Financial Management Questions

Question 1. What Is The Financial Management Reform?

Answer :

The Financial Management Reform is the new policy framework that had been adopted by the Fiji Government to improve performance and accountability.

Question 2. Why Was The Fmr Introduced?

Answer :

The framework has been introduced following public concern over Government's in efficiencies and wastage as reflected in numerous Auditor-General Reports as well as reports by international agencies on public expenditure practices in Fiji. These reports have highlighted the need for Government to seriously address its resource allocation and financial management processes.

Question 3. What Are Some Of The Problems With The Current Management Of Government Finances?

Answer :

The Fiji Government's current financial management structure, has been in place since the 1980s with minor changes throughout the years. A review of the current structure revealed the following problems:

- inadequate links between government policy decisions and implementation.
- a focus on the resources given to Government agencies rather than how the agencies perform with the resources allocated to them.
- Central control of finances by the Ministry of Finance which contributes to slow delivery of service.
- poor financial management and spending control.

Question 4. What Changes Will The Fmr Introduce?

Answer :

The FMR will strengthen and modernize the management of Government finances to:

better align government policy priorities with budget resources;

adopt a performance focus;

provide more effective control over public spending;

strengthen accountability and transparency in financial management.

Question 5. How Will The Fmr Bring About These Changes?

Answer :

Through the implementation of the following four major components:

Financial Management Act 2004 – The Financial Management Bill is expected to become law in 2005. The legislation has been drafted to give legal effect to the Financial Management Reform policy framework.

Financial Management Information System – to be introduced progressively, the new system will support the changes by automating most current manual processes, strengthen the monitoring of budgets and control over spending.

Performance Budgeting - involves the allocation of resources to agencies based on the goods and services to they deliver. Therefore budgets will reflect the level of performance expected with the resources provided. This will be linked to the annual corporate planning process. More information is available in the “Guide to Performance Budgeting.

Training and Capacity Building – As the FMR process involves a significant amount of change over time, training needs to be conducted at all levels to ensure the sustainability of the changes.

Question 6. What Is Financial Management Information System (fmis)?

Answer :

FMIS is financial management software that transforms financial data into information that is useful for decision- making. Government is in the process of acquiring a FMIS for the Whole of Government. This will replace the current General Ledger System.

Question 7. How Is Fmis Related To The Financial Management Reform?

Answer :

FMIS is a component of the FMR. The new FMIS is required to:

- Support the re-defined framework.
- Support the transition to accrual accounting.
- Support the introduction of Performance Budgeting.

Question 8. Why Do We Need A New Fmis?

Answer :

There are some key problems associated with the current system. These include:

- Slow processing of transactions;
- Inaccurate and untimely financial information and reports i.e. information is not recorded on real time.

Question 9. What Are The Benefits Of The Fmis?

Answer :

Benefits of the FMIS include:

- Automates most of the manual processes e.g. recording of Commitments;
- Improves efficiency and effectiveness;
- Provide decision makers with a tool that will support accountability, and decentralization of accounting processes.

Question 10. What Are The Main Responsibilities Of A Chief Financial Officer Of An Organization?

Answer :

Responsibilities of Chief Financial Officer (CFO):

The chief financial officer of an organization plays an important role in the company's goals, policies, and financial success. His main responsibilities include:

- ***Financial analysis and planning:*** Determining the proper amount of funds to be employed in the firm.
- ***Investment decisions:*** Efficient allocation of funds to specific assets.
- ***Financial and capital structure decisions:*** Rising of funds on favorable terms as possible, i.e., determining the composition of liabilities.
- Management of financial resources (such as working capital).
- ***Risk Management***: Protecting assets.

Question 11. Discuss Conflict In Profit Versus Wealth Maximization Objective?

Answer :

Profit maximization is a short–term objective and cannot be the sole objective of a company. It is at best a limited objective. If profit is given undue importance, a number of problems can arise like the term profit is vague, profit maximization has to be attempted with a realization of risks involved, it does not take into account the time pattern of returns and as an objective it is too narrow. Whereas, on the other hand, wealth maximization, is a long-term objective and means that the company is using its resources in a good manner.

