1 NATURE SIGNIFICANCE AND SCOPE OF FINANCIAL MANAGEMENT

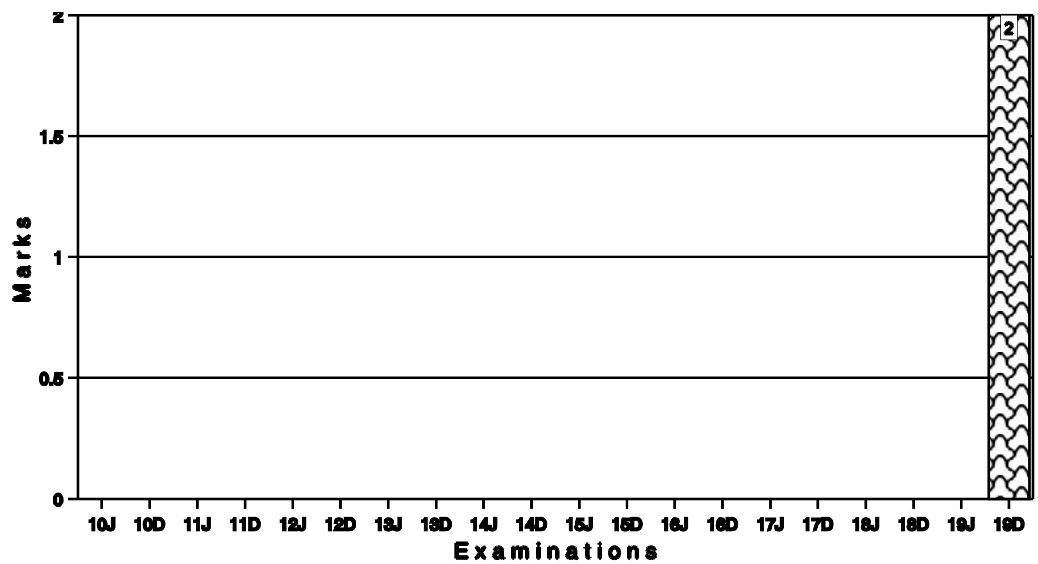
THIS CHAPTER INCLUDES

- 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

Objective Short Notes Distinguish Descriptive Practical



CHAPTER AT A GLANCE

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

OBJECTIVE QUESTIONS

2019 - Dec [31] Which of the following is *true* regarding financial decisions of a firm?
(a) Investment Decisions are dependent on Financing Decisions.
(b) Financing Decisions are dependent on Dividend Decisions.
(c) Dividend Decisions are dependent on Investment Decisions.
(d) All are three decisions are inter- related. **(1 mark)**

2019 - Dec [33] The competing objectives of financial management have been:
(a) Profit Maximization and Wealth Maximization
(b) Profit Maximization and Economic Value Maximization
(c) Economic Value Maximization and Wealth Maximization
(d) EPS Maximization and Economic Value Maximization **(1 mark)**

MULTIPLE CHOICE QUESTIONS

1. Financial management means the management of finance of a business or an organization in order to achieve the __________ objectives
   (a) Financial
   (b) Social
   (c) Financial and Social
   (d) None of the above
2. _________ is that business activity which concerns with the acquisition and conversion of capital funds in meeting financial needs and overall objectives of a business enterprise.
   (a) Structured Finance
   (b) Business Finance
   (c) Legal
   (d) Sourcing
3. _________ is broadly concerned with raising of funds, creating value to the assets of the business enterprise by efficient allocation of funds
   (a) Financial management
   (b) Treasury Management
   (c) Liquidity Management
   (d) Fund Management
4. Financial Management is concerned with :
   (a) Investment Decision
   (b) Financing Decision
   (c) Dividend Decisions
   (d) All of the above
5. _________ are concerned with the determination of how much funds to procure from amongst the various avenues available i.e. the financing mix or capital structure:
   (a) Investment Decision
   (b) Financing Decision
   (c) Dividend Decisions
   (d) All of the above

6. ___________ is to decide whether the firm should distribute all profits or retain them or distribute a portion and retain the balance:
   (a) Investment Decision

(b) Financing Decision
(c) Dividend Decisions
(d) All of the above

7. __________ ensures that firm utilizes its available resources most efficiently under conditions of competitive markets
(a) Profit maximisation
(b) Wealth maximisation
(c) Goal maximisation
(d) None of the above

