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Class XII Business Studies Notes

FINANCIAL MANAGEMENT

Key Notes and Important Questions with Answers

CHAPTER – 9

FINANCIAL MANAGEMENT

Introduction

Money required for carrying out business activities is called business finance. Finance is needed to establish a business, to run it, to modernize it, to expand or diversify it.

Meaning of Financial Management

Financial management is the activity concerned with the planning, raising, controlling and administering of funds used in the business. It is concerned with optimal procurement as well as usage of finance. It aims to reduce the cost of funds. It also aims at ensuring availability of enough funds whenever required as well as avoiding idle finance.

Objectives of Financial Management

(A) Primary Objective:

- **Wealth Maximisation:** The main objective of Financial management is to maximise shareholder's wealth. Example- If Mr. X purchases 100 shares @ '100 of ABCLtd. his wealth in company's is '10,000/-. After some time, the market price of share increases to '130/-. Therefore, his wealth would be ' 13,000/-. His wealth increases by '3,000/-. If the market price of the share decreases to '90/- he loses his wealth by '1,000/-

  The market price of a company shares is linked to three basic financial decisions and shareholder's wealth maximisation.

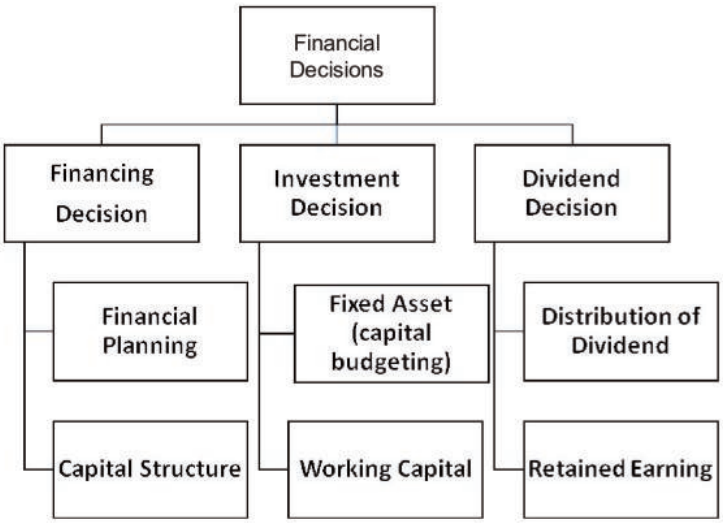
  Wealth of shareholders = number of shares x market price per share.

(B) Other objectives:

1. **To procure sufficient funds for the organisation:** Adequate and regular supply of funds is to be maintained for smooth operations of the business.
2. To ensure effective utilisation of funds.

3. **To ensure safety of funds :** The chances of risk in investments should be minimum possible.

Financial Decisions:



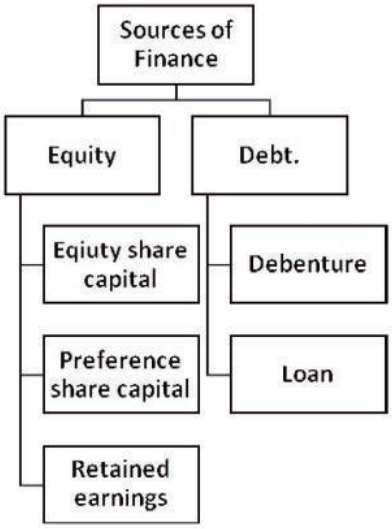
FINANCING DECISION

Decision is taken at two stages:

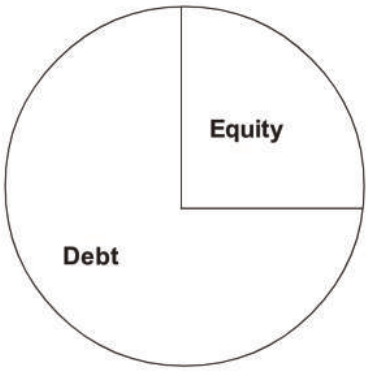
I STAGE
FINANCIAL
PLANNING

1. Estimating overall requirement of funds.
2. Deciding different sources of finance.

2nd STAGE
CAPITAL
STRUCTURE



Deciding how much amount is to be arranged from which source.



FIRST STAGE: FINANCIAL PLANNING

The process of estimating the fund requirement of a business and specifying the sources of funds is called financial planning. It ensures that enough funds are available at right time so that a firm could honour its commitments and carry out its plans.

