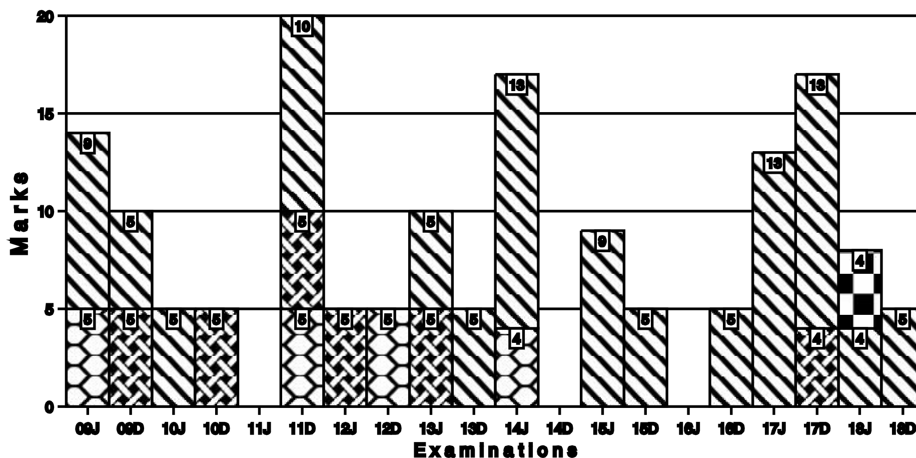
1 NATURE SIGNIFICANCE AND SCOPE OF FINANCIAL MANAGEMENT

THIS CHAPTER INCLUDES

- Introduction
- Nature, Significance, Objectives and Scope (Traditional, Modern and Transitional Approach)
- Risk-Return and Value of the Firm
- Financial Distress and Insolvency
- Financial Sector Reforms and their Impact
- Functions of Finance Executive in an Organisation

Marks of Objective, Short Notes, Distinguish Between, Descriptive & Practical Questions

Legend



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CHAPTER AT A GLANCE

Topic	Important Highlight
Financial Management	Financial Management is concerned with investment, financing and dividend decisions in relation to objectives of the company. Financial Management is concerned with the efficient procurement and utilization of the funds. It embraces in it all the activities concerned with raising funds, investing them in the desired areas and distributing surplus so earned to the shareholders termed as financing, investment and dividend decisions respectively.
Investment Decision	Investment decisions are concerned with allocation of funds which will result in future benefits. Before making investment, cut off rate needs to be decided. Also, evaluation of the various projects has to be done in terms of net present value and decide which project to invest in.
Financing decision	Once it is decided where to invest, the next question to decide is how to acquire funds for investing the same in the desired projects. Financing decision also ambits in itself the decision regarding the proportion of debt and equity. It aims towards achieving what is known as optimum capital mix.
Dividend Decisions	Dividend decision takes into account the manner in which the surplus generated is to be distributed and how much to retain. Determination of dividend payout ratio and retention ratio depends upon various factors.

Objectives of Financial Management	Broadly, there are two alternative objectives a business firm can pursue: A. Profit maximisation B. Wealth maximisation **A. Profit Maximisation** Profit maximisation is one of the objective of financial management since profit acts as a reward for taking risk and is also an icon of business performance. Evaluation of profit maximisation is one of the objectives of financial management **B. Wealth Maximisation:** It is a long term objectives of financial management whereby the business strives to increase the wealth of the shareholders i.e. the stockholding of individual shareholder by maximising the market price per share.
Economic Value Added	• EVA is short form of Economic Value Added. • EVA stands for cash flow after tax of a business less the cost of capital. • Now a days EVA is used in determining the value of a firm since it is a true indicator as against earnings. • EVA = Net operating profit after tax (NOPAT) (–) Capital Employed ×Cost of Capital.
Financial Distress	The term 'financial distress' denotes a situation wherein the financial position and affairs of any firm is endangered. A capital structure with high quantum of debt can prove adverse in case there is paucity of cash inflows. Failure to pay interest and principal can further worsen the situation and may lead the organisation to what is known as financial distress. Under financial distress the firm repays the debt taken and accumulated interest by resorting to such

	practices like selling asset at low prices which consequentially prove quite disastrous to the organisation as a whole. But if the organisation is unable to settle its dues, there arises the situation of what is known as bankruptcy.
Responsibilities/ Functions of the Financial Manager	• Forecasting of Cash Flow • Raising Funds • Managing the Flow of Internal Funds • To Facilitate Cost Control • To Facilitate Pricing of Product, Product Lines and Services • Forecasting Profits • Measuring Required Return • Managing Assets • Managing Funds

SHORT NOTES

2009 - June [7] Write note on the following:

(v) Financial distress **(5 marks)**

Answer:

⇒ The term 'financial distress' denotes a situation wherein the financial position and affairs of any firm is endangered.

