9 Financial Management

Fastrack Revision

- **Business Finance:** Money or funds required for a business for carrying out its operations is called business finance. It includes acquisition of funds, use of funds and distribution of profits.
- **Financial Management:** It includes those business activities that are concerned with acquisition and conservation of capital funds in meeting the financial needs and overall objectives of a business enterprise.

  "Financial management is an area of financial decision-making, harmonising individual motives and enterprise goals." —***Weston and Brigham***
- **Aims of Financial Management**
  - Reduce cost of funds procured
  - Keep risks under control
  - Achieve effective deployment of fund
  - Ensure availability of sufficient funds while avoiding idle funds
- **Role/Importance of Financial Management**
  - **Amount of Long-term and Short-term Financing:** Financial management takes decision to determine the capital requirements of business, both long-term and short-term.
  - **Determination of Capital Structure:** Financial management helps to determine the capital structure of the company and determine the sources from where required capital will be raised keeping in view the risk and return matrix.
  - **Allocation of Fund:** Financial management helps to decide about the allocation of funds into profitable avenues, keeping in view their safety as well.
  - **Financial Control:** Financial management helps to exercise overall financial controls in order to promote safety, profitability and conservation of funds.
- **Objectives of Financial Management**
  - **Primary Objective:** The goal of a firm should be to maximise the wealth of owners in the long run. Increase in the market price of shares is an indicator of the financial health of a firm.
  - **Other Objectives:** These includes objectives which help a firm to achieve the primary objectives. These are:
    - Ensure availability of funds at reasonable costs.
    - Ensure effective utilisation of funds.
    - Ensure safety of funds through creation of reserves.
    - Maintain liquidity and solvency.

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Continuous increase in prices of shares and higher dividends help to achieve the financial management's basic objective of 'wealth maximisation'.

- **Financial Decisions:** It refers to the decisions concerning financial matters of a business firm. It is concerned with three broad decisions:

Financial Decisions
- Investment Decision
  - Capital Budgeting
  - Working Capital
- Financing Decision
  - Equity
  - Debt
  - Financial Institutions
- Dividend Decision
  - Retained Earnings
  - Distribution of Dividends

- **Investment Decision**
  - It seeks to determine as to how the firm's funds are invested in different assets.
  - It helps to evaluate new investment proposals and select the best option on the basis of associated risk and return.
  - Investment decision may be long-term or short-term.
  - A long-term investment decision is called capital budgeting decision and short-term investment decision is called working capital decision.
- **Factors Affecting Investment Decision**
  - **Cash Flows of the Project:** The expected cash flow from the proposed project should be carefully analysed. These cash flows are in the form of a series of cash receipts and payments over the life of an investments.
  - **Rate of Return:** The expected rate of return should be carefully studied in terms of risk associated with the proposed project.
  - **Investment Criteria:** The decision to invest in a particular project involves a number of calculations regarding the amount of investment, interest rate, cash flows and rate of return.
- **Types of Investment Decision**
  - **Capital Budgeting Decision/Fixed Capital/Long-term Investment Decision**
    - It refers to the amount of capital required for investment in fixed assets or long-term projects which will yield return and influence the earning capacity of business over a period of time.

- It affects the value of assets, competitiveness and profitability of business.

➤ **Working Capital/Short-term Investment Decision**
- It refers to the amount of capital required to meet day-to-day running of business.
- It relates to decisions about cash, inventory and receivables.
- It affects both liquidity and profitability of business.

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Investment decisions affect the day-to-day working and liquidity as well as profitability of a business.

▶ **Financing Decision**

➤ These are decisions related to raising of funds from various long-term sources.

➤ Financing decisions involve determining various sources of finance, funds to be raised from each source and cost associated with each source.

➤ Firm needs a judicious mix of debt and equity as they can be compared on the basis of factors such as interest/dividend payout and repayment of principle, tax deductibility, risk and floatation costs.

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Debt involves 'Financial Risk' = Risk of default on payment of interest on borrowed funds and the repayment of the principle amount whereas shareholder's funds involve no fixed commitment w.r.t. payment of returns or repayment of capital.

▶ **Factors Affecting Financing Decision**

➤ **Cost:** The cost of raising funds from different sources are different. The cheapest source should be selected.

➤ **Risk:** The risk associated with different sources is different. More risk is associated with borrowed funds as compared to owners fund.

