

NCERT Solutions for Class 12 Business Studies

Chapter 9 – Financial Management

Very Short Answer Type:

1.

What is meant by capital structure?

Ans: The amalgamation of debt and equity is called capital structure, which is then used by the company to finance its requirements for adequate funds. Although equity is created via ordinary shares or retained earnings, liabilities can be acquired through mortgages.

2.

State the two objectives of financial planning.

Ans: The framework of financial rules, processes, plans, and expenditures that are essential to the enterprise's economic success is known as financial management.

The objectives of financial planning are:

1. To ensure that proper utilization of funds is available for the organizational activities. 2. To understand the capital structure, which is made of debt and equity, is necessary for a business.

3.

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

Ans: The existence of predetermined financial expenses causes trading upon the equity model to boost profits to equity shareholders.

4.

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'.

Ans: A transportation system that will be run on an extensive basis is the kind of enterprise that Amrit does. Consequently, additional funding for operations is required.

5.

Ramnath is into the business of assembling and selling of 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.

Ans: The working capital need is lower since Ramnath has implemented the strategy of trading the goods for payment and buying supplies on credit for a period of three months.

Short Answer Type:

1.

What is financial risk? Why does it arise?

Ans: Financial risk is the situation when a company or organization cannot meet its fixed expenses, which include interest payments, loan repayment, and preference dividend payout. It's a crunch moment where an organization is unable to accomplish the desired financial constraints. Exactly here, financial risk could arise due to the high level of debt in the capital structure. A high level of debt leads to a high amount of interest, leading to a delay in payment.

2.

Define current assets? Give four examples of such assets.

Ans: The present assets of a business are those that might be turned into funds or cash equivalents inside the present accounting cycle. Current assets provide liquidity to the company. Cash, short-term investments, marketable securities, and debtors are examples of current assets.

3.

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

Ans: The primary goal of financial handling is to maximize the value of shareholders. Consequently, the main goal of financial governance is to make choices that will benefit investors. Gains happen when the market value of shares rises. Once the primary objective of

wealth maximization is achieved, the other objectives, like maintaining liquidity and proper utilization of funds, are fulfilled along with it.

4.

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

Ans: The technique of proper allocation, acquisition, and use of funds by the company is called financial management. Investment choices, economic decisions, and dividend selections constitute the 3 main monetary decisions that form the foundation of financial management.

5.

Sunrises Ltd. dealing in readymade garments, is planning to expand its business operations in order to cater to international market. For this purpose the company needs 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 issue of debenture would be considered a rational decision by the company. Give reason to justify your answer. (Ans. No, Cost of Debt (10%) is more than ROI which is 8%).

Ans: Debentures are often only preferred by businesses whenever the price of borrowing is less than the total expense of capital. The average price of capital for Sunrises Limited is 10%, or ₹8,00,000, depending on the ₹80,00,000 total invested capital.

The equation used to get the Return on Investment (ROI) was,

$$\text{ROI} = \text{Return} / \text{Investment} = ₹8,00,000 / ₹1,00,00,000 = 8\%.$$

Any further investment of ₹80,00,000 is likewise anticipated to generate a return on investment of 8%, provided the business maintains the present degree of competence. This would result in a further return of ₹6,40,000. However, if the cost of debt (or cost of raising funds through debentures) remains ₹800,000, then it would exceed the return generated from the investment (₹640,000).

In such a situation, raising funds through debentures would not be financially beneficial for the company. Hence, the company shouldn't issue debentures when the cost of debt is higher than the return on investment.

6.

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

Ans: Working capital in a business is the surplus that is determined by subtracting the present liabilities from the current assets of the company/organization. By increasing the working capital, the liquidity of an organization increases.

But when more current assets are present, business results in a fall in the profitability of the organization, as current assets offer low returns, which causes a fall in the profit of the business.

7.

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 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 out 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 concept so identified. (Financial Planning).

b. 'There is no restriction on payment of dividend by a company'. Comment. (Legal & Contractual Constraints).

Ans: A) The key idea in this context is capital planning; the choice of investing in capital has an effect on the business's profitability over the long run.

The business intends to make an investment in novel equipment, which takes money and will directly affect procedures, which will harm its financial performance.

The following objectives can be achieved:

1. Cash flow: Investment will continue to bring new machinery, which will further increase the organization's profit margin.

2. Add funds: This is going to be useful to determine when the profit made on investment will exceed the expense of borrowing funds when a business wishes to obtain money from both internal and external sources.

3. Investment deployed: The business intends to generate money from both internal and external sources. It's critical to understand that the rates of interest on cash obtained from both internal and outside funding will vary.

B) Businesses use a portion of their profits to distribute dividends to investors. Paying off dividends is based on the following factors:

1. Legal Constraint: Legal constraints are those that are specified in company laws and have an effect on when dividends are paid out, and must be correctly adhered to.

