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Internal Assesment Test - III

Sub:	Financial Mangement.							Code:	16 MBA 22
Date:	26.05.17	Duration:	90 mins	Max Marks:	40	Sem:	II	Branch:	MBA

	Marks	OBE CO	OBE RBT
Part A - Answer Any Two Full Questions (16*02=32 Marks)			
1 (a) Write a note on leverage	[02]	CO1	L1
(b) Explain the concept of Working Capital Management.	[06]	CO2	L2
(c) From the following information	[08]	CO1	L1
2 (a) What is Operating Cycle.?	[02]	CO2	L5

1 (a) Write a note on leverage [02] CO1 L1

The use of borrowed money to increase production volume, and thus sales and earnings. It is measured as the ratio of total debt to total assets. The greater the amount of debt, the greater the financial leverage.
Since interest is a fixed cost (which can be written off against revenue) a loanallows an organization to generate more earnings without a corresponding increase in the equity capital requiring increased dividend payments (which cannot be written off against the earnings). However, while high leverage may be beneficial in boom periods, it may cause serious cash flow problems in recessionary periods because there might not be enough sales revenue to cover the interest payments.

(b) Explain the concept of Working Capital Management. [06] CO2 L2

Working capital management involves the relationship between a firm's short-term assets and its short-term liabilities. The goal of working capital management is to ensure that a firm is able to continue its operations and that it has sufficient ability to satisfy both maturing short-term debt and upcoming operational expenses. The management of working capital involves managing inventories, accounts receivable and payable, and cash.

(c) From the following information [08] CO1 L1

Sales	1,00,000
Variable cost	50,000
Interest	10,000
Fixed cost	30,000

Calculate operating leverage , financial leverage, Combined Leverage

2 (a) What is Operating Cycle.? [02] CO2 L5

The operating cycle is also known as the *cash conversion cycle*. In the context of a manufacturer the operating cycle has been described as the amount of time that it takes for a manufacturer's cash to be converted into products plus the time it takes for those products to be sold and turned back into cash. In other words, the manufacturer's operating cycle involves:

- paying for the raw materials needed in its products
- paying for the labor and overhead costs needed to convert the raw materials into products
- holding the finished products in inventory until they are sold
- waiting for the customers' cash payments for the products that have been sold

(b) What are the disadvantage of inadequate working capital [06] CO1 L2

1. Excessive Working Capital means idle funds which earn no profits for the business and hence the business cannot earn a proper rate of return on its investments

2. When there is a redundant working capital, it may lead to unnecessary purchasing and accumulation of inventories causing more chances of theft, waste and losses.

3. Excessive working capital implies excessive debtors and defective credit policy which may cause higher incidence of bad debts.

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4. It may result into overall inefficiency in the organisation.

5. When there is excessive working capital, relations with banks and other financial institutions may not be maintained.

6. Due to low rate of return on investments, the value of shares may also fall.

7. The redundant working capital gives rise to speculative transactions.

Disadvantages or Dangers of Inadequate Working Capital:
1. A concern which has inadequate working capital cannot pay its short-term liabilities in time. Thus, it will lose its reputation and shall not be able to get good credit facilities.

2. It cannot buy its requirements in bulk and cannot avail of discounts, etc.

3. It becomes difficult for the firm to exploit favourable market conditions and undertake profitable projects due to lack of working capital.

4. The firm cannot pay day-to-day expenses of its operations and it creates inefficiencies, increases costs and reduces the profits of the business.

5. It becomes impossible to utilize efficiently the fixed assets due to non-availability of liquid funds.

6. The rate of return on investments also falls with the shortage of working capital.

(c) From the following data, prepare a statement showing WC requirement for the year 2016. [08] CO3 L3

1. Estimated output is 1,30,000 units (52 weeks)

2. Stock of RM 2 weeks and material in process for 2 weeks, 50% of wages and OH are incurred.
3. Finished goods remain in storage for 2 weeks.
4. Creditors 2 weeks
5. Debtors 4 weeks
6. Outstanding wages and OH 2 weeks
7. SP per unit Rs 15
8. Analysis of cost per unit is as below:

Raw Material	Rs 5 per unit
Labour	Rs 3 per unit
Overhead	Rs 2 per unit
Profit	Rs 5 per unit

Assume the operation are evenly spread throught out the year.