8. ___________ means the management of an organization maximizes the present value not only for shareholders but for all including employees, customers, suppliers and community at large
(a) Profit maximisation
(b) Wealth maximisation
(c) Goal maximisation
(d) None of the above

9. Which of the following is not a correct statement?
(a) Profit maximisation is vague conceptually.
(b) Profit maximisation ignores timing of returns
(c) Profit maximisation emphasis is generally on short run projects
(d) Profit maximisation considers timing of returns

10. Advantage of profit maximisation is:
(a) Easy to calculate profits
(b) Easy to determine the link between financial decisions and profits.
(c) Both (a) and (b)
(d) None of the above

11. Which of the following is not the advantage of wealth maximisation?
(a) Emphasizes long term
(b) Recognises risk and uncertainty
(c) Recognises the timings of return
(d) Easy to determine the link between financial decisions and profits

12. Wealth maximisation objective is superior to the profit maximisation concept.
(a) True
(b) False

13. Profit maximisation is the narrow objective of financial management

because profit is a test of economic efficiency.

(a) True

(b) False

14. Profit maximisation goes beyond the quantitative aspects as it also considers qualitative benefits in a firm.

(a) True

(b) False

15. __________ is the after tax cash flow generated by a business minus the cost of the capital it has deployed to generate that cash flow

(a) Net Present Value(NPV)

(b) Economic value added (EVA)

(c) Internal Rate of Return(IRR)

(d) Discounted Cash Flow

16. Representing real profit versus paper profit, EVA underlines shareholder value, increasingly the main target of leading companies strategies

(a) True

(b) False

17. There is growing evidence that EVA, not earnings, determines the value of a firm.

(a) True

(b) False

18. Which of the following statement is not correct?

(a) There are two key components to EVA. The net operating profit after tax (NOPAT) and the capital charge, which is the cost of capital times the amount of capital

(b) EVA underlines shareholder value

(c) There is no difference between EVA ,earnings per share, return on assets, and discounted cash flow, as a measure of performance

(d) EVA = (Operating Profit) – (A Capital Charge)

19. Finance Manager has to take following decision:

(a) Investment decision

(b) Financing decision

(c) Dividend decision

(d) All of the above

20. A finance manager is not required to trade-off between the risk and return.

(a) True
(b) False

21. At risk return trade off, market price of share is:
    (a) Minimised
    (b) Maximised
    (c) No affect
    (d) Uncertain
22. Liquidity is not an important aspect of financial management.
    (a) True
    (b) False
23. Which of the following statement is correct?
    (a) Current Ratio is the ratio of current assets to current liabilities
    (b) Current Ratio is the ratio of current assets to short term liabilities
    (c) Current Ratio is the ratio of current assets to long term liabilities
    (d) Current Ratio is the ratio of current assets and fixed assets to current liabilities
24. Liquidity ratio enables a company to assess its :
    (a) Current Assets only
    (b) Current liabilities only
    (c) Net Working Capital
    (d) Fixed Assets
25. Net working capital is:
    (a) Current Assets + Current Liabilities
    (b) Current Assets - Current Liabilities
    (c) Current Assets - Total Liabilities
    (d) Current Assets + Fixed Assets-Current Liabilities
26. Average Collection Period (ACP) tells us the average number of days receivables are outstanding i.e., the average time a bill takes to convert into cash.
    (a) True
    (b) False
27. Financial decisions are affected by liquidity analysis of a company in the following areas:
    (a) Management of cash and marketable securities;
    (b) Credit policy of a firm and procedures for realisation

(c) Management and control of inventories
(d) All of the above

28. The gross profit margin ratio indicates the profits relative to sales after deduction of direct production cost
(a) True
(b) False

29. Failure of a firm is technical if it is unable to meet its_______ obligations.
(a) Current
(b) Non-current
(c) Both (a) and (b)
(d) None of the above

30. Which of the following is solvency ratio:
(a) Debt to Equity ratio
(b) Debt to total Funds Ratios
(c) Interest coverage ratio
(d) All of the above

31. Study of financial management:
(a) Is an art
(b) Is a science
(c) Mixture of science as well as art
(d) None of the above

32. Which of the following is not a direct function of finance manager:
(a) Forecasting of cash flow
(b) Raising funds
(c) To facilitate cost control.
(d) To arrange board meeting

33. __________ reflects on the ability of management to earn a return on resources put in by the shareholders evaluating the performance of the company in different spheres.
(a) Profitability ratio
(b) Liquidity Ratio
(c) Solvency Ratio
(d) Net Working Capital