⇒ A capital structure with high quantum of debt can prove adverse in case there is paucity of cash inflows.

⇒ Failure to pay interest and principal can further worsen the situation since there will be a mounting pressure from providers of finance.

⇒ Further, it may lead the organisation to what is known as financial distress.

⇒ Under financial distress the firm repays the debt taken and accumulated interest by resorting to practices like selling asset at low prices which consequentially prove quite disastrous to the organisation as a whole.

⇒ But if the organisation is unable to settle its dues, there arises the situation of what is known as bankruptcy.

2011 - Dec [7] Write note on the following:
(ii) Financial distress **(5 marks)**

Answer:

Please refer 2009 - June [7] (v) on page no. 26

—— Space to write important points for revision ——

2012 - Dec [7] Write note on the following:
(iv) Economic value added (EVA) **(5 marks)**

Answer:

- EVA is short form of Economic Value Added.
- EVA stands for cash flow after tax of a business less the cost of capital.
- EVA is used in determining the value of a firm since it is a true indicator as against earnings.
- EVA = Net operating profit after tax (NOPAT) (–) Capital Employed × Cost of Capital.
- Thus, there are two components of EVA, being NOPAT and capital charge where capital charge refers to the product of capital employed and cost of capital.

Wealth Maximisation:

It is a long term objectives of financial management whereby the business strives to increase the wealth of the shareholders i.e. the stockholding of individual shareholder by maximising the market price per share.

Advantages of Wealth Maximisation:

⇒ As against the profit maximisation, the approach of wealth maximisation is long term in nature.
⇒ It considers the timing impact.
⇒ It takes into account the concept of risk and uncertainty.

Disadvantages of Wealth Maximisation:

⇒ Lack of direct relationship between financial decisions and price of shares.
⇒ Merely an increase in shareholder's wealth does not lead to wealth maximisation since there exist a large number of other stake holders also.

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2014 - June [6] Write note on the following:
(d) Financial insolvency. **(4 marks)**

Answer:

Generally the affairs of a firm should be managed in such a way that the total risk-business as well as financial-borne by equity holders is minimized and is manageable, otherwise, the firm would obviously face difficulties. If cash inflow is inadequate, the firm will face difficulties in payment of interest and repayment of principal. If the situation continues long enough, a time will come when the firm would face pressure from creditors. Failure of sales can also cause difficulties in carrying out production operations. The firm would find itself in a tight spot. Where the investors would not invest further; creditors would recall their loans and capital market would heavily discount its securities. Thus, the firm would find itself in a situation called distress. It may also have to sell its assets to discharge its obligations to outsiders at prices below their economic values i.e., resort to distress sale. So when the sale proceeds are inadequate to meet outside liabilities, the firm is said to have failed or become bankrupt or (after due processes of law are gone through) insolvent.

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DISTINGUISH BETWEEN

2009 - Dec [4] (a) Distinguish between the following:
(iii) 'Business risk' and 'financial risk'. **(5 marks)**

Answer:

Business Risk	Financial Risk
1. It is the risk that encompasses in it the threat of variation of return.	1. Financial risk is the risk associated with fixed rate charges like interest etc.
2. It is concerned with earning before interest and tax i.e. EBIT.	2. It deals with EAIT i.e. earning after interest and tax.

3. It is also called operating risk.	3. Inability to manage the financial risk leads to a situation known as financial distress.