If the share value is to stay high, the company has to reduce its costs and use the resources properly. If the company follows the goal of wealth maximization, it means that the company will promote only those policies that will lead to an efficient allocation of resources.

Question 12. Differentiate Between Financial Management And Financial Accounting?

Answer :

Though financial management and financial accounting are closely related, still they differ in the treatment of funds and also with regards to decision - making.

Treatment of Funds: In accounting, the measurement of funds is based on the accrual principle. The accrual based accounting data do not reflect fully the financial conditions of the organization. An organization which has earned profit (sales less expenses) may said to be profitable in the accounting sense but it may not be able to meet its current obligations due to shortage of liquidity as a result of say, uncollectble receivables. Whereas, the treatment of funds, in financial management is based on cash flows. The revenues are recognized only when cash is actually received (i.e. cash inflow) and expenses are recognized on actual payment (i.e. cash outflow).

Thus, cash flow based returns help financial managers to avoid insolvency and achieve desired financial goals.

Decision-making: The chief focus of an accountant is to collect data and present the data while the financial manager's primary responsibility relates to financial planning, controlling and decision- making. Thus, in a way it can be stated that financial management begins where financial accounting ends.

Question 13. Explain The Relevance Of Time Value Of Money In Financial Decisions?

Answer :

Time value of money means that worth of a rupee received today is different from the worth of a rupee to be received in future. The preference of money now as compared to future money is known as time preference for money.

A rupee today is more valuable than rupee after a year due to several reasons:

Risk: there is uncertainty about the receipt of money in future.

Preference for present consumption

Most of the persons and companies in general, prefer current consumption over future consumption.

Inflation: In an inflationary period a rupee today represents a greater real purchasing power than a rupee a year hence.

- ***Investment opportunities:*** Most of the persons and companies have a preference for present money because of availabilities of opportunities of investment for earning additional cash flow.

Many financial problems involve cash flow accruing at different points of time for evaluating such cash flow an explicit consideration of time value of money is required.

Question 14. Explain Briefly The Limitations Of Financial Ratios?

Answer :

The limitations of financial ratios are listed below:

- Diversified product lines: Many businesses operate a large number of divisions in quite different industries. In such cases, ratios calculated on the basis of aggregate data cannot be used for inter-firm comparisons.
- Financial data are badly distorted by inflation: Historical cost values may be substantially different from true values. Such distortions of financial data are also carried in the financial ratios.
- Seasonal factors may also influence financial data.
- To give a good shape to the popularly used financial ratios (like current ratio, debt- equity ratios, etc.): The business may make some year-end adjustments. Such window dressing can change the character of financial ratios which would be different had there been no such change.
- Differences in accounting policies and accounting period: It can make the accounting data of two firms non-comparable as also the accounting ratios.
- There is no standard set of ratios against which a firm’s ratios can be compared: Sometimes a firm’s ratios are compared with the industry average. But if a firm desires to be above the average, then industry average becomes a low standard. On the other hand, for a below average firm, industry averages become too high a standard to achieve.

Question 15. What Do You Understand By Weighted Average Cost Of Capital?

Answer :

Weighted Average Cost of Capital:

The composite or overall cost of capital of a firm is the weighted average of the costs of various sources of funds. Weights are taken in proportion of each source of funds in capital structure while making financial decisions. The weighted average cost of capital is calculated by calculating the cost of specific source of fund and multiplying the cost of each source by its proportion in capital structure. Thus, weighted average cost of capital is the weighted average after tax costs of the individual components of firm's capital structure. That is, the after tax cost of each debt and equity is calculated separately and added together to a single overall cost of capital.

Question 16. Explain In Brief The Assumptions Of Modigliani-miller Theory?

Answer :

Assumptions of Modigliani – Miller Theory:

- Capital markets are perfect. All information is freely available and there is no transaction cost.
- All investors are rational.
- No existence of corporate taxes.
- Firms can be grouped into "Equivalent risk classes" on the basis of their business risk.

Question 17. What Is Optimum Capital Structure? Explain.