34. Affairs of the firm should be managed in such a way that the total risk – business as well as financial borne by equity shareholders is minimised and is manageable.
(a) True
(b) False

35. With the evolution of finance from being mere a descriptive study to the one that is highly developed discipline, the role of financial managers has also undergone a sea change.
    (a) True
    (b) False
36. Finance function includes
    (a) Financial control
    (b) Effective assets management
    (c) Financial planning
    (d) All of the above
37. Finance function includes
    (a) Procurement of additional capital for expansion and extension
    (b) Evaluating financial performance
    (c) Allocation of net profits
    (d) Preparation of annual financial statement and determination
    (e) All of the above
38. The functions of finance manager are
    (a) Financial planning and procurement of funds'
    (b) Co-ordination and control
    (c) Business forecasting
    (d) All of the above

39. The functions of finance manager are
    (a) Management of fixed and current assets
    (b) Inventory management
    (c) Credit collection
    (d) All of the above
40. Financial management is a part of-
    (a) Business management
    (b) Financial accounting
    (c) Management accounting
    (d) Human resource management
    (e) All of the above
41. The financial management is responsible for the __________function of the concern.
    (a) Finance

(b) Marketing
(c) Accounting
(d) Managerial
(e) All of the above

42. Match the following-

Part (A)

Authors

1. Howard and Upton
2. Weston and Brighan
3. Joseph L. Massie
4. Ezra Soloman

Part (B)

(Statement of authors)

(a) Financial management is the application of planning and control function to the finance function.
(b) Financial management is an area of financial decision making harmonising individual motives and enterprise goals.
(c) Financial management is the operational activity of a business that is responsible for obtaining and effectively utilising the funds necessary for efficient operations.
(d) Financial management is concerned with the efficient use of an important economic resource, namely Capital Fund.

	1	2	3	4
A.	(a)	(b)	(c)	(d)
B.	(d)	(c)	(a)	(b)
C.	(c)	(a)	(b)	(d)
D.	(c)	(d)	(a)	(b)
E.	(a)	(c)	(b)	(d)

43. The profit maximisation is a vague concept. This is a-
(a) Limitation of profit maximisation objective
(b) Importance of profit maximisation objective
(c) Concept of profit maximisation objective
(d) Principle of profit maximisation objective
(e) All of the above

44. The profit maximisation objective ignores time value of money. Is this statement true?

(a) Yes
(b) No
(c) Cannot say
(d) All of these
(e) None of the above

45. Which of the following is a limitation of profit maximisation objective?
(a) Financial management ignores time value of money
(b) Financial management overlooks quality aspect of profit from future activities
(c) Ignores social responsibility of business
(d) All of these
(e) None of the above

46. How to achieve wealth maximisation?
(a) Avoid high level of risks
(b) Reduction in cost
(c) Pay dividends
(d) Seek growth
(e) All of the above

47. Which of the following is not function of financial management?
(a) Planning of funds
(b) Raising of funds
(c) Allocation of funds
(d) Control of funds
(e) All of the above

48. Which of the following finance functions was written by John J Hampton?
(a) Managing funds
(b) Managing assets
(c) Liquidity functions
(d) Profitability function
(e) All of the above

49. Which of the following is not function of Financial controller?
(a) Financial statements
(b) Internal audit
(c) Social responsibility
(d) Safety of records
(e) Budget

50. Which of the following is not function of treasurer?
    (a) Management of cash
    (b) Management of credit
    (c) Inventory management
    (d) Management of pension
    (e) Distribution of dividend
51. Nature of Financial management can be judged by the study of the nature of investment, financing and dividend decision
    (a) True
    (b) False
52. Capital is not a scarce resource
    (a) True
    (b) False

53. ____________Is concerned more and more with the questions as to how cost of funds be measured and how the expected returns on projects be measured.
    (a) Investing decision
    (b) Financing decision
    (c) Dividend decision
    (d) All of the above
54. Financing decision aims at:
    (a) Maximising returns on investments
    (b) Minimising risk
    (c) Both(a) and (b)
    (d) None of the above
55. Time is of no essence while selecting criteria for investment decision
    (a) True
    (b) False
56. Liquidity is assessed through use of ratio analysis
    (a) True
    (b) False
57. Liquidity ratios provide an insight into the present cash solvency of a firm and its ability to remain solvent in the event of calamities.
    (a) True