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2010 - Dec [4] Distinguish between the following:
(i) 'Financial distress' and 'insolvency'. **(5 marks)**

Answer:

Please refer 2014 - June [6] (d) on page no. 28

—— Space to write important points for revision ——

2011 - Dec [4] Distinguish between the following:
(v) 'Financial risk' and 'business risk'. **(5 marks)**

Answer:

Please refer 2009 - Dec [4] (a) (iii) on page no. 28

—— Space to write important points for revision ——

2012 - June [4] Distinguish between the following:
(i) 'Financial distress' and 'insolvency'. **(5 marks)**

Answer:

Please refer 2014 - June [6] (d) on page no. 28

—— Space to write important points for revision ——

2013 - June [4] Distinguish between the following:
(i) 'Profit maximisation' and 'wealth maximisation'. **(5 marks)**

Answer:

Profit maximisation:

Profit maximisation is one of the objective of financial management since profit acts as a reward for taking risk and is also an icon of business performance.

Evaluation of profit maximisation as one of the objectives of financial management:

Advantages of Profit Maximisation:

⇒ The ultimate objective of each business is profit maximisation.

⇒ Profit acts as a reward for taking risk.
⇒ It helps to counteract with the future uncertainties.
⇒ Profit is also an icon of business performance.
⇒ Last but not the least, profit is the measuring rod which measures the financial soundness of any organisation.

Disadvantages of Profit Maximisation:

Reasons as to why profit maximisation is not an objective of financial management:

⇒ Profit maximisation is a narrow approach.
⇒ Profit is a vague term since different persons have different perspective for the very same term.
⇒ It ignores the timing of return.
⇒ Does not take into account the risk factor.
⇒ Lastly, it is a short term concept only.

Wealth Maximisation:

It is a long term objectives of financial management whereby the business strives to increase the wealth of the shareholders i.e. the stockholding of individual shareholder by maximising the market price per share.

Advantages of Wealth Maximisation:

⇒ As against the profit maximisation, the approach of wealth maximisation is long term in nature.
⇒ It considers the timing impact.
⇒ It takes into account the concept of risk and uncertainty.

Disadvantages of Wealth Maximisation:

⇒ Lack of direct relationship between financial decisions and prices of shares.
⇒ Merely an increase in shareholder's wealth does not lead to wealth maximisation since there exist a large number of other stake holders also.

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2017 - Dec [2] Distinguish between the following:

(d) Financing decision and dividend decisions. **(4 marks)**

Answer:

Financial Management embraces in it all the activities concerned with raising funds, investing them in the desired areas and distributing surplus so earned to the shareholders termed as financing, investment and dividend decisions respectively.

Financing decision: Once it is decided where to invest, the next question to decide is how to acquire funds for investing the same in the desired projects. Financing decision also ambits in itself the decision regarding the proportion of debt and equity. It aims towards achieving what is known as optimum capital mix.

Dividend decisions: This decision takes into account the manner in which the surplus generated is to be distributed and how much to retain. Determination of dividend payout ratio and retention ratio depends upon a large number of factors.

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DESCRIPTIVE QUESTIONS

2008 - Dec [1] {C} Comment on the following:

(i) Investment, financing and dividend decisions are inter-related.

(5 marks)

Answer:

⇒ Financial management is concerned with the efficient procurement and utilisation of the funds.

⇒ It embraces in it all the activities concerned with raising funds, investing them in the desired areas and distributing surplus so earned to the shareholders termed as financing, investment and dividend decisions respectively.

- **Investment decision:** These decisions are concerned with allocation of funds which will result in future benefits. Before making investment, cut off rate needs to be decided. Also, evaluation of the various projects has to be done in terms of net present value and decide which project to invest in.

- **Financing decision:** Once it is decided where to invest, the next question to decide is how to acquire funds for investing the same in the desired projects. Financing decision also ambits in itself the decision regarding the proportion of debt and equity. It aims towards achieving what is known as optimum capital mix.
- **Dividend decisions:** This decision takes into account the manner in which the surplus generated is to be distributed and how much to retain.

  Determination of dividend payout ratio and retention ratio depends upon a large number of factors.

  Financial management is a term of wide importance. It covers not only the task of raising funds as per the requirements but also deals with the effective deployment of resources and disposal of the surplus. Thus, financial management covers in its ambit not only investment and financing decision but also dividend decisions, all of which are inter-related to each other.

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2009 - June [1] {C} Comment on the following:

(i) Failure of a firm is technical if it is unable to meet its current obligations.

