |

Taking interest rate to be 9% rank these proposals by using Net Present value method and profitability index method.

**UNIT IV: WORKING CAPITAL DECISIONS**

1. Discuss the factors, which influence the need for working capital. How will you examine the adequacy of Working Capital?
2. What do you understand by analysis of Working Capital? Discuss the techniques, which are used in such analysis.
3. "Management of Working Capital is a constant headache for the financial manager of a Company". Comment on this statement and critically examine the role of Working Capital in financial management.
4. Discuss the various working capital management policies and show the impact of these policies on Risk, liquidity, and profitability.

5. Point out the factors that influence the motive for holding cash by a firm. Discuss in brief the various collection and disbursement methods by which a firm can improve its cash management efficiency.
6. Explain the principal motive for holding cash by a business firm and discuss the Inter-relationship between liquidity and profitability.
7. What should be the objectives of Receivable management? How can management succeed in maintaining investment in receivables at the optimum level?
8. What is the importance of inventory management for a business? Write a note on operating control of inventories.
9. What is reorder point? How is it determined? Give suitable example.
10. Define the term economic order quantity. How is it computed? Explain with proper example.
11. Write short notes on: (a) Bank Guarantee (b) Letter of Credit (c) Bill discounting, and (iv) Factoring
12. A company is manufacturing only one product. The sale price and variable cost of the product is Rs. 10 and 6 respectively. Presently company is allowing credit period of 45 days to its customers, and its sale for the current year is Rs. 1 lakh. Loss due to default in payment by customers for the current year is 1% of total annual sale.

    With a view to increase sales of the product, the company is planning to increase credit period for its customers. The alternative plans under consideration of the management are as follows.

    Alternative A - Credit Period: 60 Days; Expected increase in Sales: Rs. 5000; Expected Loss due to Default: 2% of Total Sales

    Alternative B - Credit Period: 75 Days; Expected increase in Sales: Rs. 8000; Expected Loss due to Default: 3% of Total Sales

    Alternative C - Credit Period: 90 Days; Expected increase in Sales: Rs. 10000. Expected Loss due to Default: 4% of Total Sales

    Required Rate of Return on investment in receivables is 20%.

    You are required to calculate (i) Additional Gain on Alternative Policies, (ii) Required Return on Investment, and (iii) Suggest Best Alternative to the Company. Assume 360 days in a year.
13. Jubilant Limited's inventory planning period is one year. Its inventory requirements for the year 2011-12 are 1600 units. The material acquisition cost (estimated) for the company is Rs. 50 per order, and the carrying costs are 1% of material cost per unit for an item. The firm can procure inventories in various lots at a uniform price of Rs. 100 per unit. The alternative lot sizes are 1600, 800, 400, 200, and 100 units. Suggest the most suitable order quantity for the company by using (i) Trial & Error Approach, and (ii) Mathematical Approach of EOQ.

## UNIT V: DIVIDEND POLICY

1. Critically examine the essentials of a sound dividend policy of company.
2. What considerations are kept in view while deciding the dividend policy of a company? Explain with illustrations.
3. Discuss the salient features of a stable dividend policy and point out its advantages. In this context explain why certain companies prefer a stable dividend rate while some other prefer a stable payout Ratio?
4. Explain the various principles underlying the policies of dividend distributions. Under what circumstances company pays stock dividend.
5. Describe Bonus Shares. Discuss the salient features of the guidelines issued by the Government of India for issue of Bonus Shares.
6. What do you understand by Bonus Shares? Differentiate between bonus shares and right shares.
7. What is the "Traditional Theory of Dividend"? How the dividend is assigned at under this model. Give example.
8. What do you understand by Walter Model of determining dividend policy of a company? How is it worked out? Critically explain?
9. What is Gordon's dividend model? Explain how is it designed? What are the implications of Gordon's formula?
10. Explain the dividend irrelevance theory of Miller and Modigliani (MM Model). Are dividend decisions irrelevant for valuation of a firm? Examine critically.

## SUGGESTED READINGS:


- James C Van Horne: Financial Management and Policy, Prentice Hall
- IM Panday: Financial Management, Vikas Publishing House
- PV Kulkarni: Financial Management, Himalaya Publishing House
- Prasanna Chandra, Financial Management, Tata McGraw Hill Publishing Co.
- RP Rustagi, Financial Management, Galgotia Publishing Company
- MY Khan and PK Jain: Financial Management, Tata McGraw Hill Publishing Co
- RA Brealey and SC Myers, Principles of Corporate Finance, McGraw-Hill