

Business Studies
Class XII
Chapter: 9
Financial Management

Objective type questions:

Q1.

The cheapest source of finance is:

- a) Debenture.
- b) Equity share capital.
- c) Preference share.
- d) Retained earnings.

Answer: (d) Retained earnings.

Explanation:

Retained earnings is the cheapest source of finance as it involves only opportunity cost. Debentures involve fixed interest cost and shares involve dividend cost. Retained earnings are the part of profit that is retained after payment of dividend.

Q2.

A decision to acquire a new and modern plant to upgrade an old one is a

- (a) financing decision.
- (b) working capital decision.
- (c) investment decision.
- (d) None of the above.

Answer: (c) investment decision.

Explanation:

To acquire a new and modern plant to upgrade an old one is an investment decision. It relates to how the firm's funds are invested in different assets. Business needs to invest financial resources such that they earn the highest possible return for their shareholders.

Q3.

Other things remaining the same, an increase in the tax rate on corporate profit will

- (a) make the debt relatively cheaper.
- (b) make the debt relatively the dearer.
- (c) have no impact on the cost of debt.
- (d) we can't say.

Answer: (a) make the debt relatively cheaper.

Explanation:

An increase in the tax rate on corporate profit will make the debt relatively cheaper. This is because interest that is to be paid to the debtors is a tax deductible expense.

Q4.

Companies with a higher growth potential are likely to

- (a) pay lower dividends.
- (b) pay higher dividends.
- (c) dividends are not affected.
- (d) none of the above.

Answer: (a) pay lower dividends.

Explanation:

Companies with a higher growth potential are likely to pay lower dividends as growth potential is high, the company is likely to invest more on development. Therefore, it will pay lower dividend.

Q5.

Financial leverage is called favourable if

- (a) Return on investment is lower than the cost of debt.
- (b) ROI is higher than the cost of debt.
- (c) Debt is easily available.

(d) If the degree of existing financial leverage is low.

Answer: (b) ROI is higher than the cost of debt.

Explanation:

Proportion of debt in the capital is known as financial leverage. It is said to be favourable situation when return on investment is higher than cost of debt. In such a case, EPS also increases.

Q6.

Higher debt-equity ratio results in

- (a) lower financial risk.
- (b) higher degree of operating risk.
- (c) higher degree of financial risk.
- (d) higher EPS.

Answer: (c) higher degree of financial risk.

Explanation:

Higher debt-equity ratio results in higher degree of financial risk as it is mandatory to pay interest to debenture holders even in case of loss. Higher debt equity means that debt proportion is high in overall capital so interest obligations are more.

Q7.

Higher working capital usually results in

- (a) higher current ratio, higher risk and higher profits.
- (b) lower current ratio, higher risk and profits.
- (c) higher equity, lower risk and lower profits.
- (d) lower equity, lower risk and higher profits.

Answer: (a) higher current ratio, higher risk and higher profits.

Explanation:

Higher working capital usually results in higher current ratio, higher risk and higher profits. Working capital is the excess of current assets over current liabilities of a firm.

Q8.

Current assets are those assets which get converted into cash

- (a) within six months.
- (b) within one year.
- (c) between one year and three years.
- (d) between three and five years.

Answer: (b) within one year.

Explanation:

Current assets are the assets that can be readily convertible into cash within one year. Cash, debtors, B/R, stock, etc are some of the current assets.

Q9.

Financial planning arrives at

- (a) minimising the external borrowing by resorting to equity issues.
- (b) entering that the firm always have significantly more fund than required so that there is no paucity of funds.
- (c) ensuring that the firm faces neither a shortage nor a glut of unusable funds.
- (d) doing only what is possible with the funds that the firms has at its disposal.

Answer: (c) ensuring that the firm faces neither a shortage nor a glut of unusable funds.

Explanation:

Financial planning arrives at ensuring that the firm faces neither a shortage nor a glut of unusable funds. Financial Planning refers to estimation of capital required and deciding the sources of funds.

Q10.

Higher dividend per share is associated with:

- (a) High earnings, high cash flows, unstable earnings and higher growth opportunities.
- (b) High earnings, high cash flows, stable earnings and high growth opportunities.
- (c) High earnings, high cash flows, stable earnings and lower growth opportunities.
- (d) High earnings, low cash flows, stable earnings and lower growth opportunities.

Answer: (d) High earnings, low cash flows, stable earnings and lower growth opportunities.

Explanation:

Higher dividend implies high earnings, high cash flows, stable earnings and lower growth opportunities. Higher dividend shows that there is stability in the cash flows of the company.