(5 marks)

Answer:

Please refer 2009 - June [7] (v) on page no. 26

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If the firm is unable to meet its current obligations, then the failure of the firm is technical. Technical bankruptcy or technical failure can be calculated by working out current ratio, quick ratio, working capital i.e. (Current Assets-Current Liabilities).

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2009 - June [3] (c) "Discounted cash flow is very close to economic value added." Comment. **(4 marks)**

Answer:

For Economic value added -

- EVA is short form of Economic Value Added.
- EVA stands for cash flow after tax of a business less the cost of capital.
- EVA is used in determining the value of a firm since it is a true indicator as against earnings
- EVA = Net operating profit after tax (NOPAT) (–) Capital Employed × Cost of Capital.
- Thus, there are two components of EVA, being NOPAT and capital charge where capital charge refers to the product of capital employed and cost of capital.

Discounted cash flow:- It is simply the present value of cash flow arising to the firm.

Economic value added:- It is calculated as follows:

Operating profit		xxx
Less:	Economic taxes	xxx
	NOPAT	xxx
Less:	Capital charge	xxx
	Economic value added	xxx

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2009 - Dec [1] {C} Comment on the following:

(i) Financial sector acts as conduit for the transfer of financial resources from net savers to net borrowers. **(5 marks)**

Answer:

⇒ In any economy, the financial sector plays a major role in the mobilization and channelising of saving.

⇒ Financial institutions, instruments and markets constitute the financial sector.

⇒ They act as conduit for the transfer of financial resources from net savers to net borrowers.

⇒ Financial sector performs this basic economic function of intermediation essentially through transformation mechanisms.

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2010 - June [1] {C} Comment on the following:

(iv) Traditional approach of business finance considers efficient utilization of resources. **(5 marks)**

Answer:

⇒ The traditional approach of finance was concerned merely with procurement of funds.

⇒ The approach includes proper instrument selection, institutions through which funds are raised and legal and accounting practices and their relationship with the enterprise.

⇒ The traditional approach played very little role in financial planning and direction.

⇒ Efficient utilization of resources alongwith financing decisions requires financial planning and proper direction.

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2011 - Dec [1] {C} Comment on the following:

(iv) Financial gearing is a double-edged sword. **(5 marks)**

(v) Financial policy and corporate strategy are most significant concerns of top management. **(5 marks)**

Answer:

(iv) ⇒ Financial leverage is calculated as a relation between EBIT (Earning Before Interest and Tax) and EBT (Earning Before Tax)

⇒ A high financial leverage has a positive impact on EPS (Earning Per Share) and consequently MPS (Market Per Share)

⇒ A higher EBIT has potential of covering interest expense and consequently result in higher EPS.

⇒ Financial gearing is often termed as a fair weather friend.

⇒ It is so, because a high financial leverage may prove out to be quite a risky if EBIT is not sufficient to cover the interest expense.

⇒ Thus, financial gearing proves out to be a double edged sword since it will help to accelerate the EPS when the company is doing well. However, in case the vice-versa happens i.e. the company is not performing well, EPS of geared company falls down in a greater proportion than that of a low geared company.

(v) Financial policy and corporate strategy are most significant concerns of top management.

⇒ Financial policy & corporate strategy are the most significant concerns of the top management.

⇒ Financial policy is the backbone and helps the top management to determine strategy.

⇒ They are the basic tools which aid management in taking decisions & execution of plans.

⇒ Financial policy ambits in itself all the 3 dimensions- financing, investing & dividend decision.

⇒ for further details ***please refer 2008 - Dec [1] {C} (i) on page no. 31***

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2013 - June [1] {C} Comment on the following:

(i) Liquidity and profitability are competing goals for the financial executives. **(5 marks)**

Answer:

⇒ The term 'liquidity' refers to the firm's ability to honour its future obligation.

⇒ It calls for striking a proper balance between the receivables and payables.

⇒ Liquidity management requires arrangement of receivables in such a manner that they are realised before the maturity of payables.

⇒ A finance manager should determine the need of liquid assets, well in advance, and should arrange them in such a way that there is no scarcity of funds.

⇒ On the other hand the term 'profitability' means effective utilisation of funds in such a manner that they yield the highest return.

