NCERT SOLUTIONS

CLASS - 12th

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Subject : Business Studies

Chapter : 9

Chapter Name : Financial Management

Q1 What is meant by capital structure?

Answer. Capital structure means the proportion of debts and equity used for financing the operations of business.

Capital structure= Debt/Equity

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Q2 State the two objectives of financial planning.

Answer. Two objectives of financial planning are as follows -

→ To ensure availability of funds whenever these are required.

→ To see that firm does not raise resources unnecessarily.

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Q3 Name the concept of financial management which increases the return to equity shareholders due to the presence of fixed financial charges.

Answer. Financial leverage increases the return to equity shareholders due to the presence of fixed financial charges.

Page : 253 , Block Name : Very Short Answer Type

Q4 Amrit is running a ‘transport service’ and earning good returns by providing this service to industries. giving reason, state whether the working capital requirement of the firm will be ‘less’ or ‘more’.

Answer. Requirements of working capital will be less since service sectors like transport service require no inventory and manufacturing overheads.

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Q5 Ramnath is into the business of assembling and selling televisions. Recently he has adopted a new policy of purchasing the components on three months credit and selling the complete product in cash. Will it affect the requirement of working capital? give reason in support of your answer.

Answer. It will affect the working capital. Requirement of working capital will be less since the current liabilities are getting reduced.

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Q1 What is financial risk? Why does it arise?

Answer. Financial risk refers to the risk of a company not being able to cover its fixed financial costs. The fixed costs of an enterprise may include interest obligations, preference dividend or repayment obligations. Financial risk is directly associated with the debt capital in the capital structure. If the debts will be more than the financial risk will also increase.

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Q2 Define current assets? Give four examples of such assets.

Answer. Current assets of a company are those assets which can be converted into cash or cash equivalents within one year. These may include cash in hand, cash at bank, trade receivables, inventory, prepaid expenses etc. These assets are used to provide liquidity and to meet the current liabilities of the company.

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Q3 What are the main objectives of financial management? Briefly explain.

Answer. The main objective of financial management is to maximise shareholders wealth. The shareholders wealth comprises the shares. Thus their wealth is maximised when the market value of shares of the company is maximised. Thus financial management aims at those activities which will increase more benefits to the firm than the costs in order to increase the market value of the shares. It also aims to achieve the objective of profit maximisation and maintaining adequate liquidity in the company.

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Q4 Financial management is based on three broad financial decisions. What are these?

Answer. Financial management is based on three broad financial decisions which are explained below -

→ Investment Decision: Investment decision mainly relates to how the firm is going to invest its funds in different assets. It determines the proportion of current assets and fixed assets in the company.

→ Financing Decision: Financing decision aims at determining how the company is going to raise its capital through various sources. It determines the proportion of the debt and equity capital in the total capital of the company.

→ Dividend Decision: Dividend is the amount of profits which is paid to the shareholders on the shares purchased by them. Thus this decision pertains to the amount of dividend to be paid to the shareholders and the amount of retained earnings in the business for meeting investment requirements.

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Q5 Sunrises Ltd. dealing in readymade garments, is planning to expand its business operations in order to cater to the international market. For this purpose the company needs an additional `80,00,000 for replacing machines with modern machinery of higher production capacity. The company wishes to raise the required funds by issuing debentures. The debt can be issued at an estimated cost of 10%. The eBIT for the previous year of the company was `8,00,000 and total capital investment was `1,00,00,000. Suggest whether the issue of debenture would be considered a rational decision by the company. give reason to justify your answer.

Answer. No, the issue of debenture would not be considered a rational decision by the company.

Reason: Cost of debt: 10%

ROI: $\frac{8,00,000}{1,00,00,000}\times 100 = 8 \%$

Cost of debt is greater than ROI.

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Q6 How does working capital affect both the liquidity as well as profitability of a business?

Answer. Working capital of a business enterprise is the amount of funds available at its disposal for the day to day administration and management of the organisation. It is the difference between the current assets and current liabilities. If more working capital will be employed by the business then it will increase its liquidity. However it yields less return as compared to fixed assets, thus it will decrease profitability. Thus proper balance must be maintained between the liquidity and profitability by using adequate amount of working capital.