Q11.

A fixed asset should be financed through:

- a) a long term liability.
- b) a short term liability.
- c) a medium term liability.
- d) a mix of long and short term liabilities.

Answer: (a) a long-term liability.

Explanation:

Fixed assets are the assets that are purchased for long term use and not likely to be converted into cash quickly. Such assets should be financed through a long-term liabilities such as long term borrowings, shares, etc.

Q12.

Current assets of a business firm should be financed through:

- a) Current liability only.
- b) Long term liability only.
- c) Fixed liabilities only.
- d) Both types (i.e., long and short term liabilities).

Answer: (a) Current liability only.

Explanation:

Current assets are the assets that can be readily converted into cash within 12 months. Debtors, B/R, stock, etc. These assets shall be financed through current liabilities.

Short answer questions:

Q1.

What is meant by capital structure?

Answer:

Capital structure refers to the mix between owners and borrowed funds. Owner's funds consist of equity share capital, Preference share capital, Reserves & surplus. Borrowed funds consist of Debentures, Loans, Deposits, etc. A company needs to decide upon the optimum mix of these sources, which refers to the capital structure.

Q2.

Discuss the two objectives of financial planning.

Answer:

The twin objectives of financial planning are:

(a) To ensure availability of funds whenever these are required: This includes a proper estimation of the funds required for different purposes such as for the purchase of long-term assets or to meet day-to-day expenses of business etc.

(b) To see that the firm does not raise resources unnecessarily: Excess fund is almost as bad as inadequate funding. Even if there is some surplus money, good financial planning would put it to the best possible

use so that the financial resources are not left idle and don't unnecessarily add to the cost.

Q3.

What is 'Financial Risk?' Why does it rise?

Answer:

Proportion of debt in the total capital determines the overall financial risk. Financial risk is the situation that the company will not be able to meet its fixed financial charges. With higher degree of debt in the overall capital, i.e. high Debt Equity ratio, the overall cost of capital declines and profitability (EPS) increases. However, due to higher repayment and interest payment obligations, the financial risk increases.

Q4.

Define 'Current Assets.' Give four examples of such assets.

Answer:

Current assets are the assets that can be readily converted into cash within 12 months. Debtors, B/R, stock, short term investments, etc. are some of the current assets. These assets shall be financed through current liabilities.

Q5.

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

Answer:

Three broad financial decisions are:

(a) Investment Decision: The financial manager is required to study, analyse and evaluate various investment proposals and take decisions in the interest of the enterprise. These decisions, respectively, affect the liquidity and profitability of an enterprise.

(b) Financing decision: Financing decision involves determining the quantum of finance to be raised from various sources. It involves the identification of various available sources from where funds can be raised. The firm has to decide the proportion of funds to be raised from the various sources, depending on the risk and returns involved.

(c) Dividend decision: Financial management is also concerned with the appropriation of profits. The company has to meet various obligations out of its profit.

Q6.

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

Answer:

The primary objective of financial management is to maximise shareholder's wealth. To achieve the wealth

maximisation objective, management needs to achieve the following specific objectives:

- Ensure availability of sufficient funds at reasonable cost and reasonable risk.
- Effective utilisation of funds, to ensure returns are more than cost of funds.
- Ensuring safety of funds by creating reserves, reinvesting profits, etc.
- Avoiding idle finance, else it will unnecessarily add to cost of finance.

Q7.

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

Answer:

Working capital is the excess of current assets over current liabilities. It affects both liquidity as well as profitability of a business.

Increase in working capital increases the liquidity of the business. But current assets have low returns so this decreases the profitability of the business.

Long answer questions:

Q1.

**What is working capital? How is it calculated?
Discuss five important determinants of working capital requirement.**

Answer:

Working capital is the excess of current assets over current liabilities. It is calculated by deducting current liabilities from current assets. If current assets are equal to current liabilities, it means that current assets are totally financed by current liabilities. If current assets are greater than current liabilities, then the excess is surely financed by non-current liabilities or long-term loans and share capital. Every business organisation needs to invest in current assets for the smooth functioning of day to day operations.

The important determinants of working capital requirement are:

(a) Nature of the business: In case of cash nature of business, inventories and book debts are lesser, so small working capital will be sufficient. On the other hand, trading and manufacturing business enterprises have larger stock and book debts, so their net working capital is higher.

