NCERT Solutions for Class 12

Business Studies

Chapter 9 – Financial Management

Multiple Choice:

1. The cheapest source of finance is

(a) debenture

(b) equity share capital

(c) preference share

(d) retained earning

Ans: (d) Retained earnings are the cheapest source of finance. Retained income is the portion of an organization's net income or profits that it keeps after paying dividends. An organization's retained earnings or profits can be reinvested for the purposes of expansion, modernization, and so on. It entails neither a cost nor a risk in terms of fundraising. Furthermore, unlike other forms of financing, it does not impose any repayment obligations.

2. 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

Ans: (c) Purchasing a new and modern plant to replace an old one is an investment decision. The decision to invest funds in order to earn the highest possible return is referred to as an investment decision. The decision to acquire a new plant is considered as a long-term investment decision that affects the business's long-term working and earning capacity. Working capital decisions, on the other hand, refer to investment decisions that affect the day-to-day operations of the business. Financing decisions, on the other hand, refer to decisions about where funds can be raised.

3. 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

Ans: (a) When corporate profits are taxed more heavily, debt becomes more affordable. This is due to the fact that interest due to debtors is deducted from total income before calculating the value of tax. As a result, as the value of taxes rises, the debt becomes more affordable.

4. 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

Ans: (a) Companies with greater potential for growth are more likely to pay lower dividends. This is due to the fact that companies with higher growth potential have larger investment plans and require more funds for investment. As a result, they retain a greater portion of their earnings to finance the necessary investment and, as a result, pay lower dividends.

5. 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

Ans: (b) Financial leverage is the percentage of debt in total capital. A favorable situation is defined as one in which the return on investment exceeds the cost of debt. In other words, as the ROI ie. Return on Investment increases, so does the earning per share, and financial leverage is said to be favorable.

6. 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

Ans: (c) A higher debt-equity ratio denotes a situation in which the proportion of debt to total capital is greater. This implies a greater level of financial risk. This is because, in the event of a debt, a business is required to pay interest and return principal to the debtors. As a result, increased debt raises the financial risk for the company.

7. 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

Ans: (a) A firm's working capital is the amount of current assets that exceed current liabilities. If a company has more working capital, it will have a higher current ratio (current assets over current liabilities), higher risk, and higher profits.

8. 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

Ans: (b) Current assets are assets that can be converted into cash or used to pay off liabilities within a 12-month period, i.e. one year. Current assets include cash, cash equivalents, inventories, debtors, bills receivables, and so on.

9. 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

Ans: (c) Financial planning seeks to ensure that the firm does not face a scarcity or glut (excess) of unusable funds. If funds are insufficient, the company will be unable to carry out the planned activities as well as commitments. On the other hand, if excess funds are available, it raises the cost of doing business and encourages waste. As a result, financial planning focuses on ensuring that just enough funds are available at the right time.

10. 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

Ans: (d) If a company pays a higher dividend per share, it is associated with higher earnings because only if they earn more will they be able to pay higher dividends; higher cash flow because dividend payments involve cash outflow; stable earnings because stable earnings indicate that the company is confident about future earning potentials as well as lower growth opportunities because it requires more capital.

11. A fixed asset should be financed through

(a) a long term liability

(b) a short term liability

(c) a mix of long and short term liabilities

Ans: (a) Fixed assets are assets that are invested in a company for a longer period of time, typically more than one year. Because these assets will have a long-term impact on the business's growth and profitability, they should be financed with long-term liabilities such as long-term loans, preference shares, retained earnings, and so on.

12. Current assets of a business firm should be financed through

(a) current liability only

(b) long-term liability only

(c) both types (i.e. Long and short liabilities)

Ans: (c) Current assets are assets that can be converted into cash or cash equivalents quickly and provide liquidity to a business. Both types of liabilities (short & long) can be used to finance a company's current assets.

Short Answer Type:

1. What is meant by capital structure?

Ans: The proportion of debt and equity used to fund a company's operations is referred to as its capital structure. In other words, capital structure is the proportion of debt and equity capital in the capital structure. It is difficult to say what type of capital structure is best for a company. The capital structure should be designed to maximize the wealth of equity shareholders by increasing the value of their equity shares. Alphabetically, the Capital structure is $\frac{\text{Debt}}{\text{Equity}}$ or $\frac{\text{Debt}}{\text{Equity}+\text{Debt}}$.

2. Discuss the two objectives of Financial Planning.

Ans: Financial planning entails creating a blueprint for a company's financial operations. It ensures that the appropriate amount of funds are available for organizational operations at the appropriate time. As a result, it ensures that everything runs smoothly. Firms use financial planning to forecast how much money will be needed at what time, taking into account growth and performance. The two primary goals of financial planning are as follows.