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Q7 Aval Ltd. is engaged in the business of export of canvas goods and bags. In the past, the performance of the company had been upto the expectations. In line with the latest demand in the market, the company decided to venture into leather goods for which it required specialised machinery. For this, the Finance Manager Prabhu prepared a financial blueprint of the organisation's future operations to estimate the amount of funds required and the timings with the objective to ensure that enough funds are available at the right time. He also collected the relevant data about the profit estimates in the coming years. By doing this, he wanted to be sure about the availability of funds from the internal sources of the business. For the remaining funds, he is trying to find alternative sources from outside. a. Identify the financial concept discussed in the above paragraph. Also, state the objectives to be achieved by the use of financial concepts so identified.

a. 'There is no restriction on payment of dividend by a company'. Comment

Answer. a. The financial concept discussed in the above paragraph is known as Financial planning. Objectives to be achieved by the use of financial concept so identified are:

a (1) Requirement of specialized machinery in order to venture into leather goods.

a (2) Availability of enough funds.

a (3) Finding alternative sources from outside sources

b. 'There is no restriction on payment of dividend by a company'- this statement is incorrect. The law has imposed certain legal restrictions on the payment of dividend along with the contractual restrictions.

Page : 254 , Block Name : Short Answer Type

Q1 What is working capital? Discuss five important determinants of working capital requirement?

Answer. Working capital of a business enterprise is the amount of funds available at its disposal for the day to day administration and management of the organisation. It is the difference between the current assets and current liabilities.

Working Capital = Current Assets – Current Liabilities

Factors affecting working capital requirement are as follows:

→ Nature of Business: The business enterprise may deal in manufacturing or in trading activities. A trading business requires less working capital as it doesn't have a long processing cycle. However a manufacturing business requires more working capital.

→ Scale of Operation : A large sized organisation has more working capital requirements than a small sized organisation. It is so because a large sized organisation has more requirements to maintain inventory and has more expenses in the day to day activities.

→ Production Cycle : If the production cycle of a business enterprise is long, i.e. It requires more time to convert raw materials into finished products, then it has to maintain more working capital in order to meet its expenses.

→ Credit Allowed Different firms allow different credit terms to their customers. A liberal credit policy results in a higher amount of debtors, increasing the requirements of working capital.

(v) Credit Availed Just as a firm allows credit to its customers it also may get credit from its suppliers. The more credit a firm avails on its purchases, the working capital requirement is reduced.

Page : 255 , Block Name : Long Answer Type

Q2 “Capital structure decision is essentially optimisation of risk-return relationship.” Comment.

Answer. Capital structure refers to the mix between owners and borrowed funds. It can be calculated as Debit/Equity.

Debt and equity differ significantly in their cost and riskiness for the firm. Cost of debt is lower than the cost of equity for a firm because the lender's risk is lower than the equity shareholder’s risk, since lenders earn on assured return and repayment of capital and therefore they should require a lower rate of return. Debt is cheaper but is more risky for a business because payment of interest and the return of principal is obligatory for the business. Any default in meeting these commitments may force the business to go into liquidation. There is no such compulsion in case of equity, which is therefore, considered riskless for the business. Higher use of debt increases the fixed financial charges of a business. As a result increased, use of debt increases the financial risk of a business.

Capital structure of a business thus, affects both the profitability and the financial risk. A capital structure 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.

Page : 255 , Block Name : Long Answer Type

Q3 “A capital budgeting decision is capable of changing the financial fortunes of a business.” Do you agree? give reasons for your answer?

Answer. Investment decisions can be long term or short term. A long term investment decision is also called a capital budgeting decision. It involves commiting the finance on a long term basis, e.g., making investment in a new machine to replace an existing one or acquiring new fixed assets or opening a new branch etc. These decisions are very crucial for any business. They affect its earning capacity over the long-run, assets of a firm, profitability and competitiveness, are all affected by the capital budgeting decisions. Moreover, these decisions normally involve huge amounts of investment and are irreversible except at a huge cost. Therefore, once made, it is almost impossible for a business to wriggle out of such decisions. Therefore, they need to be taken with utmost care. These decisions must be taken by those who understand them comprehensively. A bad capital budgeting decision normally has the capacity to severely damage the financial fortune of a business.

Page : 255 , Block Name : Long Answer Type

Q4 Explain the factors affecting dividend decision?

Answer. Dividend decision relates to distribution of profit to the shareholders and its retention in the business for meeting the future investment requirements.

Factors affecting dividend decision are as follows:

→ Earnings Dividends are paid out of current and past year earnings. Therefore, earnings is a major determinant of the decision about dividend.

→ Stability of Earnings Other things remaining the same, a company having stable earnings is in a position to declare higher dividends. As against this, a company having unstable earnings is likely to pay a smaller dividend.

→ Growth Opportunities Companies having good growth opportunities retain more money out of their earnings so as to finance the required investment. The dividend in growth companies, is therefore, smaller than that in non-growth companies.

→ Cash Flow Position Dividends involve an outflow of cash. A company may be profitable but short on cash. Availability of enough cash in the company is necessary for declaration of dividend by it.