⇒ Thus, the two prime goal which every finance manager has in priority being 'liquidity' and 'profitability' often seem to be competitive in nature. Their contradictory nature is on account of the fact that for survival of business it is essential to have adequate amount of cash. But at the same time having excess cash may result in blocking of cash and there by acting as a hindrance in the path of profitability.

⇒ To conclude, a finance manager needs to strike out a proper balance between the goals of liquidity and profitability.

—— Space to write important points for revision ——

2013 - Dec [1] {C} Comment on the following:

(i) Financial gearing is a fair weather friend. **(5 marks)**

Answer :

Please refer 2010 - Dec [1] {C} (v) of Chapter - 3 on page no. 116

—— Space to write important points for revision ——

2014 - June [1] Comment on the following:

(c) Economic Value Added (EVA) concept is in conformity with the objective of wealth maximisation. **(5 marks)**

Answer:

Please refer 2012 - Dec [7] (iv) on page no. 27

—— Space to write important points for revision ——

2014 - June [2] (c) The time value of money concept is needed to maximise wealth. Explain. **(4 marks)**

Answer:

(i) The time value of money is the principle that the purchasing power of money can vary over time; money today might have a different purchasing power than money a decade later.

(ii) The time value of money is the central concept in finance theory.

(iii) Businesses use time-value-of-money formulae to make rational decisions on future expectations.

(iv) Discounting allows us to understand what we would need to invest today if we wanted to receive a certain amount in the future.

(v) Time value of money is important concept to maximize the wealth.

—— Space to write important points for revision ——

2014 - June [5] (a) Financial management means the management of finances of a business organisation in order to achieve financial objectives. Elaborate the financial objectives of a firm. **(4 marks)**

Answer:

Profit Maximisation: Profit maximisation is one of the objective of financial management since profit acts as a reward for taking risk and is also an icon of business performance.

Evaluation of profit maximisation as one of the objectives of financial management.

Advantages of Profit Maximisation:

(i) The ultimate objective of each business is profit maximisation.
(ii) Profit acts as a reward for taking risk.
(iii) It helps to counteract with the future uncertainties.
(iv) Profit is also an icon of business performance.
(v) Last but not the least, profit is the measuring rod which measures the financial soundness of any organisation.

Wealth Maximisation: It is a long term objectives of financial management whereby the business strives to increase the wealth of the shareholders i.e. the stockholding of individual shareholder by maximising the market price per share.

Advantages of Wealth Maximisation:

(i) As against the profit maximisation, the approach of wealth maximisation is long term in nature.
(ii) It considers the timing impact.
(iii) It takes into account the concept of risk and uncertainty.

—— Space to write important points for revision ——

2015 - June [1] Comment on the following:

(a) Financial distress is different from insolvency. **(5 marks)**

Answer:

Generally the affairs of a firm should be managed in such a way that the total risk-business as well as financial-borne by equity holders is minimized and is manageable, otherwise, the firm would obviously face difficulties. If cash inflow is inadequate, the firm will face difficulties in payment of interest and repayment of principal. If the situation continues long enough, a time will come when the firm would face pressure from creditors. Failure of sales can also cause difficulties in carrying out production operations. The firm would find itself in a tight spot. Investors would not invest further. Creditors would

recall their loans. Capital market would heavily discount its securities. Thus, the firm would find itself in a situation called distress. It may have to sell its assets to discharge its obligations to outsiders at prices below their economic values i.e., resort to distress sale. So when the sale proceeds are inadequate to meet outside liabilities, the firm is said to have failed or become bankrupt or (after due processes of law are gone through) insolvent.

—— Space to write important points for revision ——

2015 - June [2A] (Or) (ii) High return on investment (ROI) indicates efficient use of assets. Comment. **(4 marks)**

Answer:

Return on Investment: This is an important profitability ratio from the angle of shareholders and reflects on the ability of management to earn a return on resources put in by the shareholders. The beauty of the ROI ratio is that earning of the company can be viewed from different angles so as to take decisions on different causes responsible, to reduce or to enhance the profitability of the company.

A high ratio indicates efficient use of assets and low ratio reflects inefficient use of assets by a company.