To ensure availability of funds whenever these are required: The primary goal of financial planning is to ensure that sufficient funds are available in the company for various purposes such as the purchase of long-term assets, meeting day-to-day expenses, and so on. It ensures that funds are available on time. In addition to availability, financial planning attempts to specify the sources of finance.

To see that firm does not raise resources unnecessarily: Excessive funding is just as bad as insufficient or scarce funding. If there is a surplus of funds, financial planning must invest it as wisely as possible, as keeping financial resources idle is a significant loss for an organization.

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

Ans: Financial risk occurs when a company is unable to meet its fixed financial charges, such as interest payments, preference dividends, and repayment obligations. In other words, it refers to the likelihood of the company failing to meet its fixed financial obligations. It manifests itself as the proportion of debt in the capital structure rises. This is due to the fact that the company is required to pay the interest charges on debt in addition to the principal amount. As a result, the greater the debt, the greater the payment obligations, and thus the greater the chances of payment default. As a result, increased use of debt entails increased financial risk for the company.

4. Define a 'current asset'. Give four examples of such assets.

Ans: Current assets are assets that are retained in the business with the intention of converting them anytime into cash within a short period of time i.e. one year. For example, goods are purchased with the intent of reselling them and earning a profit, debtors exist to convert them into cash, i.e., receive the amount from them, and bills receivable exist to receive cash against them. Current assets include short-term investments, debtors, stocks, and cash equivalents.

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

Ans: Financial management is the efficient acquisition, allocation, and utilization of a company's funds. It focuses on three major aspects of financial decisions: investment decisions, financial decisions, and dividend decisions.

1. Investment decisions include the purchase of fixed assets (called capital budgeting). Investment in current assets is also a type of investment decision that is referred to as a working capital decision.

2. Financial decisions - They concern the raising of funds from various sources, which will be determined by the decision on the type of source, the period of financing, the cost of financing, and the resulting returns.

3. Dividend decision - The finance manager must make a decision on net profit distribution. Net profits are typically divided into two categories:

4. Dividend for shareholders- A dividend, as well as the rate at which it will be paid, must be determined.

5. Retained profits- The amount of retained profits must be finalized, which will be determined by the enterprise's expansion and diversification plans.

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

Ans: Financial management is generally concerned with the procurement, allocation, and control of a company's financial resources. The goals could be

1. Ensure a consistent and adequate supply of funds to the concern.

2. To ensure adequate returns to shareholders, which will be determined by earning capacity, market price of the share, and shareholder expectations.

3. To ensure that funds are used as efficiently as possible. Once the funds are obtained, they should be used in the most efficient and cost-effective manner possible.

4. To ensure investment safety, funds should be invested in safe ventures to achieve an adequate rate of return.

5. To plan a sound capital structure-Capital should be composed in a sound and equitable manner so that a balance between debt and equity capital is maintained.

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

Ans: A company's working capital is defined as the excess of current assets (such as cash on hand, debtors, stock, and so on) over current liabilities. Working capital has an impact on a company's liquidity as well as its profitability. The liquidity of the business increases as the amount of working capital increases. However, because current assets provide a low return, increasing working capital reduces business profitability. For example, increasing the business's inventory increases its liquidity, but because the stock is kept idle, the profitability falls. Low working capital, on the other hand, impedes the day-to-day operations of the business. As a result, working capital should be allocated in such a way that a balance between profitability and liquidity is maintained.

Long Answer Type:

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

Ans: Every business must make a decision about investing in current assets, also known as working capital. Current assets are those that can be converted into cash or cash equivalents in a short period of time (less than or equal to one year). Working capital is divided into two broad categories: gross working capital and net working capital. Gross working capital (or simply working capital) is the amount of money invested in current assets. In contrast, net working capital refers to the amount of current assets that exceeds current liabilities. Current liabilities are those obligatory payments that are due for payment, such as bills payable, unpaid expenses, creditors, and so on. Net Working Capital is calculated by subtracting current assets from current liabilities. i.e.

$$\text{NWC} = \text{Current Assets - Current Liabilities}$$

The five determinants of working capital requirement are as follows:

(i) Type of Business: A firm's working capital requirements are determined by the nature of its business. A business that provides services or trades will not require a large amount of working capital. This is due to the fact that such organizations have a short operating cycle and no processing is done. The raw materials and outputs are the same in this case, and the sale occurs immediately. In contrast, a manufacturing firm has a long operating cycle, and raw materials need to be converted into finished goods before the final sale transaction occurs. As a result, such businesses require a large amount of working capital.