→ Shareholder Preference If the shareholder in general, desire that at least a certain amount should be paid as dividend, the companies are likely to declare the same.

→ Taxation Policy If tax on dividend is higher it would be better to pay less by way of dividends. As compared to this, higher dividends may be declared if tax rates are relatively lower.

→ Stock Market Reaction For investors, an increase in dividend is a good news and stock prices react positively to it. Similarly, a decrease in dividend may have a negative impact on the share prices in the stock market.

→ Access to Capital Market Large and reputed companies generally have easy access to the capital market and therefore, depend less on retained earnings to finance their growth. These companies tend to pay higher dividends than the smaller companies which have relatively low access to the market.

→ Legal constraints Certain provisions of the Company's Act place restriction on payouts as dividend. Such provisions have to be adhered, while declaring dividends.

→ Contractual Constraints While granting loans to a company, sometimes the lender may impose certain restrictions on the payment of dividends in future. The companies are required to ensure that the dividends does not violate the terms and conditions of the loan agreement in this regard.

Page : 255 , Block Name : Long Answer Type

Q5 Explain the term 'Trading on equity'? Why, when and how it can be used by company.

Answer. Trading on equity refers to the increase in profit earned by the equity shareholders due to presence of fixed financial charges. When the rate of earning or Return on Investment (ROI) of a company is higher than the rate of interest on borrowed funds only then a company should opt for trading on equity.

Page : 255 , Block Name : Long Answer Type

Q6 'S' Limited is manufacturing steel at its plant in India. It is enjoying a buoyant demand for its products as economic growth is about 7–8 per cent and the demand for steel is growing. It is planning to set up a new steel plant to cash on the increased demand. It is estimated that it will require about `5000 crores to set up and about `500 crores of working capital to start the new plant.

a. Describe the role and objectives of financial management for this company.

b. Explain the importance of having a financial plan for this company. give an imaginary plan to support your answer.

c. What are the factors which will affect the capital structure of this company?

d. Keeping in mind that it is a highly capital-intensive sector, what factors will affect the fixed and working capital. Give reasons in support of your answer.

Answer. a) Role of Financial Management Financial management is concerned with the proper management of funds. It involves

→ Managerial decisions relating to procurement of long term and short term funds.

→ Keeping the risk associated with respect to procured funds under control.

→ Utilisation of funds in the most productive and effective manner

→ Fixed debt equity ratio in capital.

b) Importance of financial plan for the company:

→ Financial Planning ensures provision of adequate funds to meet working capital requirements.

→ It brings about a balance between in flow and out flow of funds and ensures liquidity throughout the year.

→ It solves the problems of shortage and surplus of funds and ensures proper and optimum utilisation of available resources.

→ It ensures increased profitability through cost benefit analysis and by avoiding wasteful operations.

→ It seeks to eliminate waste of funds and provides better financial control.

→ It seeks to avail the benefits of trading on equity

c) Capital structure refers to the proportion in which debt and equity funds are used for financing the operations of a business. A capital structure is said to be optimum when the proportion of debt and equity is such that it results in an increase in the value of shares. The factors that will affect the capital structure of this company are:

→ Equity Funds: The composition of equity funds in the capital structure will be governed by the following factors

The requirement of funds of ‘S’ Limited is for long term. Hence, equity funds will be more appropriate.

→ There are no financial risks attached to this form of funding.

→ If the stock market is bullish, the company can easily raise funds through issue of equity shares.

→ If the company already has raised a reasonable amount of debt funds, each subsequent borrowing will come at a higher interest rate and will increase the fixed charges.

→ Debt Funds: The usage and the ratio of debt funds in the capital structure will be governed by factors like

→ The availability of cash flow with the company to meet its fixed financial charges. The purpose is to reduce the financial risk associated with such payments which can further be checked by using 'debt' service coverage ratio.

→ It will provide the benefit of trading on equity and hence will increase the earning per share of equity shareholders. However, 'return on investment' ratio will be the guiding principle behind it. The company should opt for trading on equity only when return on investment is more than the fixed charges.

→ Interest on debt funds is a deductible expense and therefore, will reduce the tax liability.

→ It does not result in dilution of management control.

d) The working and fixed capital requirement of 'S' Limited will be high due to the following reasons:

→ The business is capital intensive and the scale of operation is large.

→ Heavy investments are required for building up the production base and for technological upgrade.

→ In the case of the steel industry, the major input is iron ore and coal. The ratio of cost of raw material to total cost is very high. Hence, higher will be the need for working capital.

→ The longer the operating cycle, the larger is the amount of working capital required as the funds get locked up in the production process for a long period of time.

→ Terms of credit for buying and selling goods, discount allowed by suppliers and to the customers also determines the quantum of working capital.