(b) False

58. Current Ratio which is the ratio of current assets to current liabilities, is widely used by corporate units to judge the ability to discharge short-term liabilities covering the period upto________________.
    (a) One month
    (b) One year
    (c) Five year
    (d) Lifetime

59. Liquidity ratio enables a company to assess its_________________.
    (a) Net working capital
    (b) Sales
    (c) Performance
    (d) None of the above

60. For calculation of net working capital we deduct current liabilities from current assets.
    (a) True
    (b) False

61. The only feasible purpose of Financial Management is:
    (a) Wealth Maximisation
    (b) Sales Maximisation
    (c) Profit Maximisation
    (d) Assets maximisation

62. Finance Function comprises
    (a) Safe custody of funds only
    (b) Expenditure of funds only
    (c) Procurement of finance only
    (d) Procurement & effective use of funds

63. The objective of wealth maximization takes into account
    (a) Amount of returns expected
    (b) Timing of anticipated returns
    (c) Risk associated with uncertainty of returns

(d) All of the above

64. Financial management mainly focuses on
    (a) Efficient management of every business
    (b) Brand dimension
    (c) Arrangement of funds
    (d) All elements of acquiring and using means of financial resources for financial activities
65. If the Present Value of Cash Inflows are greater than the Present Value of Cash Outflows, the project would be
    (a) Accepted
    (b) Rejected with condition
    (c) Rejected with approval
    (d) Rejected
66. Finance functions are:
    (a) Planning for funds
    (b) Raising of fund
    (c) Allocation of resources
    (d) All of the above
67. Time value of money indicates that
    (a) A unit of money obtained today is worth more than a unit of money obtained in future
    (b) A unit of money obtained today is worth less than a unit of money obtained in future
    (c) There is no difference in the value of money obtained today and tomorrow
    (d) None of the above
68. If the nominal rate of interest is 10% per annum and there is quarterly compounding, the effective rate of interest will be:
    (a) 10% per annum
    (b) 10.10 per annum
    (c) 10.25%per annum
    (d) 10.38% per annum
69. Financial statements are an important source of information to shareholders and stakeholders.
    (a) True
    (b) False
70. Capital budgeting decisions are long term decisions
    (a) True

(b) False

71. Capital budgeting decisions are reversible in nature.
    (a) True
    (b) False
72. Cash Profits and accounting profits are same.
    (a) True
    (b) False
73. Cash Flows are same as profit before tax
    (a) True
    (b) False
74. Risk free interest rate and cost of capital are same things.
    (a) True
    (b) False
75. Economic Value Added (EVA) of a firm is always positive.
    (a) True
    (b) False
76. Swap Ratio and Share Exchange Ratio are one and the same thing
    (a) True
    (b) False
77. The term 'EVA' is used for:
    (a) Extra Value Analysis
    (b) Economic Value Added
    (c) Expected Value Analysis
    (d) Engineering Value Analysis
78. Effective dividend policy is an important tool to achieve the goal of wealth maximization
    (a) True
    (b) False
79. An operating cash flows is $12000 and gross fixed asset expenditure is $5000 then freecash flow will be:
    (a) $ 7,000
    (b) $ 7,000
    (c) $ 17,000
    (d) $ 10,000

80. Cost which has occurred already and not affected by decisions is classified as:
    (a) Sunk cost
    (b) Occurred cost
    (c) Weighted cost
    (d) Mean cost

81. If pay-out ratio is 0.45 then retention ratio will be
    (a) 0.55
    (b) 1.45
    (c) 1.82
    (d) 0.45
82. Business finance can broadly be defined as the activity concerned with:
    (a) planning of the funds used in the business
    (b) raising of the funds used in the business
    (c) controlling and administering of the funds used in the business
    (d) All of the above
83. Corporate finance is concerned with :
    (a) Budgeting and financial forecasting
    (b) Cash management and credit administration
    (c) Investment analysis and fund procurement of the business
    (d) All of the above
84. Raising of funds should involve :
    (a) minimum cost
    (b) to bring maximum returns
    (c) Both (a) and (b)
    (d) None of the above
85. ____________ordinarily means utilisation of money for profits or return
    (a) Investment
    (b) Financing
    (c) Dividend
    (d) All of the above
86. ____________is a major aspect of investment decision making process
    (a) Capital budgeting
    (b) Capital Structure
    (c) Working capital
    (d) Dividend decision

87. Investment decisions and capital budgeting are considered as synonymous in the business world.
    (a) True
    (b) False