It includes the exploration of different alternatives of source of finance, selection of the best alternative and implementation of financial plans and policies. In layman's language we can say that financial planning means deciding in advance how much to spend, on what to spend, according to the funds at your disposal. Following are the tasks which come under financial planning:

(i) Determination of Financial Objectives.

(ii) Formulation of Financial Policies and Rules.

(iii) Forecasting the Needs of Finance.

(iv) Developing Alternative sources of Finance.

(v) Selection of Best Alternative.

(vi) Implementing Financial Plans and Policies.

Financial planning includes both short term as well as long term planning. Short term planning is usually in the form of annual budgets. Long term planning takes the form of capital budgets.

Importance of Financial Planning

1. To ensure availability of adequate funds at right time.
2. To see that the firm does not raise funds unnecessarily.
3. It provides policies and procedures for the sound administration of finance function.
4. It results in preparation of plans for future. Thus new projects can be under taken smoothly.
5. It attempts to achieve a balance between inflow and outflow of funds. Adequate liquidity is ensured throughout the year.
6. It serves as the basis of financial control. The management attempts to ensure utilization of funds in tune with the financial plans.

SECOND STAGE: CAPITAL STRUCTURE

The main sources of funds are owner's funds i.e. equity/share holder's funds and the borrowed funds i.e. Debts. Borrowed funds have to be repaid at a fixed time and thus some amount of financial risk (i.e. risk of default on payment) is there in debt financing. Moreover interest on borrowed funds has to be paid regardless of whether or not a firm has made a profit. On the other hand, shareholder's fund involves no commitment regarding payment of returns or re-payment of capital. A firm mixes both debt and equity in making financing decisions.

Capital structure refers to the optimal mix between owner's funds and borrowed funds. It will be said to be optimal when the proportion of debt and equity is such that it results in an increase in the value of the equity share. The proportion of debt in the overall capital of a firm is called Financial Leverage or Capital Gearing. When the proportion of debt in the total capital is high then the firm will be called highly levered firm but when the proportion of debts in the total capital is less, then the firm will be called low levered firm.

$$\text{Financial leverage} = \frac{Debt}{Equity}$$

Factors affecting Capital structure or financing decision

1. **Trading on Equity:** It refers to the increase in profit earned by the equity shareholders due to the presence of fixed financial charges like interest. Trading on equity happens when the rate of earning of an organisation is higher than the cost at which funds have been borrowed and as a result equity shareholders get higher rate of dividend per share. The use of more debt along with the equity increases EPS as the debt carries fixed amount of interest which is tax deductible. Let us understand with an example-

	Company X	**Company Y**	**Company Z**
Equity share cap. (of Rs 10 each)	10,00,000	5,00,000	2,00,000
12% preference share	——	——	3,00,000
Debenture @10%	——	5,00,000	5,00,000
Total Capital	**10,00,000**	**10,00,000**	**10,00,000**

	Company X	**Company Y**	**Company Z**
Earning before int. and taxes(EBIT) @25% p.a.	2,50,000	2,50,000	2,50,000
Less interest on debt	——	(50,000)	(50,000)
Profit after tax (available for equity & pref. Share holders).	2,50,000	2,00,000	2,00,000
Tax @ 40%	1,00,000	80,000	80,000
Profit available for equity + preference shareholders	1,50,000	1,20,000	1,20,000

Less preference dividend.	——	——	36,000
Profit for equity shareholders	1,50,000	1,20,000	84,000
No. of equity shares 20,000	1,00,000	50,000	20,000
Earnings per share	₹ 1.50	₹ 2.40	₹ 4.20

Thus the EPS of company Y and Z is higher than company X because of application of 'Trading on Equity'

2. **Cash Flow Position:** In case a company has strong cash flow position then it may raise finance by issuing debts, as they are to be paid back after some time and interest has to be paid on debt.

3. **Interest Coverage Ratio:** It refers to the number of times earning before interest and taxes of a company covers the interest obligation. High interest coverage ratio indicates that company can have more of borrowed funds. Formula for calculating ICR = EBIT/interest.

4. **Return on Investment:** If return on investment is higher than the rate of interest on debt then it will be beneficial for a firm to raise finance through borrowed funds.

5. **Floatation Cost:** The cost involved in issuing securities such as brokers commission, under writer's fees, cost of prospectus etc. is called floatation cost. While selecting the source of finance, floatation cost should be taken into account.

6. **Control:** When existing shareholders are ready to dilute their control over the firm then new equity shares can be issued for raising finance but in reverse situation debts should be used.

7. **Tax Rate:** Interest on debt is allowed as a deduction; thus in case of high tax rate, debt is preferred over equity but in case of low tax rate more preference is given to equity.