—— Space to write important points for revision ——

2015 - Dec [1] Comment on the following:

(a) Financial sector performs basic economic function of intermediation through transformation mechanisms. **(5 marks)**

Answer:

- In any economy, the financial sector plays a major role in the mobilization and channelising of saving.
- Financial institutions, instruments and markets constitute the financial sector.
- They act as conduit for the transfer of financial resources from net savers to net borrowers.
- Financial sector performs this basic economic function of intermediation

essentially through four transformation mechanisms:

1. Liability-asset transformation (i.e., accepting deposits as a liability and converting them into assets such as loans);
2. Size-transformation (i.e., providing large loans on the basis of numerous small deposits);
3. Maturity transformation (i.e., offering savers alternate forms of deposits according to their liquidity preferences while providing borrowers with loans of desired maturities); and
4. Risk transformation (i.e., distributing risks through diversification which substantially reduces risks for savers which would prevail in the absence of financial intermediation).

—— Space to write important points for revision ——

2016 - Dec [1] Comment on the following:

(a) Financial management has changed significantly in its scope and complexity in recent times. **(5 marks)**

Answer:

- Financial management in India has also changed substantially in scope and complexity in view of recent government policy.
- Some of the changes include introduction of new financial instruments and transactions like options and future contracts, foreign currency swaps, and interest rate swaps, GDR (Global Depository Receipts), Euro Issues, globalization of capital markets, finance mix, liberalisation measures taken by government etc.
- All these have emphasised the need for effective and efficient use of corporate financial resources.
- Under the changed circumstances, financial management covers the following:
  1. **Raising the funds:** Apart from Indian Public and Financial Institutions, companies have started raising funds etc. in the international markets by way of Euro Issues and from International Financial Institutions.

2. **Investment Decisions:** Presently, investment decisions of firms are not confined to Indian territory but spread over globally. Foreign investors are encouraged. Hence the competitions in India as well as from abroad have made the financial management more complex and foreign exchange management has become highly specialised area in financial management.
3. **Dividend Decisions:** In view of wealth maximisation of firm, the internal generation of funds are not paid out by way of dividend or issue of bonus shares. They are utilised by companies in portfolio management by floating mutual funds etc.

—— Space to write important points for revision ——

2017 - June [1] (a) "The EVA is a tool to underline the shareholders value." Comment. **(5 marks)**

Answer:

Economic Value Added

- EVA is short form of Economic Value Added.
- EVA stands for cash flow after tax of a business less the cost of capital.
- Now a day's EVA is used in determining the value of a firm since it is a true indicator as against earnings.
- EVA = Net operating profit after tax (NOPAT) (–) Capital Employed × Cost of Capital.
- Thus, there are two components of EVA, being NOPAT and capital charge where capital charge refers to the product of capital employed and cost of capital.
- EVA underlines shareholder value, increasingly the main target of leading companies strategies.
- There is growing evidence that EVA, not earnings, determines the value of a firm.

—— Space to write important points for revision ——

2017 - June [2A] (Or) (ii) Explain the concept of financial insolvency and compare it with technical bankruptcy. **(4 marks)**

Answer:

Financial Insolvency

Generally the affairs of a firm should be managed in such a way that the total risk-business as well as financial-borne by equity holders is minimized and is manageable, otherwise, the firm would obviously face difficulties. If cash inflow is inadequate, the firm will face difficulties in payment of interest and repayment of principal. If the situation continues long enough, a time will come when the firm would face pressure from creditors. Failure of sales can also cause difficulties in carrying out production operations. The firm would find itself in a tight spot. Investors would not invest further. Creditors would recall their loans. Capital market would heavily discount its securities. Thus, the firm would find itself in a situation called distress. It may have to sell its assets to discharge its obligations to outsiders at prices below their economic values i.e., resort to distress sale. So when the sale proceeds are inadequate to meet outside liabilities, the firm is said to have failed or become bankrupt or (after due processes of law are gone through) insolvent.

Technical Insolvency

Failure of a firm is technical if it is unable to meet its current obligations. The failure could be temporary and might be remediable. When liabilities exceed assets i.e. the net worth becomes negative, bankruptcy arises. Technical bankruptcy can be ascertained by comparing current assets and current liabilities i.e. working out current ratio or quick ratio. On the other hand, solvency ratios indicate long term liquidity i.e. the ability of the firm to discharge its term-liabilities.