Answer :

Optimum Capital Structure: Optimum capital structure deals with the issue of right mix of debt and equity in the long-term capital structure of a firm. According to this, if a company takes on debt, the value of the firm increases up to a certain point. Beyond that value of the firm will start to decrease. If the company is unable to pay the debt within the specified period then it will affect the goodwill of the company in the market.

Therefore, company should select its appropriate capital structure with due consideration of all factors.

Question 18. Explain The Assumptions Of Net Operating Income Approach (noi) Theory Of Capital Structure?

Answer :

Assumptions of Net Operating Income (NOI) Theory of Capital Structure According to NOI approach, there is no relationship between the cost of capital and value of the firm i.e. the value of the firm is independent of the capital structure of the firm.

Assumptions:

- The corporate income taxes do not exist.
- The market capitalizes the value of the firm as whole. Thus the split between debt and equity is not important.
- The increase in proportion of debt in capital structure leads to change in risk perception of the shareholders.
- The overall cost of capital (Ko) remains constant for all degrees of debt equity mix.

Question 19. Explain The Principles Of "trading On Equity"?

Answer :

The term trading on equity means debts are contracted and loans are raised mainly on the basis of equity capital. Those who provide debt have a limited share in the firm's earning and hence want to be protected in terms of earnings and values represented by equity capital.

Since fixed charges do not vary with firms earnings before interest and tax, a magnified effect is produced on earning per share. Whether the leverage is favorable, in the sense, increase in earnings per share more proportionately to the increased earnings before interest and tax, depends on the profitability of investment proposal. If the rate of returns on investment exceeds their explicit cost, financial leverage is said to be positive.

Question 20. Differentiate Between Business Risk And Financial Risk?

Answer :

Business Risk and Financial Risk:

Business risk refers to the risk associated with the firm’s operations. It is an unavoidable risk because of the environment in which the firm has to operate and the business risk is represented by the variability of earnings before interest and tax (EBIT). The variability in turn is influenced by revenues and expenses. Revenues and expenses are affected by demand of firm’s products, variations in prices and proportion of fixed cost in total cost.

Whereas, financial risk refers to the additional risk placed on firm’s shareholders as a result of debt use in financing. Companies that issue more debt instruments would have higher financial risk than companies financed mostly by equity. Financial risk can be measured by ratios such as firm’s financial leverage multiplier, total debt to assets ratio etc.

Question 21. Explain The Term 'ploughing Back Of Profits'?

Answer :

Ploughing back of Profits:

Long-term funds may also be provided by accumulating the profits of the company and by ploughing them back into business. Such funds belong to the ordinary shareholders and increase the net worth of the company. A public limited company must plough back a reasonable amount of its profits each year keeping in view the legal requirements in this regard and its own expansion plans. Such funds also entail almost no risk. Further, control of present owners is also not diluted by retaining profits.

Question 22. Discuss The Features Of Deep Discount Bonds?

Answer :

Features of Deep Discount Bonds:

Deep discount bonds are a form of zero-interest bonds. These bonds are sold at discounted value and on maturity; face value is paid to the investors. In such bonds, there is no interest payout during the lock- in period. The investors can sell the bonds in stock market and realize the difference between face value and market price as capital gain.

IDBI was the first to issue deep discount bonds in India in January 1993. The bond of a face value of Rs. 1 lack was sold for Rs. 2700 with a maturity period of 25 years.

Question 23. Explain The Methods Of Venture Capital Financing?

Answer :

Some Common Methods of Venture Capital Financing:

Equity financing: The venture capital undertaking requires long-term funds but is unable to provide returns in initial stage so equity capital is the best option.

Conditional Loan: A conditional loan is repayable in the form of a royalty after the venture is able to generate sales. No interest is paid on such loans.

Income note: It is hybrid security; the entrepreneur has to pay both interest and royalty on sales but at substantially low rates.

Participating debenture: Such security carries charges in three phases - in the start-up phase, no interest is charged, next stage a low rate of interest up to a particular level of operation is charged, after that, high rate of interest is required to be paid.

Question 24. Explain The Concept Of Debt Securitization?