8. **Cost:** The cost of raising funds from different sources are different. The cheapest source should be selected.

9. **Risk:** The risk associated with different sources is different. More risk is associated with borrowed funds as compared to owner's fund as interest is paid on it and it is to be repaid also, after a fixed period of time or on expiry of its tenure

10. **Period of Finance:** For permanent capital requirement, Equity shares must be issued as they are not to be paid back and for long and medium term requirement, preference shares or debentures can be issued.

Q.1 State the formula for calculating financial leverage. (1)

[Hint: Debt/ Equity]

Q.2 What is the impact of business risk on Capital structure. (1)

[Increase in risk will decrease use of debt]

Q.3 Under what situation, will an increase in debt decrease the EPS?

(i) When rate of return is less than rate fo interest.

(ii) Decrease in earnings.

Q.4 'Cost of debt' is lower that the 'Cost of equity share capital'. Give reason, why even then a company cannot work only with debt. (3)

(Because equity share capital is a permanent source of capital & provides risk capital). (1)

Q.5 What is favourable financial leverage? (1)

(When capital structrue has more debt than equity)

Q.6 Amita Ltd. does not have any debt in its capital structure but Kajal Ltd. has debt @ 15% in its capital structure. Rate of return of both companies is 20%. Which company enjoys the benefits of trading on equity and why? (3)

[Hint: Kajol Ltd. because interest is a tax deductible item.]

INVESTMENT DECISION

It relates to how the firm's funds are invested in different assets. Investment decision can be long-term or short-term. Long term investment decision is called capital budgeting decision as they involve huge amounts of funds and are irreversible except at a huge cost. These decisions influence overall business risks of the firms short term investment decisions are called working capital decisions, which affect day to day working of a business. These decisions affect the liquidity as well as profitability of a business.

Factors affecting Investment Decisions

1. **Cash flows of the project :** The series of cash receipts and payments over the life of an investment proposal should be considered and analysed for selecting the best proposal. Example-

Investment proposals

	No.1	No. 2	No.3
Net cash inflow during life time of investment.	5,00,000	7,00,000	2,00,000
Life time of investment.	10 years	10 years	10 years

Investment should be made in proposal No. 2 as net cash inflow is more.

2. **Rate of Return :** The expected returns from each proposal and risk involved in them should be taken into account to select the best proposal.

Details	NO.1	No.2	No.3
Rate of return = $\frac{\text{Total return during lifetime of investment}}{\text{Initial investment}} \times 100$	13%	24%	15%

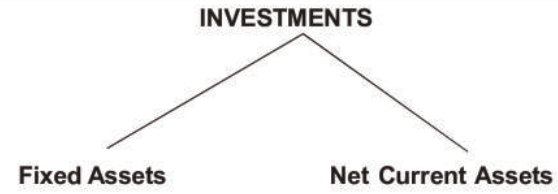
3. **Investment Criteria Involved :** The various investment proposals are evaluated on the basis of capital budgeting techniques. These involve calculations regarding investment amount, interest rate, cash flows, rate of return, risk involved in project etc.

If key criteria to be considered while choosing the investment channel is RISK. In that case, the investment channel with LEAST RISK should be chosen.

Q.1 Name the financial decision which will help a businessman in opening a new branch of its business? (Investment decision) (1)

Q.2 A company wants to open a new unit which will require machinery worth 15 crores. Identify the financial descision involved? (Investment decision) (1)

Q.3 Name the financial decision in which a businessman uses huge amount of funds for using advanced technology in business. (Investment decision) (1)



Fixed Capital

Fixed capital refers to investment in long-term assets. Investment in fixed assets like land, plant and machinery for longer duration and they must be financed through long-term sources of capital. Decisions relating to fixed capital involve huge capital and are not reversible without incurring heavy losses.

Factors Affecting Requirement of Fixed Capital

1. **Nature of Business :** Manufacturing concerns require huge investment in fixed assets & thus huge fixed capital is required for them but trading concerns need less fixed capital as they are not required to purchase plant and machinery etc.

2. **Scale of Operations :** An organisation operating on large scale requires more fixed capital as compared to an organisation operating on small scale.

   For Example **-** A large scale steel enterprise like TISCO requires large investment as compared to a mini steel plant.

3. **Choice of Technique :** An organisation using capital intensive techniques requires more investment in plant & machinery as compared to an organisation using labour intensive techniques.

4. **Technology upgradation :** Organisations using assets which become obsolete faster require more fixed capital as compared to other organisations.

5. **Growth Prospects :** Companies having more growth plans require more fixed capital. In order to expand production capacity more plant & machinery are required.