3 (a) Write a note on optimal capital structure. [02] CO3 L3

Every firm should aim at achieving the optimal capital structure and try to maintain it. Optimal capital structure refers to the combination of debt and equity in total capital that maximizes the value of the company. An optimal capital structure is designated as one at which the average cost of capital is the lowest which produces an income that leads to maximization of the market value of the securities at that income.

Optimal capital structure may be defined as that relationship of debt and equity which maximizes the value of company's share in the stock exchange.

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Kulkarni and Satyaprasad defined optimum capital structure as 'the one in which the marginal real cost of each available method of financing is the same'. They included both the explicit and implicit cost under the term real cost.

According to Prof Ezra Solomon, 'Optimal capital structure is that mix of debt and equity which will maximize the market value of a company'. Hence there should be a judicious combination of the various sources of long-term funds which provides a lower overall cost of capital and so a higher total market value for the capital structure. Optimal capital structure may thus be defined as, the mixing of the permanent sources of funds used by the firm in a manner that will maximize the company's common stock price by minimizing the firm's composite cost of capital.

(b) What are the different types of dividend? [06] CO2 L3

CASH DIVIDENDS

Shareholders of record receive payment in the form of cash or electronic transfer based on how many shares of stock they own. However, to pay cash dividends, a company must meet two conditions: It can't pay cash dividends unless there are positive retained earnings, and it must have enough ready cash to pay the dividends.

For example, imagine that you own 2,000 shares of common stock in ABC Corporation. ABC has both a surplus of cash and positive retained earnings, so the board of directors decides to pay a cash dividend of $10 per share. Your dividend is $20,000 (2,000 shares x $10).

PROPERTY DIVIDENDS

In this case, the corporation issues a dividend for one of the assets of the corporation. It could be any asset: inventory, equipment, vehicle, whatever.

When a company issues a property dividend, it has to restate the value of the distributed asset at fair value.

STOCK DIVIDENDS

Corporations normally issue stock dividends when they're low in operating cash but still want to throw the investors a bone to keep them happy. Although no money immediately changes hands, issuing stock dividends operates the same as cash dividends: Each shareholder of record gets a certain number of extra shares of stock based on how many shares that shareholder already owns.

This type of dividend is expressed as a percentage rather than a dollar amount. For example, if a company issues a stock dividend of 5 percent, and the investor owns 1,500 shares, that investor receives an additional 75 shares of stock (1,500 x .05).

(c) ARC currently equity capital consisting of 15000 equity shares of Rs 100 each. The management is planning to raise Rs 25,00,000 to finance a major programme of [08] CO1 L3 expansion and is considering 3 alternative method of financing.

1. To issues 25000 equity of Rs 100 each.
2. To issues 25000 8% debenture of Rs 100 each
3. To issues 25000 8% preference share of Rs 100 each.

The companys EBIT is Rs 8,00,000. Assume a corporate rate 50% , determine EPS in each alternative and comment on the result.

Part B - Compulsory (01*08=08 marks)

4

(a) What are the factors influencing working capital requirements.? [04] CO1 L4

Working capital requirement is influenced by various factors. In fact, any and every activity of a company affects the working capital requirements of the company. The magnitude of influence may be different. Some important of them are listed below:**Factors Influencing Working Capital Management**

Nature of the Industry / Business: The management of working capital is completely different from industry to industry. A simple comparison of the service industry and manufacturing industry can clarify the point. In a service industry, there is no inventory and therefore, one big component of working capital is already avoided. So, the nature of the industry is a factor in determining the working capital requirement.