2. Contractual Restrictions: Dividend payments deplete the company's liquidity. Contractual restraints refer to the limitations placed on the company's ability to pay dividends with funds raised as a loan.

Long Answer Type:

1.

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

Ans: Working capital in a business is the surplus that is identified by subtracting all recent liabilities from the current assets of the organization. These recent assets include assets that can be converted into cash or a cash equivalent within the current accounting period.

Two extensive variations of working capital can be denoted as,

1. Gross Working Capital

2. Net Working Capital

The present liabilities included on the financial statements of a business are referred to as gross working capital. The gap between a company's present assets & liabilities on its financial report is known as net working capital. In the overall picture of capital finance and management, net working capital is thought to hold far more importance.

The formula for working capital is $\text{working capital} = \text{current assets} - \text{current liabilities}$.

The following elements influence the working capital requirements:

1. Business Technique: The nature of an organization's activities dictates its working capital requirements. The amount of working capital needed will depend on the scope of a company and its activities. Businesses that provide services, for instance, will need less working capital than

production facilities, which would need more. This type of business has an extended operational process.

2. Scale of Operations: The capital is determined by the size of the business. Businesses that operate on a large scale will want more working capital since they must keep an elevated amount of inventory. Likewise, a business that operates on a limited budget must have less working capital.

3. Changes in Business Cycle: The many stages that a firm goes through also affect its financial resources. Working capital tends to be greater when market demand is strong because there is going to be a greater need for manufacturing; conversely, when market demand is poor, the opposite will be true.

4. Production Functioning: Each sector will undergo a distinct manufacturing phase, based on the kind of business. Working capital requirements will be greater for a company with an extended manufacturing process and reduced for a company with a shorter production period.

5. Growth Prospects: Firms with maximum growth prospects and the ones that search for expansion have a higher working capital demand.

2.

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

Ans: An organization’s capital framework is a combination of debt & equity that it employs to monetize its funding demands. While equity is created through common stock or retained earnings, debt can be acquired through loans. Loans, debentures, bank loans, and other forms of borrowing are all possible.

An owner’s fund, on the other hand, may take the shape of equity share capital, reserves, retained earnings, preference share capital, etc. There are risks and profits associated with both debt and equity. Equity is relatively expensive but carries less risk for the company than debt, which is relatively inexpensive but carries more risk.

Debt fundraising is less expensive than equity fundraising. Despite being less expensive, debt has greater dangers because of its commitment to lenders. There is no such requirement to pay dividends on equity.

Additionally, the financial return provided by the sources of revenue raises the value per stake. Greater profits per share are provided by loans, but the risk is frequently increased. Consequently, return and risk must be taken into account while considering choices on capital layout.

3.

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

Ans: Random capital budgeting decisions have the power to alter a company's fate. Therefore, they must be taken seriously. The decision of capital budgeting involves considering fixed capital for different projects. Capital budgeting includes purchasing new assets, or it can be regarding the replacement or modernization of existing assets. All the above outcomes have a long-term impact on the firm and can affect profitability & risk factors.

The points below focus on the vital importance of capital budgeting decisions:

1. Investing in assets that will endure will impact a company's goal by yielding profits in the future. Thus, a company's decision-making process will have an impact on its long-term development.
2. To gather assets, a substantial sum of money is needed. Hence, the cash that is spent will have to be restricted for a particular amount of time, which makes it even more crucial to prepare decisions regarding capital budgeting.
3. Since asset acquisition affects the firm over the long run, it carries a considerable risk. The firm will suffer if the asset's yield is lower than the amount it invested.
4. Once the chosen decisions are made, they're irreversible. It's because reversing leads to a massive loss. Hence, consider the risk factors before execution.

4.

Explain the factors affecting dividend decision?

Ans: A dividend decision is a decision to share a portion of profit between shareholders and what should be kept as retained earnings. The following factors affect dividend decisions:

1. Companies can use their past & present profits to pay rewards. Naturally, a business with larger earnings will likely be in more advantageous circumstances to distribute dividends than one with lower profits.
2. Compared to businesses that do not have lucrative revenue, those with steady earnings are better positioned to pay dividends.
3. Businesses have a consistent dividend-sharing strategy that is only altered in response to increases in earnings.
4. Businesses seeking greater development may choose to spend a great deal of their revenues in expansion while keeping a part as dividends. As a result, these businesses pay out smaller

dividends.