6. **Diversification :** In case a company goes for diversification then it will require more fixed capital to invest in fixed assets like plant and machinery.

7. **Financing alternatives:** When an asset is taken on lease, the firm pays lease rent and uses it. So, fixed capital requirements are low since the firm can avoid funds required to purchase it.

8. **Collaboration :** If companies are under collaboration, Joint venture, then they need less fixed capital as they share plant & machinery with their collaborators.

Working Capital

Working Capital refers to the capital required for day to day working of an organisation. Apart from the investment in fixed assets every business organisation needs to invest in current assets, which can be converted into cash or cash equivalents within a period of one year. They provide liquidity to the business. Working capital is of two types - Gross working capital and Net working capital. Investment in all the current assets is called Gross Working Capital whereas the excess of current assets over current liabilities is called Net Working Capital.

Networking Capital = Current Assets- Current Liabilities

Basis	Fixed Capital	Working Capital
1. Nature	The amount of fixed capital remains blocked in business.	The amount of working capital revolves around in the business.
2. Purpose	Buy fixed assets.	Buy current asset.
3. Main Sources	Shares, debentures, loans and retained earnings.	Commercial banks, public deposits etc.
4. Time Period	Required for long term use.	Required for short-term use.

Factors affecting requirement of working capital:

Name of the factor	Requirement of More working capital	Requirement of Less working capital
Nature of business	Manufacturing concern because of processing work.	Trading concern because of no production.
Scale of operation	Large scale operation because of huge inventory.	Small scale operations because of small inventories.
Business Cycle	During boom period because of more production.	During depression period because of less production.
Seasonal factors	Peak season because of more demand.	Lean season, because of low demand.
Credit allowed to customers	Sales on 'credit basis'	Sales on 'cash basis'
Credit availed from suppliers.	Purchase on 'cash basis'	Purchase on 'Credit basis'
Inflation Vs Deflation	During inflation, due to high price level for raw material, wages etc.	During deflation, due to low price level.

Operating cycle/ Turnover of working capital. It is the time period from purchase of raw material to realisation from debtors.	**Long operating cycle.**  	Short operating cycle.
Availability of raw material	Higher lead time to acquire raw material, so higher stock of raw material would be needed.	Lower lead time, so less stock of raw material would be needed.
Growth prospects	High growth prospects.	Low growth prospects.
Level of competition	High competition would require high amount of stock keeping.	Low competition would require less amount of stock keeping.
Production cycle	Long production cycle.	Short production cycle

Q.1 'Fixed capital decisions are irreversible'. Why? (Huge funds involved). (1)

Q.2 Name any two seasonal industries.

(Woolen industry, ice-cream industry) (1)

Q.3 How is operating cycle related to requirement of working capital? (1)

(Longer operating cycle require more working capital)

Dividend Decision

Dividend refers to that part of the profit which is distributed to shareholders. A company is required to decide how much of the profit earned by it should be distributed among shareholders and how much should be retained. The decision regarding dividend should be taken keeping in view the overall objective of maximising shareholder's wealth.



Factors affecting Dividend Decision

1. **Earnings :** Companies having high and stable earning could declare high rate of dividends as dividends are paid out of current and past earnings.

2. **Stability of Dividends :** Companies generally follow the policy of stable dividend. The dividend per share is not altered/changed in case earnings change by small proportion or increase in earnings is temporary in nature.

3. **Growth Prospects :** In case there are growth prospects for the company in the near future them it will retain its earning and thus, no or less dividend will be declared.

4. **Cash Flow Positions:** Dividends involve an outflow of cash and thus, availability of adequate cash is foremost requirement for declaration of dividends.

5. **Preference of Shareholders :** In case shareholders desire for dividend then company may go for declaring the same. There are always some shareholders who depend upon a regular income from their investments.

6. **Taxation Policy :** A company is required to pay tax on dividend declared by it. If tax on dividend is higher, company will prefer to pay less by way of dividends whereas if tax rates are lower then more dividends can be declared by the company.

7. **Stock market reaction**: Increase in dividend is good news for investors and hence market price of the shares increases in the stock market. Decrease in dividend reduces the market price of share.

8. **Legal constraints :** Under provisions of Companies Act, all earnings can't be distributed and the company has to provide for various reserves. This limits the capacity of company to declare dividend.