Seasonality of Industry and Production Policy: Businesses based on seasons like manufacturing of ACs whose demand peaks in summer and dips in winter. The requirement of working capital will be more in summer compared to winter if they are produced in the fashion of their demand. The policy of producing throughout the year can smoothen the fluctuation of working capital requirement.

Competition: If the industry is competitive, quick response to customer needs is compulsory and therefore a higher level of inventory is maintained. Liberal credit terms are also mandatory with good service to survive in the market. So, higher the competition, higher would be the requirement of working capital.

Production Cycle Time: The production cycle time refers to the time required for converting the raw materials into finished goods. Higher, this time, higher would be the time of blocking funds in the working capital.

Credit Policy: Liberal credit policy demands a higher level of working capital and tight credit policy reduces it.

Growth and Expansion: Some industries are static and others are growing. Obviously, growing industry grows the requirement of working capital also as compared to static industry.

Raw Material Short Supply: If the raw material supply is not smooth for any reason, companies tend to store more of raw materials than needed and that increased requirement of working capital.

Net Cash Profit: Profit or retained earnings are one of the sources of working capital for the business. It will depend on net cash profits as to how much working capital financing is required from external sources.

Taxes: Taxes are often paid in advance. This also blocks a part of working capital. Depending on the tax environment of the industry, working capital needs are also affected.

Dividend Policy: Dividend policy determines the level of retained profits with the business and retained profits are also used for working capital. This is how; dividend policy affects the need for working capital.

Price Levels: The price levels of inventory and other expenses such as labour rates etc increase the working capital requirement. If the company also is able to increase the price of their finished goods, it reduces this impact.

(b) Distinguish between gross working capital and net working capital. [04] CO3 L4

There are two concepts or senses used for working capital.

These are:

1. Gross Working Capital

2. Net working Capital

1. Gross Working Capital:

The concept of gross working capital refers to the total value of current assets. In other words, gross working capital is the total amount available for financing of current assets. However, it does not reveal the true financial position of an enterprise. How? A borrowing will increase current assets and, thus, will increase gross working capital but, at the same time, it will increase current liabilities also.

As a result, the net working capital will remain the same. This concept is usually supported by the business community as it raises their assets (current) and is in their advantage to borrow the funds from external sources such as banks and the financial institutions.

In this sense, the working capital is a financial concept. As per this concept:

Gross Working Capital = Total Current Assets

2. Net Working Capital:

The net working capital is an accounting concept which represents the excess of current assets over current liabilities. Current assets consist of items such as cash, bank balance, stock, debtors, bills receivables, etc. and current liabilities include items such as bills payables, creditors, etc. Excess of current assets over current liabilities, thus, indicates the liquid position of an enterprise.

The ratio of 2:1 between current assets and current liabilities is considered as optimum or sound. What this ratio implies is that the firm/ enterprise have sufficient liquidity to meet operating expenses and current liabilities. It is important to mention that net working capital will not increase with every increase in gross working capital. Importantly, net working capital will increase only when there is increase in current assets without corresponding increase in current liabilities.

Course Outcomes		PO1	PO2	PO3	PO4	PO5	PO6	PO7	PO8	PO9
CO1:										
CO2:										
CO3:										
CO4:										
CO5:										
CO6:										

Cognitive level	KEYWORDS

L1	List, define, tell, describe, identify, show, label, collect, examine, tabulate, quote, name, who, when, where, etc.
L2	summarize, describe, interpret, contrast, predict, associate, distinguish, estimate, differentiate, discuss, extend
L3	Apply, demonstrate, calculate, complete, illustrate, show, solve, examine, modify, relate, change, classify, experiment, discover.
L4	Analyze, separate, order, explain, connect, classify, arrange, divide, compare, select, explain, infer.
L5	Assess, decide, rank, grade, test, measure, recommend, convince, select, judge, explain, discriminate, support, conclude, compare, summarize.