➤ **Flotation Cost:** The costs involved in issuing securities such as broker's commission, underwriter's fees, expenses on prospectus, etc., are called flotation costs. Higher the flotation cost, less attractive is the source of finance.

➤ **Cash Flow Position of the Business:** In case, the cash flow position of a company is good enough, then it can easily use borrowed funds and pay interest on time.

➤ **Control Considerations:** In case, the existing shareholders want to retain the complete control of business, then finance can be raised through borrowed funds but when they are ready for dilution of control over business, equity can be used for raising finance.

➤ **State of Capital Markets:** During boom period, finance can easily be raised by issuing shares but during depression period, raising finance by means of debt is easy.

➤ **Period of Finance:** For permanent capital requirement, equity shares must be issued as they are not to be paid back and for long and medium-term requirement, preference shares or debentures can be issued.

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Borrowed funds are considered the cheapest source of finance as interest paid is a deductible expense for computation of tax liability.

▶ **Dividend Decision:** Dividend decision relates to disposal of profit by deciding the proportion of profit which is to be distributed among shareholders and the proportion of profit which is to be retained in the business for meeting the investment requirements.

▶ **Factors Affecting Dividend Decision**

➤ **Amount of Earnings:** If the earnings of the company are high, dividends are paid at a higher rate and *vice-versa*.

➤ **Stability of Earnings:** If the earnings of a company are stable, it is likely to pay higher dividends.

➤ **Stability of Dividend:** A company is more likely to maintain a stable dividend rate over a period of time, unless there is a significant change in its earnings. If the shareholders prefer regular income in the form of dividends, the company is likely to maintain a stable dividend payout rate.

➤ **Taxation Policy:** If the tax rate is high, the company is likely to pay less dividend.

➤ **Stock Market Reaction:** If a company wants positive reactions at stock market, it is likely to pay higher dividends.

➤ **Access to Capital Market:** A large company can access funds easily from capital market as per its requirements, therefore, it is likely to retain lesser profits and is likely to pay higher dividends.

➤ **Legal Constraint:** The legal constraint should be considered at the time of dividend payment by a company.

➤ **Contractual Constraints:** The contractual constraints may also affect the dividend payment by a company.

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The decision regarding dividend should be taken keeping in view the overall objective of maximising shareholders' wealth.

▶ **Financial Planning:** It involves preparation of a financial blueprint of an organisation. It is the process of estimating the fund requirement of a business and determining the possible sources from which it can be raised.

▶ **Objectives of Financial Planning**

➤ To ensure availability of funds whenever they are required.

➤ Estimation of the funds required for different purposes (long-term assets/working capital requirement):
- Estimate the time at which these funds need to be made available.
- Specify sources of these funds.

➤ To see that the firm does not raise resources unnecessarily:
- Shortage of funds => firm cannot meet its payment obligations.
- Surplus funds => do not earn returns but adds to costs.

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Financial planning aims to match funds requirements with their availability.

- **Importance of Financial Planning**
  - It ensures smooth running of a business enterprise by ensuring availability of funds at the right time.
  - It helps in anticipating future requirements of funds and evading business shocks and surprises.
  - It facilitates coordination among various departments of an enterprise, like marketing and production functions, through well-defined policies and procedures.
  - It increases the efficiency of operations by curbing wastage of funds, duplication of efforts and gaps in planning.
  - It helps to establish a link between the present and the future.
  - It provides a continuous link between investment and financing decisions.
  - It facilitates easy performance as evaluation standards are set in clear, specific and measurable terms.
- **Capital Structure:** It refers to proportion of debt and equity used for financing business operations.

  On the basis of ownership, sources of business finance are classified into two categories:
  - Owners' Funds (Equity)
  - Borrowed Funds (Debt)

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Financial Leverage/Ratio of Debt and Equity/Trading on Equity

(i) $\frac{Debt}{Equity}$ *or* *(ii)* $\frac{Debt}{Debt + Equity}$

[When debt is taken as the proportion of total capital]