Q. A Decision is taken to distribute certain parts of profit to shareholders after paying tax. What is this decision called? (1)

(Dividend decision)

Q. Which type of company is in a position to declare high dividends? (1)

[Hint: Company with good profits and reserves, steady return]

Q. A company is earning good amount of profits since last twelve years. It has good amount of reserves also. But fixed cost burden is also high. Due to credit sales policy, it does not have sufficient amount of cash. Can it declare good rate of dividend? Give reason in support of your answer. (1)

[Hint: No, due to lack of availability of cash]

Key terms to Crack Case Studies

Financial Management

1. Financial blueprint of operations — Financial planning.
2. Decisions affecting liquidity and profitability of a business — Short term investment decisions.
3. Decisions affecting financial risk and profitability of a business — Capital structure decisions.
4. Long term investment decisions — Capital budgeting decisions
5. Proportion of debt and equity — Capital structure
6. Cheapest source of finance — Debt
7. Riskfree source of finance — Equity
8. Decisions relating to disposal of profits — Dividend decision
9. Decision relating to quantum of funds to be raised from varions long term sources — Financing decision
10. Most suitable combination of owners funds and borrowed funds to generate higher EPS — Trading on equity/Financial leverage.

QUESTIONS FOR PRACTICE

Q.1 HCL Company's finance manager has decided to retain its entire profit to meet financial requirement for its growth. Name the type of decision involved.(Dividend) (1)

Q.2 Tata sons has debt equity ratio of 4:1 and Bajaj has 1:1 debt equity ratio. Name the advantage, Tata sons may have over Bajaj.(Trading on equity (1)

Q.3 Dabur India has decided to increase credit limit and duration of credit to its customers to boost its sales. Name the type of decision involved. (working capital) (1)

Q.4 Bharti Ltd. is a leading mobile company. It is planning to acquire Queen Ltd's (its close competitor) business worth Rs. 1,000 crore. Which financial decision is involved in it? Explain it.(Investment) (3)

Q.5 Chandra Ltd. is a manufacturer of Laptops. It made a profit of 1000 crores. The director have proposed a dividend of 38%. As a finance manager of the company. What factors would you consider while formulating a dividend policy of the company? (Any four) (4)

Q.6 Pankaj is engaged in Warehousing - Business Identify the working capital requirements of Pankaj stating the reason in support of your answer. Pankaj is also planning to start his Transport business. Explain any two factors that will affect his fixed capital requirements. (2+2)

Q.7 How is overall finanial risk calculated?

Q.8 How does financial management help in maximisation of shoreholders' wealth? (Taking right financial decisions)

Q.9 How does 'Trading on Equity' affect the Capital structure of a company?

Explain with the help of a suitable example. (5)

Q.10 "During annual general meeting of Prakash Ltd. CEO, Mr. Rajnesh put the expansion plan for the coming year before shareholders and asked for suitable

source of finance to finance manager. Finance manager Mr. Kant proposed issue of debentures than equity with a plan that they can be paid back whenever requirement of funds is over"

In the above paragraph, which component affecting financing decision has been highlighted? Explain the component. (Flexibility) (3)

Q.11 Jai Bharat Company Ltd. is an auto part supplier company in Guru Gram, Haryana. Its business is spread over several cities. The CEO of company wants to open a factory in Gujrat near Tata Motors Ltd. but due to recession for the last two years, its business is facing slow down. Company needs capital. Rakesh Gupta is CA and financial advisor of the company. He opines that during recession profit falls and investors prefer to invest indebentures to earn fixed income. Therefore, the company should issue debentures.

In this paragraph, which factor affecting financing decision has been highlighted? Explain (State of capital market). (3)

Q.12 How will increase in number of creditors affect the working capital requirements of a company? (1)

Q.13 "Tax benefits are available only in case of payment of interest and not on the payment of preference dividend." Why? (Interest is an expense while dividend is an appropriation) (1)

Q.14 "Ranbaxy Ltd. has been earning handsome profits since last 15 years. Company enjoy fair goodwill in the market, so company can easily arrange debt as well equity from the market, whenever needed. Therefore company decided to declare dividend with a hike of 15% from, last year."

Which two components affecting dividend decision have been highlighted in the above paragraph. (2+2)

(i. Stability of earning ii. Access to capital markets)

Q.15 'REI Agro Food Ltd 'is a famous multinational company. Mr. S.K.Nagi is its finance manager. He is making efforts to increase the market value of capital invested by the equity shareholders. He already knew it could be possible only when price of the shares increases and price of shares increase only if

financing, Investment and dividend decisions are taken optimally. He did the same and achieved success.

Which objective of financial management has been referred here? Explain.

(3)

Q.16 Name the factor due to which a petro chemical company requires much higher investment in fixed capital than an information technology company. However both may generate same amount of revenue.(Nature of business)

(3)