

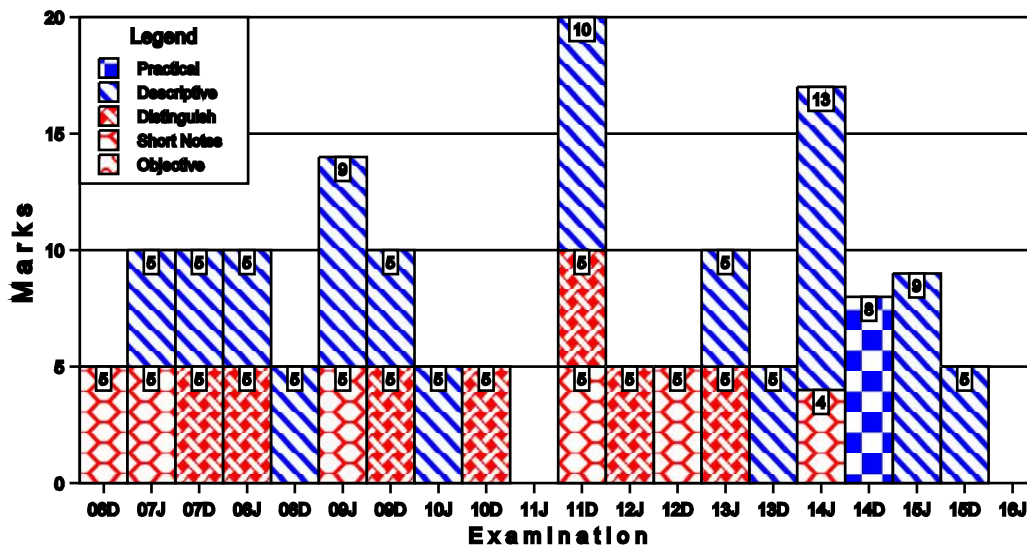
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Nature, Significance and Scope of Financial Management

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 Short Notes, Distinguish Between, Descriptive & Practical Questions



Questions of Dec 2008 are from CS Final Gr. II Old Course and from June 2009 onwards are from CS Professional Programme New Course

Chapter at a Glance

Financial Management: Financial Management, to be more precise, is, thus 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 a large number of factors.

Objectives of Financial Management:

Broadly, there are only 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 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.

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.

Advantages of Wealth Maximisation:

- As against the profit maximisation, the approach of wealth maximisation is long term in nature.
- It does consider 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.

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.

- $EVA = \text{Net operating profit after tax (NOPAT)} (-) \text{Capital Employed} \times \text{Cost of Capital}$.
- 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.

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 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 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.

Financial Management as a Science or Art

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.

Responsibilities/Functions of the Financial Manager

Some of the Responsibilities/Functions of the Financial Manager are as under:

- 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

Financial Sector

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.

SHORT NOTES

2006 - Dec [7] Write note the following:

(v) Economic value added (EVA) and wealth-maximisation. (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.
- Now a days EVA is used in determining the value of a firm since it is a true indicator as against earnings
- $EVA = \text{Net operating profit after tax (NOPAT)} - \text{Capital Employed} \times \text{Cost of Capital}$.
- 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.

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Advantages of Wealth Maximisation:

- ⇒ As against the profit maximisation, the approach of wealth maximisation is long term in nature.
- ⇒ It does consider 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.

2007 - June [7] Write note on the following:

- (vi) 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 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.

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

- (v) Financial distress (5 marks)

Answer:

Please refer 2007 - June [7] (vi) on page no. 28

2011 - Dec [7] Write note on the following:

- (ii) Financial distress (5 marks)

Answer:

Please refer 2007 - June [7] (vi) on page no. 28

2012 - Dec [7] Write note on the following:

- (iv) Economic value added (EVA) (5 marks)

Answer:

Please refer 2006 - Dec [7] (v) on page no. 27

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. 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.

DISTINGUISH BETWEEN

2007 - Dec [4] 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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2008 - June [4] Distinguish between the following:

- (ii) 'Financial distress' and '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.

2009 - Dec [4] (a) Distinguish between the following:

- (iii) 'Business risk' and 'financial risk'. (5 marks)

Answer:

Please refer 2007 - Dec [4] (iii) on page no. 29

2010 - Dec [4] Distinguish between the following:

- (i) 'Financial distress' and 'insolvency'. (5 marks)

Answer:

Please refer 2008 - June [4] (ii) on page no. 29

2011 - Dec [4] Distinguish between the following:

- (v) 'Financial risk' and 'business risk'. (5 marks)

Answer:

Please refer 2007 - Dec [4] (iii) on page no. 29

2012 - June [4] Distinguish between the following:

- (i) 'Financial distress' and 'insolvency'. (5 marks)

Answer:

Please refer 2008 - June [4] (ii) on page no. 30

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.
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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 does consider 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.

DESCRIPTIVE QUESTIONS

2007 - June [1] {C} Comment on the following:

- (i) 'Wealth maximisation' objective of the financial management is redefined as 'value maximisation'. (5 marks)

Answer:

- ⇒ Wealth maximisation objective of the financial management is redefined as value maximisation.
- ⇒ The objective of wealth maximisation talks about increasing the wealth of equity shareholders.
- ⇒ Increase in wealth of shareholders calls for increase in market price of shares.
- ⇒ Thus, what is required ultimately is the increase in market price or market value of shares.
- ⇒ Therefore, the concept of wealth maximisation can better be construed as value maximisation.