Answer :

Debt securitization is a method of recycling of funds. It is especially beneficial to financial intermediaries to support the lending volumes. Assets generating steady cash flows are packaged together and against this assets pool, market securities can be issued. The debt securitization process can be classified in the following three functions.

The origination function: The credit worthiness of a borrower seeking loan from a finance company, bank, housing company or a leasing company is evaluated and a contract is entered into and repayment schedule is structured over the life of the loan.

- ***The pooling function:*** Similar loans or receivables are clubbed together to create an underlying pool of assets. This pool is transferred in favors of a special purpose vehicle (SPV).
- ***The securitization function:*** After structuring, issue the securities on the basis of asset pool. The securities carry a coupon and an expected maturity, which can be asset based or mortgaged based. These are generally sold to investors through merchant bankers.

The process of securitization is generally without recourse i.e. the investor bears credit risk or risk of default and the user is under an obligation to pay to investor only if the cash flows are received by him from the collateral.

Question 25. Name The Various Financial Instruments Dealt With In The International Market?

Answer :

Financial Instruments in the International Market: Some of the various financial instruments dealt with in the international market are:

- Euro Bonds.
- Foreign Bonds.
- Fully Hedged Bonds.
- Medium Term Notes.
- Floating Rate Notes.
- External Commercial Borrowings.
- Foreign Currency Futures.
- Foreign Currency Option.
- Euro Commercial Papers.

Question 26. Differentiate Between Factoring And Bills Discounting?

Answer :

The differences between Factoring and Bills discounting are:

- Factoring is called as 'Invoice Factoring' whereas Bills discounting is known as 'Invoice discounting.'
- In Factoring, the parties are known as the client, factor and debtor whereas in Bills discounting, they are known as drawer, drawee and payee.

Factoring is a sort of management of book debts whereas bills discounting is a sort of borrowing from commercial banks.

For factoring there is no specific Act, whereas in the case of bills discounting, the Negotiable Instruments Act is applicable.

Question 27. Explain The Concept Of Multiple Internal Rate Of Return?

Answer :

In cases where project cash flows change signs or reverse during the life of a project for example, an initial cash outflow is followed by cash inflows and subsequently followed by a major cash out-flow, there may be more than one internal rate of return (IRR).

Question 28. Explain The Concept Of Discounted Payback Period?

Answer :

Concept of Discounted Payback Period

Payback period is time taken to recover the original investment from project cash flows. It is also termed as break even period. The focus of the analysis is on liquidity aspect and it suffers from the limitation of ignoring time value of money and profitability. Discounted payback period considers present value of cash flows, discounted at company's cost of capital to estimate breakeven period i.e. it is that period in which future discounted cash flows equal the initial outflow. The shorter the period, better it is. It also ignores post discounted payback period cash flows.

Question 29. Explain The Term "desirability Factor"?

Answer :

Desirability Factor: In certain cases we have to compare a number of proposals each involving different amount of cash inflows. One of the methods of comparing such proposals is to work out, what is known as the 'Desirability Factor' or 'Profitability Index'. In general terms, a project is acceptable if the Profitability Index is greater than 1.

Question 30. Explain Briefly The Functions Of Treasury Department?

Answer :

The functions of treasury department management is to ensure proper usage, storage and risk management of liquid funds so as to ensure that the organization is able to meet its obligations, collect its receivables and also maximize the return on its investments. Towards this end the treasury function may be divided into the following:

Cash Management: The efficient collection and payment of cash both inside the organization and to third parties is the function of treasury department. Treasury normally manages surplus funds in an investment portfolio.

Currency Management: The treasury department manages the foreign currency risk exposure of the company. It advises on the currency to be used when invoicing overseas sales. It also manages any net exchange exposures in accordance with the company policy.

Fund Management: Treasury department is responsible for planning and sourcing the company's short, medium and long-term cash needs. It also participates in the decision on capital structure and forecasts future interest and foreign currency rates.

Banking: Since short-term finance can come in the form of bank loans or through the sale of commercial paper in the money market, therefore, treasury department carries out negotiations with bankers and acts as the initial point of contact with them.

Corporate Finance: Treasury department is involved with both acquisition and disinvestment activities within the group. In addition, it is often responsible for investor relations.