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NCERT Solutions for 12th Class Business Studies: Chapter 9- Financial Management

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Short Answer Type Questions

1. What is meant by capital structure?

Ans: Capital structure refers to the mix between owners and borrowed funds. It represents the proportion of equity and debt

$$\text{Capital Structure} = \frac{\text{Debt}}{\text{Equity}}$$

2. Discuss the two objectives of Financial Planning.

Ans: Financial Planning strives to achieve the following two objectives

(i) **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.

(ii) **To See That the Firm Does Not Raise Resources Unnecessarily**

Excess funding is almost as bad as inadequate funding. Efficient financial planning ensures that funds are not raised unnecessarily in order to avoid unnecessary addition of cost.

3. What is 'financial risk? Why does it arise?

Ans: It refers to the risk of company not being able to cover its fixed

financial costs. The higher level of risks are attached to higher degrees of

financial leverage with the increase in fixed financial costs, the company its

also required to raise its operating profit (EBIT) to meet financial charges. If

the company can not cover these financial charges, it can be forced into liquidation.

4. Define a 'current assets' and give four examples.

Ans: Current assets are those assets of the business which can be converted into cash within a period of one year. Cash in hand or at bank,

bills receivables, debtors, finished goods inventory are some of the examples of current assets.

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

Ans: Financial management is concerned with the solution of three major issues relating to the financial operations of a firm corresponding to the three questions of investment, financing and dividend decision. In a financial context, it means the selection of best financing alternative or best investment alternative. The finance function therefore, is concerned with three broad decision which are as follows

(i) **Investment Decision**

The investment decision relates to how the firm's funds are invested in different assets.

(ii) **Financing Decision**

This decision is about the quantum of finance to be raised from various long term sources and short term sources. It involves identification of various available sources of finance.

(iii) **Dividend Decision**

This decision relates to distribution of dividend. Dividend is that portion of profit which is distributed to shareholders the decision involved here is how much of the profit earned by company is to be distributed to the shareholders and how much of it should be retained in the business for meeting investment requirements.

6. What is the main objective of financial management? Explain briefly.

Ans: Primary aim of financial management is to maximise shareholder's wealth, which is referred to as the wealth maximisation concept. The wealth of owners is reflected in the market value of shares, wealth maximisation means the maximisation of market price of shares.

According to the wealth maximisation objective, financial management must select those decisions which result in value addition, that is to say the benefits from a decision exceed the cost involved. Such value addition I increase the market value of the company's share and hence result in maximisation of the shareholder's wealth.

7. Discuss about working capital affecting both the liquidity as well as profitability of a business.

Ans: The working capital should neither be more nor less than ; required. Both these situations are harmful. If the amount of working capital

is more than required, it will no doubt increase liquidity but decrease profitability. For instance, if large amount of cash is kept as working capital, i then this excessive cash will remain idle and cause the profitability to fall.

On the contrary, if the amount of cash and other current assets are very ‘ little, then lot of difficulties will have to be faced in meeting daily expenses

and making payment to the creditors. Thus, optimum amount of both current assets and current liabilities should be determined so that profitability of the business remains intact and there is no fall in liquidity.

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Long Answer Type Questions

1. What is meant by working capital? How is it calculated?

Discuss five important determinants of working capital requirements.

Ans: Working capital is that part of total capital which is required to H meet day-to-day expenses, to buy raw materials, to pay wages and other

expenses of routine nature in the production process or we can say it refers 2 to excess of current assets over current liabilities.

Working Capital = Current Assets – Current Liabilities

Factors affecting working capital requirement are

2 (i) **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. This is because in trading, there is no processing required. In a manufacturing business, however, raw materials need to be converted into finished goods, which increases the expenditure on raw material, labour and other expenses,

(ii) **Scale of Operation** The firms which are operating on a higher scale of operations, the quantum of inventory, debtors required is generally high,

Such organisations, therefore, require large amount of working capital as compared to the organisations which operate on a lower scale.

(iii) **Production Cycle** Production cycle is the time span between the receipts of raw materials and their conversion into finished goods.

Some businesses have a longer production cycle while some have a shorter one. Working capital requirement is higher in terms with longer processing cycle and lower in firms with shorter processing cycle.

(iv) **Credit Allowed** Different firms allow different credit terms to their customers. A liberal credit policy results in 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.

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

Ans: 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 cost of equity for a firm because lender's risk is lower than 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.

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3. A capital budgeting decision is capable of changing the financial fortune of a business. Do you agree? Why or why not?

Ans: Investment decision 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 a 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.

4. Explain factors affecting the dividend decision.

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

How much of the profits earned by a company will be distributed as profit and how much will be retained in the business is affected by many factors. Some of the important factors are discussed as follows

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

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

(iii) **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.

(iv) **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.

(v) **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.

(vi) **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.

(vii)**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.

(viii) **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.

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

(x) **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.

5. Explain the term 'trading on equity'. Why, when and how it can used by a business organisation?

Ans: 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. Let us consider the following example

	Company 'X'	Company 'Y'
Share Capital	₹ 10 lakhs	₹ 04.00 lakhs
Loan @ 15% p.a.	—	₹ 06.00 lakhs
	₹ 10 lakhs	₹ 10.00 lakhs
Profit before interest + Tax	₹ 3 lakhs	₹ 03.00 lakhs
Interest	Nil	₹ 00.09 lakhs
Profit before tax	₹ 3 lakhs	₹ 02.01 lakhs
Tax @ 50%	₹ 1.5 lakhs	₹ 1.05 lakhs
Profit after tax	₹ 1.5 lakhs	₹ 1.05 lakhs
Share capital	₹ 10 lakhs	₹ 4.00 lakhs
Rate of return on share	15%	26.25%

It should be clear from the above example, that shareholders of the company 'X' have a higher rate of return than company 'Y' due to the loan component in the total capital of the company.

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- Chapter 2-Principles of Management
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Organise pre-service and in-service training of teachers; develop and disseminate innovative educational techniques and practices;collaborate and network with state educational departments, universities, NGOs and other educational institutions; act as a clearing house for ideas and information in matters related to school education; and act as a nodal agency for achieving the goals of Universalisation of Elementary Education.
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