2007 - Dec [1] {C} Comment on the following:

- (vi) Taxation provisions have a significant effect on financial planning of a company. (5 marks)

Answer:

- ⇒ It is true to say that taxation provisions have a significant effect on financial planning of a company.

- ⇒ Financial management is concerned with the effective procurement and utilisation of funds.
- ⇒ The scope of financial management is wide enough and covers in its purview the investment, financing and dividend decisions.
- ⇒ Finance manager has to assess and consider the impact of taxes in relation to each of these three decisions.
- ⇒ While determining investment decisions the amount of debt should be taken into consideration since interest on debt is a charge. Also the amount of tax on distribution of dividend in case of dividend decisions are to be taken care off.

2008 - June [1] {C} Attempt the following:

- (iv) "An investor suffers dilution of financial interest when he does not exercise his pre-emptive rights." Comment. (5 marks)

Answer:

- ⇒ **Section 62 of the Companies Act, 2013**, covers the concept of pre-emptive rights.
- ⇒ According to **Section 62 of the Companies Act, 2013**, the company shall be bound to offer the new issue to existing shareholders before making them available to the new ones.
- ⇒ Existing shareholders shall have the option whether to subscribe the new shares or not.
- ⇒ In case shareholder does not exercise his pre-emptive rights his financial interest dilutes.

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.

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 2007 - June [7] (vi) on page no. 28

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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).

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.
- Now a days EVA is used in determining the value of a firm since it is a true indicator as against earnings
- $EVA = \text{Net operating profit after tax (NOPAT)} (-) \text{Capital Employed} \times \text{Cost of Capital}$.
- 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	<u>xxx</u>
NOPAT	xxx
Less: Capital charge	<u>xxx</u>
Economic value added	<u>xxx</u>

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.

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.

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. 33*

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.

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

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

Answer :

Please refer 2010 - Dec [1] (v) of Chapter -3 on page no. 100

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:

- (i) EVA is short form of Economic Value Added.
- (ii) EVA stands for cash flow after tax of a business less the cost of capital.
- (iii) Now a days EVA is used in determining the value of a firm since it is a true indicator as against earnings.
- (iv) $EVA = \text{Net Operating Profit After Tax (NOPAT)} - \text{Capital Employed} \times \text{Cost of Capital}$.
- (v) 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 does consider 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.

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.

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 does consider the timing impact.

(iii) It takes into account the concept of risk and uncertainty.

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.

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.

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).

PRACTICAL QUESTIONS

2014 - Dec [4] (b) Using capital employed, compute the economic value added (EVA) with the help of following information:

	2011 -12 (₹)	2012 - 13 (₹)	2013 - 14 (₹)
Equity	10,00,000	15,00,000	17,00,000
Debt (10%)	5,00,000	7,00,000	7,00,000
Profit after tax	2,00,000	4,00,000	8,00,000

Risk-free rate of return is 7%. Beta () = 0.9, market rate of return = 15%.
Applicable tax rate is 40%. (8 marks)

Answer:

	2011-12	2012-13	2013-14
Equity (₹)	10,00,000	15,00,000	17,00,000
Debt (₹)	5,00,000	7,00,000	7,00,000

5.20■ **Solved Scanner CSPP M-II Paper 5 (New Syllabus)**

Capital employed (₹)	15,00,000	22,00,000	24,00,000
WACC (%)	11.47	11.59	11.81
Profit after tax (₹)	2,00,000	4,00,000	8,00,000
Add: Interest (₹)	50,000	70,000	70,000
Less: tax on interest (₹)	20,000	28,000	28,000
Net operating profit after tax (₹)	2,30,000	4,42,000	8,42,000
Cost of capital (₹)	1,72,050	2,54,980	2,83,440
EVA (₹)	57,950	1,87,020	5,58,560

Working Note 1

$$K_e = R_f + (R_m - R_f)$$

$$= 7 + 0.9 (15-7)$$

$$= 14.2\%$$

$$K_d = 10(1-0.4) = 6\%$$

Working Note 2

$$\text{WACC (2011-12)} = \frac{14.2 \times 10}{15} + \frac{6 \times 5}{15} = 11.47\%$$

$$\text{WACC (2012-13)} = \frac{14.2 \times 15}{22} + \frac{6 \times 7}{22} = 11.59\%$$

$$\text{WACC (2013-14)} = \frac{14.2 \times 17}{24} + \frac{6 \times 7}{24} = 11.81\%$$

Repeatedly Asked Questions		
No.	Question	Frequency
1	Write notes on Financial distress. 07 - June [7] (vi), 09 - June [7] (v), 11 - Dec [7] (ii)	3 Times
2	Distinguish between 'Business risk' and 'financial risk'. 07 - Dec [4] (iii), 09 - Dec [4] (a) (iii), 11 - Dec [4] (v)	3 Times
3	Distinguish between 'Financial distress' and 'insolvency'. 08 - June [4] (ii), 10 - Dec [4] (i), 12 - June [4] (i)	3 Times

Table Showing Marks of Compulsory Questions										
Year	11 D	12 J	12 D	13 J	13 D	14 J	14 D	15 J	15 D	16 J
Descriptive	10			5	5					
Total	10			5	5					