(b) Technology and production cycle: In case of longer span of production cycle, higher working capital will be required. The quantum of working capital may be reduced by taking advance payment for goods, cash sales and improvement in production technology, etc. At the same time, use of modern technology, machines and equipments makes the production process faster. Conversion of raw material into finished goods becomes

quicker. Labour cost is reduced. As such working capital requirement becomes lesser.

(c) Trade/business cycle fluctuations: The operation of trade cycle results in boom, recession, depression and recovery in the economy. In boom situations, demand for goods increases resulting in the increase of price, production and expansion of business activities. It will require larger amount of working capital to meet the demand and for the modernisation of plant.

In case of depression and recession, business activities slow down, demand goes on a decline, low level of inventory is required, and debtors are also reduced. As such lesser working capital is required.

(d) Credit policy: Credit policy has dual effect on the quantum of capital. Firstly the credit terms allowed by firm to other firms and secondly the credit terms allowed by other firms to the firm. More credit sales will require more working capital and in the same way in case of cash sales, lesser working capital will be sufficient.

On the other hand, in case of liberal terms from the suppliers i.e. credit sales for longer duration or payment after sales, lesser working capital will be required and vice-versa.

(e) Growth prospects: Higher growth prospects is related to higher production and thus requires more amount of working capital.

Q2.

"Capital structure decision is essentially optimisation of risk-return relationship." Comment.

Answer:

Capital structure is the combination of different financial sources used by a company for raising funds. It means the ratio of debts to equity and the ratio of debt to total capitalisation. Funds can be either owner's funds or borrowed funds. Owner's funds are in the form of shares, retained earnings, etc. Borrowed funds constitute loans, debentures and bonds. Both the sources have risk and cost associated with them. Cost of debt is less as interest paid is a tax deductible expense but this puts an additional liability on the company to pay interest irrespective of profit or loss. But higher return can be achieved through debt at lower cost.

Raising funds through equity is costlier as it involves payment of dividend and also voting rights are provided to shareholders that affect the decision making of the organisation. Capitalisation is the sum total of debt and equity. The cost of procuring funds should be less. While borrowing funds, it should be kept in mind that the cost of servicing of debts would be reasonably low.

Q3.

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

Answer:

The financial manager is required to study, analyse and evaluate various investment proposals and take decisions in the interest of the enterprise. Decisions for investments for a short term (regarding working capital) are called Working Capital decisions and those for long term (regarding investment in fixed assets/ branch) are called Capital Budgeting decisions. These decisions, respectively, affect the liquidity and profitability of an enterprise.

These decisions are very crucial for any business since they affect its earning capacity over the long run. The size of assets, the 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. A bad capital budgeting decision normally has the capacity to severely damage the financial fortune of a selected or rejected. If there is only one project then its viability in terms of the rate of return viz., investment and its comparability with the industry's average is seen.

Q4.

Explain the factors affecting the dividend decision.

Answer:

Factors affecting the dividend decision are:

- (a) **Shareholder's preference:** Preference of shareholders should be kept in mind while deciding the dividend distribution or retention of profits. If shareholders in general desire that at least a certain amount is to be paid as dividend the companies are likely to declare the same. There are always some shareholders who depend upon a regular income from their investments.
- (b) **Taxation Policy:** A dividend distribution tax is charged on companies, but dividend is tax free in hands of shareholders. Companies may pay lower dividends if tax rate is high & vice-versa, whereas, shareholders may prefer higher dividends.
- (c) **Earnings:** Dividends are paid out of current and past earning. Therefore, earnings are a major determinant of the decision about dividend.
- (d) **Stability of Earnings:** Other things remaining the same, a company having stable earning is in a position to declare higher dividends.
- (e) **Growth Opportunities:** Companies having good growth opportunities retain more money out of their earnings so as to finance the required investment.

- (f) **Access to Capital Market:** Large and reputed companies generally have easy access to the capital market and therefore may depend less on retained earnings to finance their growth. These companies tend to pay higher dividends than the smaller companies.
- (g) **Stock Market Reaction:** Investors, in general, view an increase in dividend as 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.

Q5.

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

Answer:

Trading on equity refers to the use of more debt along with equity shares in the capital structure with a view to increase earnings per share. This is possible only if the return on investment is greater than rate of interest on debt. Trading on equity refers to the additional profits that equity shares earn because of high degree of financial leverage, i.e., funds raised by issuing more debts. Difference between return on investment and rate of interest on debt increases, earnings per share increases.

Let us understand through a practical example:

XYZ Ltd. requires ₹ 4,00,000 for a project. He has two options:

- (a) Raise entire amount by issue of equity shares, or
- (b) Raise ₹ 1,50,000 through issue of equity shares and ₹ 2,50,000 by issue of 10% debentures.