—— Space to write important points for revision ——

2017 - June [4] (d) "Finance Manager has no role to play in manufacturing company." Comment. **(4 marks)**

Answer:

Finance Manager is having an important role in manufacturing company. Some of the key roles/duties of Finance Manager are as follows:

1. **Forecasting of Cash Flow:** This is necessary for the successful day to day operations of the business so that it can discharge its obligations as and when they arise.

2. **Raising Funds:** The Financial Manager has to plan for mobilising funds from different sources so that the requisite amount of funds are made available to the business enterprise to meet its requirements for short term, medium term and long term.
3. **Managing the Flow of Internal Funds:** He has to ensure that liquidity position of the company is maintained.
4. **To Facilitate Cost Control:** The Financial Manager is generally the first person to recognise when the costs for the supplies or production processes are exceeding the standard costs/budgeted figures. Consequently, he can make recommendations to the top management for controlling the costs.
5. **To Facilitate Pricing of Product, Product Lines and Services:** Finance Manager provides tools of analysis of information in pricing decisions and contribute to the formulation of pricing policies jointly with the marketing manager.
6. **Forecasting Profits:** The Financial manager is usually responsible for making forecasts of profit levels.
7. **Managing Assets:** Finance personnel meet with other officers of the firm and participate in making decisions affecting the current and future utilisation of the firm's resources.
8. **Managing Funds:** The manager is responsible for having sufficient funds for the firm to conduct its business and to pay its liabilities.

—— Space to write important points for revision ——

2017 - Dec [1] Comment on the following:

(a) Wealth maximization is a decision criterion and not a goal of a business firm. **(5 marks)**

Answer:

- Wealth maximization is a long term objectives of financial management whereby the business strives to increase the wealth of the shareholders i.e. the stockholding of individual shareholder by maximising the market price per share.
- As against the profit maximisation, the approach of wealth maximization is long term in nature.

- It takes into account the concept of risk and uncertainty.
- It is a useful criterion against which investment, financing and dividend decisions are to be judged.

—— Space to write important points for revision ——

2017 - Dec [2A] (Or) (iv) Discuss the concepts of financial distress and insolvency. **(4 marks)**

Answer:

Please refer 2014 - June [6] (d) on page no. 28

—— Space to write important points for revision ——

2017 - Dec [4] (c) Explain the statement "Higher the return the higher will be the risk". **(4 marks)**

Answer:

- Higher the risk, higher will be the return.
- The risk return tradeoff is the principle which states that the potential return rises with the increase in the risk.
- Low levels of uncertainty or risks are associated with low levels of return and *vice-versa*.
- As per the financial model, higher return on investments can be made only when investor is willing to accept the higher risk which includes possibility of losses also.
- Risk return tradeoff is an important component of investment decision.

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2018 - June [4] (c) Elaborate the symptoms through which an analyst can get indication about the probable financial distress of firm. **(4 marks)**

Answer:

Symptoms to get an indication of financial distress probability:

- Liquidity problems
- Difficulty in obtaining market credit.
- Higher prices charged by supplier of raw materials and services.
- Difficulty in obtaining the market credit.
- Delay in payment beyond the maturity or due date of payment.
- Delay in realization of funds from debtors.

- Excessive borrowings to meet the operating expenses.

—— Space to write important points for revision ——

2018 - Dec [1] Comment on the following:

(a) Profit maximization is the sole objective of Financial Management.

(5 marks)

PRACTICAL QUESTION

2018 - June [3A] (Or) (i) Strawberry Ltd. is an established confectionary maker company. Chairman of the Strawberry has recently attended one of the Management Development Programme in premier institution. He is willing to work out the Economic Value Added (EVA) of the firm. He has provided to you, the following information . You are required to calculate the EVA from the same.