88. Investment decisions are commitments of monetary resources at different times in expectation of economic returns in future
    (a) True
    (b) False
89. Capital is a :
    (a) Scarce Resource
    (b) Supply cost is very high
    (c) Both (a) and (b)
    (d) None of the above
90. Financing decision is the next step in financial management for executing the investment decision once taken.
    (a) True
    (b) False
91. Which of the following statement is not correct?
    (a) The dividend decision is not a major area of financial management
    (b) The financial manager must decide whether the firm should distribute all profits or retain them or distribute a portion and retain the balance
    (c) Optimal use of funds has become a new concern of financing decisions and top managements in corporate sector are more concerned with planning the sources and uses of funds and measuring performance
    (d) Both Investment decision and financial decisions are jointly made as an effective way of financial management in corporate units.
92. The main objectives which a business organisation pursues are :
    (a) maximisation of return
    (b) minimisation of costs
    (c) Both (a) and (b)
    (d) None of the above
93. A fair decision criterion should follow the following principle:

(a) the “Bigger and Better” principle;
(b) “A Bird in Hand is Better than Two in the Bush” principle.
(c) Both (a) and (b)
(d) None of the above

94. _______simply measures the time required for cash flows from the project to return the initial investment to the firm’s account.
(a) Urgency
(b) Pay back
(c) Rate of Return
(d) None of the above

95. Which of the following statement is not correct?
(a) Pay back decision criterion follow the principles laid down above viz. “the bigger and better” and “bird in hand
(b) Time is of essence while selecting this criterion for investment decisions
(c) The main objectives which a business organisation pursues are maximisation of return and minimisation of costs.
(d) None of the above

96. Profit maximisation as corporate goal is criticised by scholars mainly on the following grounds:
(a) It is vague conceptually
(b) It ignores timing of returns
(c) It ignores the risk factor
(d) All of the above

97. Which of the following statement is correct?
(a) Profit maximisation is not vague conceptually
(b) Profit maximisation emphasis is generally on long run projects
(c) Profit maximisation ignores risk factor
(d) All of the above

98. According to____________, shareholder wealth maximization means maximizing the net present value of a course of action to shareholders.
(a) Solomon
(b) Howard and Upton
(c) Joseph and Massie
(d) Parhter and Wert

99. Wealth maximisation is basically a single-period or, at the most, a short-term goal.

(a) True
(b) False

100. Wealth maximisation is generally preferred because it considers:
(a) wealth for the long-term
(b) risk or uncertainty
(c) the shareholders' return
(d) All of the above

ANSWER

1	(a)	**2**	(b)	**3**	(a)	**4**	(d)	**5**	(b)	**6**	(c)
7	(a)	**8**	(b)	**9**	(d)	**10**	(c)	**11**	(d)	**12**	(a)
13	(a)	**14**	(b)	**15**	(b)	**16**	(a)	**17**	(a)	**18**	(c)
19	(d)	**20**	(b)	**21**	(b)	**22**	(b)	**23**	(a)	**24**	(c)
25	(b)	**26**	(a)	**27**	(d)	**28**	(a)	**29**	(a)	**30**	(d)
31	(c)	**32**	(d)	**33**	(a)	**34**	(a)	**35**	(a)	**36**	(d)
37	(e)	**38**	(d)	**39**	(d)	**40**	(a)	**41**	(a)	**42**	(a)
43	(a)	**44**	(a)	**45**	(d)	**46**	(e)	**47**	(e)	**48**	(e)
49	(c)	**50**	(c)	**51**	(a)	**52**	(b)	**53**	(b)	**54**	(c)
55	(b)	**56**	(a)	**57**	(a)	**58**	(b)	**59**	(a)	**60**	(a)
61	(a)	**62**	(d)	**63**	(d)	**64**	(d)	**65**	(a)	**66**	(d)
67	(a)	**68**	(d)	**69**	(a)	**70**	(a)	**71**	(b)	**72**	(b)

73	(b)	**74**	(b)	**75**	(b)	**76**	(a)	**77**	(b)	**78**	(a)
79	(b)	**80**	(a)	**81**	(a)	**82**	(d)	**83**	(d)	**84**	(c)
85	(a)	**86**	(a)	**87**	(a)	**88**	(a)	**89**	(c)	**90**	(a)
91	(a)	**92**	(c)	**93**	(c)	**94**	(b)	**95**	(a)	**96**	(d)
97	(c)	**98**	(a)	**99**	(b)	**100**	(d)				