Also consider that tax rate is 30%.

The EPS in different options will be:

Particulars	Option (a)	Option (b)
Earnings before interest and tax	1,00,000	1,00,000
Less: Interest	-	25,000
Earnings before tax	1,00,000	75,000
Less: Tax @ 30%	30,000	22,500
Earnings after tax	70,000	52,500
Divide: No. of shareholders	40,000	15,000
Earnings per share	1.75	3.5

Option (b) has better EPS as it has the advantage of trading on equity. But this can be used only when the return on investment is higher than the rate of interest on debt.

Case Problem:

'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% 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 facing. 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.

Questions

Q1.

What is the role and objectives of financial management for this company?

Answer:

Financial management is required to ascertain:

- (a) **Amount of fixed assets:** Capital budgeting means taking investment decisions regarding the purchase of fixed assets. These decisions are very crucial for any business since they affect its earning capacity over the long run.
- (b) **Composition of funds used:** Composition is the mix of short term and long term sources of finance used by the company.
- (c) **Debt equity proportion in the capital structure:** Capital structure is the composition between owners' funds and outsiders' long-term funds. It tells how much amount has been invested by the owner of the business and how much amount has been borrowed from outside.
- (d) **Composition of current assets:** Current assets are called gross working capital. Current assets include cash, debtors, stock and short-term investments.

The primary objective of financial management is to maximise shareholder's wealth. To achieve the wealth maximisation objective, management needs to achieve the following specific objectives:

- Ensure availability of sufficient funds at reasonable cost and reasonable risk.
- Effective utilisation of funds, to ensure returns are more than cost of funds.
- Ensuring safety of funds by creating reserves, reinvesting profits, etc.
- Avoiding idle finance, else it will unnecessarily add to cost of finance.

Q2.

What is the importance of having a financial plan for this company? Give an imaginary plan to support your answer.

Answer:

- Financial planning will help the company to raise adequate funds. This will solve the problem of overcapitalization.
- It will help to minimise wastage of time, efforts and money.
- It will help the company to forecast more accurately.

Q3.

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

Answer:

Factors that affect capital structure of the company are:

- (a) **Cash Flow Position:** Size of projected cash flows must be considered before issuing debt. It must be kept in mind that a company has cash payment obligations.
- (b) **Interest Coverage Ratio (ICR):** The higher the ratio, lower is the risk of company failing to meet its interest payment obligations
- (c) **Return on Investment (ROI):** If the ROI of the company is higher, it can choose to use trading on equity to increase its EPS.
- (d) **Risk Consideration:** Use of debt increases the financial risk of a business. Financial risk refers to a position when a company is unable to meet its fixed financial charges namely interest payment preference dividend and repayment obligations.

Q4.

Keeping in mind that it is a highly capital intensive sector what factors will affect the fixed and working capital. Give reasons with regard to both in support of your answer

Answer:

Factors affecting fixed capital requirement are:

- (a) **Nature of Business:** The type of business has a bearing upon the fixed capital requirement. A trading concern needs lower investment in fixed assets compared with a manufacturing organisation.
- (b) **Scale of Operations:** A large organisation operating at a higher scale needs bigger plant, more space etc. and therefore, requires higher investment in fixed assets when compared with the smaller organisation.
- (c) **Choice of Technique:** Some organisations are capital intensive whereas others are labour intensive. A capital intensive organisation requires higher investment in plant and machinery compared to others.
- (d) **Technology Up gradation:** In certain industries, which employ higher technology, the assets become obsolete sooner. Consequently, their replacements become due faster, requiring higher capital requirement.
- (e) **Growth prospects:** If an organisation has growth plans, it requires higher investment in fixed assets and consequently higher fixed capital, compared to organisations which do not have immediate expansion prospects.

Factors affecting working capital requirement are:

- (a) **Nature of Business:** The basic nature of a business influences the amount of working capital required. A trading organisation usually needs a lower amount of working capital compared to a manufacturing organisation.
- (b) **Scale of Operations:** For organisations which operate on a higher scale of operation, the quantum of inventory, debtors required is generally high.
- (c) **Seasonal Factors:** Most business have some seasonality in their operations. In peak season, because of higher level of activity, higher amount of working capital is required.
- (d) **Production Cycle:** Production cycle is the time span between the receipt of raw material and their conversion into finished good Duration and the length of production cycle, affects the amount of funds required for raw materials and expenses.