(ii) Scale of Operations: The scale of operations with which the firm deals is another factor determining the working capital requirement. When a company grows in size, its need for working capital grows as well. This is due to the fact that such businesses would need to keep a large stock of inventory and debtors on hand. In contrast, if the scale of operation is small, the working capital requirement will be lower.

(iii) Fluctuations in the Business Cycle: The working capital requirements of a firm change as the business cycle progresses. During a boom period, the market thrives, resulting in increased sales, production, stock, and debtors. As a result, the need for working capital rises during this period. In contrast, during a depression, there is low demand, reduced production and sales, and so on. As a result, the working capital requirement is reduced.

(iv) Production Cycle: The time span between the transformation of raw materials into finished goods is referred to as the production cycle. The length of the production cycle varies by firm, and this determines the amount of working capital required. If a company has a longer production cycle, that is, a long time between receiving raw materials and converting them into finished goods, it will have a high working capital requirement due to inventories as well as related expenses. On the other hand, if the production cycle is short, the working capital requirement will be low.

(v) Prospects for Growth: Greater growth and expansion are associated with increased production, sales, inputs, and so on. As a result, companies with higher growth prospects require more working capital, and vice versa.

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

Ans: The capital structure of a company refers to the combination of various financial sources used to raise funds. The sources of raising funds can be divided into two categories based on ownership: borrowed funds and owners' funds. Borrowed funds can take the form of loans, debentures, bank borrowings, public deposits, and so on. Owners' funds, on the other hand, take the form of reserves, preference share capital, equity share capital, retained earnings, and so on. Thus, capital structure is considered as the combination of borrowed funds as well as funds contributed by the owners. To keep things simple, all borrowed funds are referred to as debt, while all owner funds are referred to as equity. Thus, capital structure refers to the company's use of a combination of debt and equity. The company's capital structure is determined by the risks and returns of the various alternative sources. Both debt and equity have their own set of risk and profitability considerations. While debt is a less expensive source of finance, it carries a higher risk; on the other hand, while equity is more expensive, it is less risky. Debt has a lower cost because lenders face less risk because they earn a guaranteed amount of return. As a result, they require a low rate of return, which lowers the firm's costs. Furthermore, interest on debt is deductible from taxable income. As a result, debt can provide a higher return at a lower cost. Raising funds through equity is a costly affair due to the floatation cost. Dividends are also paid to shareholders from after-tax profits. Though debt is less expensive, more debt increases financial risk. This is because debt entails obligated payments to lenders. Any failure to pay the interest on time may result in the firm's liquidation. In contrast, there is no such requirement in the case of dividend payments to shareholders. As a result, high debt is associated with high risk. The return offered by various sources is another factor that influences capital structure selection. The value of earnings per share is determined by the return offered by each source. A company's earnings per share increase when it uses a lot of debt (this situation is called Trading on Equity). This is due to the fact that as debt grows, the difference between Return on Investment and the cost of debt grows, as does the EPS. As a result, there is a high return on debt. However, while higher debt yields higher returns, it also increases the company's risk. As a result, the capital structure decision should be made with great care, taking into account the return and risk involved.

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

Ans: Yes, capital budgeting is a critical decision that must be carefully considered. It has the potential to transform a company's financial fortunes. Capital budgeting decisions are those concerning the allocation of fixed capital to various projects. Investment decisions involving the acquisition of new assets, expansion, modernization, and replacement are examples of such decisions. Long-term investments include the purchase of plant and machinery, furniture, land, and buildings, as well as expenditures for the launch of a new product, modernization, and advertising, among other things. They have long-term consequences for the business and are irreversible except at a high cost. They have an impact on a company's long-term growth, profitability, and risk. The following factors highlight the significance of capital budgeting decisions:

(i) Long-Term Implications: Investing in capital assets (long-term assets) yields a future return. As a result, they have an impact on a company's future prospects. The long-term growth prospects of a company are determined by the capital budgeting decisions it makes.

(ii) Large Amount of Funds: Investing in fixed capital necessitates a large sum of money. This makes capital budgeting decisions even more critical, as large amounts of funds remain blocked for an extended period of time. Once made, these decisions are difficult to reverse. Thus, capital budgeting decisions must be carefully considered after a thorough examination of the total amount of funds required and the sources from which they are to be raised.

(iii) High Risk: Fixed assets involve a large amount of money and, as a result, a large amount of risk. Such decisions are risky because they have an impact on the company's long-term viability. For example, deciding whether to purchase new machinery involves a risk in terms of whether the return on investment will be greater than the cost of the machinery.

(iv) Irreversible Decisions: Once made, these decisions are final. Reversing a capital budgeting decision comes at a high cost. This is due to the fact that once a large investment has been made in a project, withdrawing it would result in significant losses.