5. The dividends handed out will also be impacted if the business's financial position is poor.
6. Because investors may need an assortment of payouts, businesses have to consider what they want when disbursing dividends.
7. A significant factor in determining dividends is taxation policies. Companies offer fewer dividends when a policy imposes a high tax on dividend distribution, and vice versa.
8. Depending on the stated dividend, stock market values will change. A high dividend distribution may cause it to climb, while a low dividend payout may cause a fall.
9. At the time of loan giving, the lender may apply contractual restrictions in the form of an agreement. It is necessary to review such agreements before paying dividends.
10. Companies with improved availability of financial markets can remunerate with bigger dividends & vice versa.
11. When announcing dividend distributions, businesses shall adhere to the limitations, guidelines, and standards of the Companies Act.

5.

Explain the term "Trading on Equity"? Why, when and how it can be used by company.

Ans: It is the technique of employing debt to generate profits for the owners. This strategy involves taking on additional debt to acquire new assets that will allow them to earn interest at a higher rate than the interest paid on the debt.

Since the equity stockholders are only concerned with the profits made by the company, this procedure is used. Only in cases where the probability of recovery on investment is higher than the repayment price on the funds being borrowed can a firm get involved in it. This practice is one way that a business uses financial leverage. Adoption of this approach results in higher earnings per share.

Only after the return on investment exceeds the sum of money lent can trading in stocks be lucrative. Whenever the expected return on investment falls short of the interest rate on the money that was borrowed, it is suggested that equity trading might be avoided.

6.

'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.

Ans: 1. The following describes the function of managing the finances in this organization:

- Decisions to purchase fixed assets can be aided by the financial management team, which will eventually increase the composition of fixed assets.
- The composition of funds that are used by a company includes a mix of short & long-term funds that are used by the company. Fund composition is determined by the company's decision, which is based on profitability and liquidity. It can be said that if a firm is looking to attain maximum liquidity, it would be looking to opt for long-term financing. In the same way, companies looking for short-term liquidity will eventually choose short-term financing over others.
- The proportion of debt and equity that should be used in long-term financing, or the distribution of funds that are raised with a mix of debt and equity, which is determined by financial management.
- The amount of present assets that a company holds is dependent on the financial decisions of the company. Greater financial resources will result from a larger sum, yet earnings are going to drop, and the reverse will occur.

In this case, the basic objective of financial management will be towards increasing or maximizing shareholders' wealth. Decisions that will be beneficial for the shareholders, i.e., help in increasing the market value of their shares.

This can be achieved if financial management makes a decision that increases the value of shares, where the benefits obtained from making this decision exceed the cost of taking the

financial decision.

2. The following points emphasize how crucial financial planning is to the business:

- It helps the business to predict what it will need in the future.
- Having a financial plan will facilitate the prevention of any potential shortage or surplus. It guarantees the best possible use of finances.
- It assists in enhanced communication between the sales & production resources.
- It helps in avoiding any type of waste, such as time, money, and effort.
- If the targets and policies are well defined, then financial planning helps in evaluating the performance in a good way.

Proposed Financial Plan

50% can be used by the business through the issuance of shares, and the remaining 50% can be recouped by debts that are obtained from outside sources.

3. The following elements will influence the choice of capital structure:

i. When there is a high cash flow, businesses should choose to use debt capital. Principal on debt must be paid, together with any interest that may be owed.

ii. The debt service coverage ratio compares a company's cash availability to its obligations for cash payments. A high DSCR may lead the business to choose debt as a funding source.

iii. A company's financial risk can be directly linked to its equity cost. Higher financial risk will cause shareholders to have higher expectations, which will raise the cost of equity for that company. Choosing equity is challenging due to its growing cost.

iv. A favorable stock market environment greatly facilitates the decision to choose equity capital, while a bad stock market environment makes it more challenging.

v. A higher interest coverage ratio, which gauges how frequently EBIT can pay interest rate commitments. Because a higher interest coverage ratio means less risk for the business, it can choose to have a larger percentage of debt in its capital structure.

vi. The capital structure component is reduced when the rate of flotation cost is massive. A low capital structure is the result of a high equity flotation cost.

vii. It is challenging to select debt as a capital structure since higher interest rates result in higher debt costs.

4. The following variables have an impact on fixed capital requirements:

i. The type of business can influence fixed capital. Since S Limited, the company in question, is a manufacturing company, it will require a significant amount of fixed capital due to its lengthy working cycle.

ii. A company's operational scale also dictates whether it needs to invest in assets like buildings, machinery, land, and plants, all of which demand a significant amount of fixed capital.

iii. A business that is expanding or growing will require more fixed capital, which is what S Limited has.

The following variables will impact working capital requirements:

i. A company's working capital needs will change based on the kind of business it's engaged in. It will have a lengthy working cycle because it's a manufacturing company, and products must be operational capital.

ii. A significant amount of working capital will be needed because this business is operating on a huge scale.

iii. To increase its growth chances, the company wants to grow, which calls for greater working capital.

iv. Due to the strong demand for the product this company manufactures, it would have to increase production to meet demand. Consequently, a significant quantity of working capital will be required.