- **Factors Affecting Capital Structure**
  - **Cash Flow Position**: The size of the projected cash flow must be considered before deciding the capital structure of the firm. If there is sufficient cash flow, debt can be used. It must cover fixed payment obligations w.r.t:
    - Normal business operations.
    - Investment in fixed assets.
    - Meeting debt service commitments as well as provide a sufficient buffer.
  - **Interest Coverage Ratio (ICR)**
    - It refers to number of times EBIT of a company covers the interest obligation.
    - Interest Coverage Ratio = EBIT/Interest Expense, where EBIT = Earnings Before Interest and Tax.
    - Higher the interest coverage ratio lower shall be the risk of the company failing to meet its interest payment obligations.
    - Low interest coverage ratio => debt ≠ used.
  - **Debt Service Coverage Ratio (DSCR)**
    - It takes care of the drawback of ICR.
    - Debt Service Coverage Ratio (DSCR) = Profit after tax + Depreciation + Interest + Non-cash exp. + Preference dividend + Interest + Repayment obligation.
    - A higher debt service coverage ratio, in which the cash profits generated by the operations are compared with the total cash required for the service of debt and the preference share capital, the better will the ability of the firm to increase debt component in the capital structure.
    - Low debt service coverage ratio => debt ≠ used.
  - **Return on Investment:** If return on investment of the company is higher, the company can choose to use trading on equity to increase its EPS (Earning Per Share), *i.e.* its ability to use debt is greater.

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EPS does not always rise with increase in debt. It is possible only when Return on Investment (ROI) is more than cost of debt.

  - **Cost of Debt:** More debt can be used if cost of debt is low. However, in case of higher cost of debt, company prefers more of equity.
  - **Tax Rate:** A higher tax rate makes debt relatively cheaper and increases its attraction as compared to equity.
  - **Cost of Equity**
    - When the company uses more debt, the financial risk faced by equity holders increase so their desired rate of return increases.
    - If debt is used beyond a point, cost of equity may go up sharply and share price may decrease in spite of increased EPS.
  - **Floatation Cost**
    - Cost of public issue is more than the floatation cost of taking a loan.
    - The floatation cost may affect the choice between debt and equity and hence the capital structure.
  - **Risk Consideration:** The total risk of business depends upon both the business risk and financial risk. If a firm's business risk is lower, its capacity to use debt is higher and *vice-versa*.
  - **Flexibility:** If the firm uses its debt potential, it loses the flexibility to use more debt. To maintain flexibility, the company must maintain some borrowing power to take care of unforeseen circumstances.
  - **Control:** Debt normally does not cause dilution of control whereas a public issue makes the firm vulnerable to takeovers. To retain control, firm should issue debt.
- **Fixed Capital:** It refers to investment in long-term assets. For example, plant and machinery, furniture, land and building, vehicles, etc. The decisions taken to invest in fixed assets are known as Investment Decision or Capital Budgeting Decisions.
- **Factors Affecting Requirement of Fixed Capital**
  - **Nature of Business:** Manufacturing organisation require huge investment in fixed assets and thus, huge fixed capital is required for them but trading organisation need less fixed capital as they are not required to purchase plant and machinery, etc.

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Fixed assets should always be financed through long-term sources and never from short-term sources.

- **Scale of Operations:** An organisation operating on large scale requires more fixed capital as compared to an organisation operating on small scale.
- **Choice of Technique:** An organisation using capital intensive techniques requires more investment in plant and machinery as compared to an organisation using labour intensive techniques.
- **Technology Upgradation:** Organisations using assets which become obsolete faster require more fixed capital as compared to other organisations.
- **Growth Prospects:** Companies having more growth plans require more fixed capital. In order to expand production capacity, more plant and machinery are required.
- **Diversification:** In case, a company goes for diversification, then it will require more fixed capital to invest in fixed assets like plant and machinery.
- **Distribution Channels:** The firm which sells its product through wholesalers and retailers requires less fixed capital.
- **Collaboration:** If companies are under collaboration in joint venture, then they need less fixed capital as they share plant and machinery with their collaborators.

▶ **Working Capital:** The funds needed to meet the day-to-day operations of the business is called working capital. It is also defined as excess of current assets over current liabilities.