4. Explain the factors affecting the dividend decision.

Ans: A company's dividend decision determines how much of its profits will be distributed as dividends to the shareholders as well as how much will be kept as retained earnings. The following are the factors that influence dividend decision-making.

1. Legal prerequisites there is no legal requirement for a corporation to distribute dividends. However, there are some legal restrictions on how dividends are distributed. Dividend payments are governed by three basic rules. There are three of them: the net profit rule, the capital impairment rule, and the insolvency rule.

2. The firm's liquidity situation the firm's liquidity position also has an impact on dividend payout. Even if there are sufficient retained earnings, the company may be unable to pay a cash dividend if the earnings are not kept in cash.

3. The requirement for repayment to meet its investment needs, a company may use a variety of debt financing methods. These debts must be repaid when they reach maturity. When a company must retain profits in order to repay debt, its dividend payment capacity decreases.

4. Expected annual rate of return if a firm's expected rate of return on new investment is relatively higher, the firm prefers to retain earnings for reinvestment rather than distributing cash dividends.

5. Earnings stability if a company's earnings are relatively stable, it is more likely to pay a relatively larger dividend than a company with relatively fluctuating earnings.

6. Desire for power when the need for additional financing arises, the firm's management may prefer not to issue additional common stock due to concerns about dilution of control over management. As a result, a company prefers to retain more earnings in order to meet additional financing needs, which reduces dividend payment capacity.

7. Gaining access to the capital market if a company has easy access to capital markets for additional financing, it does not need to retain more earnings. As a result, a company's dividend payment capacity increases.

8. Individual tax situation of shareholders because dividend income is taxed more heavily in a closely held company, stockholders prefer a lower cash dividend. Stockholders in higher tax brackets prefer capital gains over dividend gains.

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

Ans: Trading on equity is the practice of increasing the proportion of debt in the capital structure in order to increase earnings per share. When the rate of return on investment exceeds the rate of interest on borrowed funds, a company resorts to trading on equity. In other words, when the company's financial leverage is favorable, it resorts to Trading on Equity. Earnings per share rise as the difference between the return on investment and the rate of interest on debt rises.

The following example explains the application of Trading on Equity in detail. Assume a company is in one of two situations. In situation I, a fund of Rs 5,00,000 is raised through equity capital, while in situation II, the same amount is raised through two sources: Rs 2,00,000 through equity capital and the remaining Rs 3,00,000 through borrowings. Assume the tax rate is 30% and the interest rate on borrowings is 10%. In both cases, earnings per share (EPS) are calculated as follows.

	Situation I	**Situation II**
Earnings before interest and tax (EBIT)	1,00,000	1,00,000
Interest		30,000

Earnings before tax (EBT)	1,00,000	70,000
Tax	30,000	21,000
Earnings after tax (EAT)	70,000	79,000
No. of equity shares	50,000	20,000
$\text{EPS} = \frac{\text{EAT}}{\text{Number of equity share}}$	$\frac{70,000}{50,000} = 1.4$	$\frac{79,000}{20,000} = 3.95$

Clearly, the EPS in the second situation is greater than the EPS in the first. In the second case, the company takes advantage of Trading on Equity to increase EPS. In this case, the return on investment is calculated as

$$\frac{\text{Earnings Before Tax (EBT)}}{\text{Total Investment}} = \frac{1,00,000}{5,00,000}$$

$$= 20\%$$

While the interest rate on borrowings is 10% As a result, trading on equity is profitable. It should be noted, however, that Trading on Equity is profitable and should be used only when the return on investment exceeds the interest on borrowed funds. Trading on equity should be avoided if the return on investment is less than the rate of interest to be paid. Assume the company earns Rs 25,000 instead of Rs 100,000. In this case, the EPS is computed as follows.

	Situation I	**Situation II**
Earnings before interest and tax (EBIT)	40,000	40,000
Interest		10,000
Earnings before tax (EBT)	25,000	10,000
Tax	30,000	3,000
Earnings after tax (EAT)	70,000	7,000

No. of equity shares	50,000	20,000
$EPS = \frac{EAT}{\text{Number of equity share}}$	$\frac{70,000}{50,000} = 1.4$	$\frac{79,000}{20,000} = 3.95$.

Clearly, the EPS in Situation II falls in this case. The return on investment is only 8% in this case $\frac{\text{Earnings Before Tax (EBT)}}{\text{Total Investment}} = \frac{40,000}{5,00,000}$ while the interest rate on borrowings is 10%.

As a result, in this situation, trading on equity is unfavorable and should be avoided. As a result, a company can use Trading on Equity if it is making a lot of money and wants to increase its earnings per share (EPS) by borrowing more money.