1.	Profit after interest and tax	₹ 150 lakh
2.	Interest	₹ 25 lakh
3.	Borrowing interest rate	10%
4.	Owners' cost of capital	18%
5.	Net worth of the company	₹ 300 lakh
6.	Tax rate applicable	33%
7.	Overall cost of capital	15%

(4 marks)

Answer:

Alternative Solution No. 1

EVA = PAT – Charges for equity

= ₹ 150 lakh – (₹ 300 lakh × 0.18)

= ₹ 96 lakh

Alternative Solution No. 2

EVA = NOPAT – Charges for capital employed

NOPAT = PAT + Interest (1 – t) = ₹ 150 lakh + ₹ 25 lakh (1– 0.33)

= ₹ 166.75 lakh

Capital employed = equity capital + debt

= ₹ 300 lakh + (₹ 25 lakh/ 10%)

= ₹ 550 lakh

Cost of capital employed = 0.15 × ₹ 550 lakh = ₹ 82.5 lakh
EVA = ₹ 166.75 lakh – ₹ 82.5 lakh = ₹ 84.25 lakh

Alternative Solution No. 3

EVA = (ROCE – Overall cost of capital) × capital employed
ROCE = EBIT/ Capital employed
EBIT (for the purpose of EVA) = PAT + Interest (1–t)
EBIT = ₹ 150 lakh + ₹ 25 lakh (1-0.33)
= ₹ 166.75 lakh
ROCE = ₹ 166.75 lakh/ ₹ 550 lakh
= 30.32%
EVA = (0.3032 – 0.15) × ₹ 550 lakh
= ₹ 84.26 lakh

—— Space to write important points for revision ——

TOPIC NOT YET ASKED BUT EQUALLY IMPORTANT FOR EXAMINATIONS

SHORT NOTES

Q1. Write a short note on the term “Finance”?

Answer:

- Finance may be defined as an art or a science of managing money.
- It includes financial service and financial instruments.
- Finance is also referred as the provision of money at the time when it is needed.
- Finance function is the procurement of funds and their effective utilization in business concerns.
- Finance is termed as ‘the Science on study of the management of funds’
- Thus finance is the procurement of funds and effective utilization of funds.

—— Space to write important points for revision ——

DESCRIPTIVE QUESTIONS

Q2. Briefly describe the financial management as a "Science" or as an "Art"?

Answer:

- Financial Management is a subject within the compass of social science as it deals with people. Its nature is nearer to applied sciences as it envisages use of classified and tested knowledge as a help in practical affairs and solving business.
- Theory of financial management is based on certain systematic principles, some of which can be tested in mathematical equations like the law of physics and chemistry.
- Financial management contains rules that hold true in general
- The use of computers, operations research, statistical techniques and econometric models find wide application in financial management as tools for solving corporate financial problems like budgeting, choice of investments, acquisition or mergers etc. This takes the financial management nearer to treatment as a subject of science.
- On the other hand, there remains a wide scope for application of value judgement in financial decision making.
- Most practical problems of finance have no hard and fast answers that can be worked out mathematically or programmed on a computer. They must be solved by value judgement, intuition and the "feel" of experience.
- Thus, despite its frequent acceptance as an applied science, finance remains largely an art.
- This makes financial management and managing a company's finance both an art and a science. It requires a feel for the situation and analytical skills alongwith a thorough knowledge of the techniques and tools of financial analysis and the know-how to apply them and interpret the results.
- The finance functions are mainly three viz., planning, organisation and financial control. In each of these finance functions elements of science and art can be observed. For example, in planning function, there are

certain goals, which may be short-term goals or long-term goals. Each falls within the area of art. Another parameter of planning is estimating funds, which may again be short-term or long-term involving techniques and skills. When involvement to techniques is there the subject matter remains science and when the skills are required to be interpreted, the subject matter becomes an art.

The discipline of financial management has both the aspects of science as well as art; where there is theory of systematic knowledge it is science and where there is application it is art.

Space to write important points for revision

Repeatedly Asked Questions		
No.	**Question**	**Frequency**
1	Write notes on Financial distress. 09 - June [1] (i), 09 - June [7] (v), 11 - Dec [7] (ii)	3 Times
2	Distinguish between 'Business risk' and 'financial risk'. 09 - Dec [4] (a) (iii),11 - Dec [4] (v)	2 Times
3	Distinguish between 'Financial distress' and 'insolvency'. 10 - Dec [4] (i), 12 - June [4] (i), 14 - June [6] (d), 17 - Dec [2A] Or (iv)	4 Times