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- *Current assets refers to those assets, which are expected to get converted into cash within a period of one year.*
- *Current liabilities refers to those liabilities which are payable within a period of one year.*

▶ **Factors Affecting Working Capital Requirements of an Organisation**

- **Nature of Business:** A trading organisation needs a lower amount of working capital as compared to a manufacturing organisation, as trading organisation undertakes no processing work.
- **Scale of Operations:** An organisation operating on large scale will require more inventory and thus, its working capital requirement will be more as compared to small organisation.
- **Business Cycle:** In the time of boom, more production will be undertaken and so more working capital will be required during that time as compared to depression.
- **Seasonal Factors:** During peak season, demand of a product will be high and thus, high working capital will be required as compared to lean season.
- **Credit Allowed:** If credit is allowed by a concern to its customers, then it will require more working capital but if goods are sold on cash basis, then less working capital is required.
- **Credit Availed:** If a firm is able to purchase raw materials on credit from its suppliers, then less working capital will be required.
- **Inflation:** Working capital requirement is also determined by price level changes. For example, during inflation prices of raw material, wages also rise resulting in increase in working capital requirements.
- **Operating Cycle:** It is the time duration starting from the procurement of goods or raw materials and ending with the sales realisation. The length and nature of the operating cycle may differ from one firm to another depending upon the size and nature of the firm.

Practice Exercise

Multiple Choice Questions

Q 1. 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. dividend decision

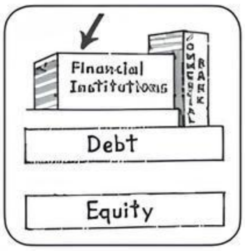
Q 2. Higher working capital usually results in:

a. higher current ratio, higher risk and higher profits
b. lower current ratio, higher risk and profits
c. higher equitably, lower risk and lower profits
d. lower equitably, lower risk and higher profits

Q 3. Moga Ltd. sells goods on cash. The company requires .... working capital.

a. more
b. less
c. nil
d. None of these

Q 4. Which of the following financial decision illustrated in the given picture?



a. Dividend decision
b. Financial planning
c. Financing decision
d. Investment decision

Q 5. ABC Ltd. earned high profit in the current year. However, Raj, the finance manager of the company, thinks that it is better to declare smaller dividend

as he is unsure about the earning potential of the company in the coming years. Raj's choice of dividend decision is based on which of the factor that affect it?

a. Growth opportunities
b. Stability of dividend
c. Stability of earnings
d. Amount of earnings

Q 6. Gross working capital refers to:

a. investment in fixed assets
b. investment in current assets
c. Both a. and b.
d. None of the above

Q 7. Higher dividends per share is associated with:

a. high earnings, high cash flows, unusual earnings and higher growth opportunities
b. high earnings, high cash flows, stable earnings and higher 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

Q 8. When stock market is bullish, company must raise funds through:

a. debt
b. equity
c. Both a. and b.
d. None of these

Q 9. Which of the following is not concerned with capital budgeting decision?

a. Opening a new branch
b. Launching a new product
c. Purchase of machinery
d. Amount receivable from debtors

Q 10. Financial leverage is called favourable if:

a. return on investment is lower than cost of debt
b. ROI is higher than cost of debt
c. debt is nearly available
d. the degree of existing financial leverage is low

Q 11. Situation of favourable financial leverage arise when:

a. ROI = Cost of Debt
b. ROI > Cost of Debt
c. ROI < Cost of Debt
d. None of these

Q 12. If return on investment is more than cost of debt, then earnings per share will .... with .... in debt.

a. rise, decrease
b. fall, increase
c. rise, increase
d. fall, decrease

Q 13. Current assets of a business firm should be financed through:

a. current liability only
b. long-term liability only
c. partly from both types *i.e.*, long and short-term liabilities
d. None of the above

Q 14. Return on investment is computed as:

a. $\frac{\text{Total Investment}}{\text{EBIT}} \times 100$
b. $\frac{\text{EBIT}}{\text{EBT}} \times 100$
c. $\frac{\text{EBIT}}{\text{Total Investment}} \times 100$
d. $\frac{\text{EBT}}{\text{Total Investment}} \times 100$

Q 15. Company can raise more .... in case of higher DSCR, while more of .... is preferred in case of lower DSCR.

a. debt, equity
b. equity, debt
c. working capital, fixed capital
d. fixed capital, working capital

Q 16. "Solar Ltd. took a loan from Merculus Finance Company. Merculus has imposed certain restrictions on Solar Ltd. on payment of dividends in future." Which factor affecting dividend decision is being highlighted in the given case?

a. Growth opportunities
b. Legal constraints
c. Contractual constraints
d. Stock market reaction

Q 17. ABC Ltd. has debt equity ratio of 3 : 1 whereas XYZ Ltd. has debt equity ratio of 1 : 1. Name the advantage ABC Ltd. will have over XYZ Ltd., when the rate of interest is lower than the rate of return on investment of the company.

a. Trading on equity
b. Low risk
c. Low cost of equity
d. Greater flexibility

Q 18. The Board of Directors of Medex Pharma Ltd., decided to issue debentures worth ₹40 lakh in order to finance a major research and development project. This would increase the debt equity ratio from 1 : 1 to 2 : 1. However, at the same time it would increase the earnings per share.
The reason that will justify the above situation is:

(CBSE SQP 2023-24)

a. Unfavourable financial leverage, as the financial risk will be higher.
b. Unfavourable financial leverage, as return on investment is lower than the cost of debt.
c. Favourable financial leverage as debt is easily available.
d. Favourable financial leverage, as return on investment is higher than cost of debt.

Q 19. The time gap between placing an order and actual receipt of material by the firm is termed as:

a. Operating cycle
b. Working capital
c. Production cycle
d. None of these

Q 20. Net working capital will be ...., if current assets are of ₹5,00,000 and current liabilities are of ₹1,00,000.

a. ₹6,00,000
b. ₹5,00,000
c. ₹4,00,000
d. None of these

Q 21. .... refers to the increase in profit earned by the equity shareholders due to the presence of fixed financial charges like interest. *(CBSE 2023)*

a. Capital structure
b. Earning per share
c. Trading on equity
d. Return on investment

Q 22. **Montex Ltd. earned a net profit of ₹4,000 crore. The finance manager of the company wants to decide how to appropriate these profits. Which financial decision will help him in deciding it?**

a. Financing decision
b. Investment decision
c. Dividend decision
d. All of these

Q 23. **Which of the following is not a factor affecting capital structure of a company?** *(CBSE 2023)*

a. Cost of debt
b. Growth opportunities
c. Cash flow position
d. Interest coverage ratio

Q 24. **Match the factors affecting fixed capital requirements given in the Column I with their explanations given in Column II:** *(CBSE 2023)*

Column I	Column II
A. Nature of business	(i) A trading organisation needs lower investments in fixed assets as compared to a manufacturing organisation.
B. Technology upgradation	(ii) A textile manufacturing company is installing a cement manufacturing plant and thus, its investments in fixed assets is increasing.
C. Diversification	(iii) A capital-intensive organisation requires higher investments in fixed assets as compared to labour-intensive organisation.
D. Choice of technique	(iv) Mobile phones became obsolete faster and are replaced much sooner than furniture or many other assets. Hence, these type of businesses require more fixed capital

	A	B	C	D
a.	(i),	(iv),	(ii),	(iii)
b.	(ii),	(iii),	(iv),	(i)
c.	(iii),	(ii),	(i),	(iv)
d.	(iv),	(i),	(iii),	(ii)

Q 25. **Match the items given under Column I with the suitable statements under Column II.**

Column I	Column II
A. Capital structure	(i) It is concerned with optional procurement as well as the usage of finance.
B. Financial management	(ii) It refers to the mix between owners and borrowed funds.
C. Working capital decisions	(iii) The proposition of debt in the overall.
D. Financial leverage	(iv) Short-term investment decisions.

	A	B	C	D
a.	(ii),	(i),	(iv),	(iii)
b.	(i),	(ii),	(iii),	(iv)
c.	(iii),	(iv),	(ii),	(i)
d.	(ii),	(iii),	(iv),	(i)

Q 26. **Current assets get converted into .... within an accounting year.**

a. cash
b. shares
c. debentures
d. None of these

Q 27. **Borrowings @ 10% and tax rate @ 30% means the after tax cost of debt is:**

a. 20%
b. 7%
c. 3%
d. 10%

Q 28. **Financial planning provides a link between .... and .... decisions.**

a. investment, dividend
b. financing, dividend
c. investment, financing
d. investment, working capital

Q 29. **Which decision is concerned about the quantum of finance to be raised from various long-term sources?**

a. Investment decision
b. Financing decision
c. Dividend decision
d. Capital budgeting decision

Q 30. **If a company acquires assets on lease, then it requires:**

a. less fixed capital
b. more fixed capital
c. less working capital
d. more working capital

Q 31. **Money is engaged in transport business and transport fruits and vegetables to different states. His business requires:**

a. more working capital
b. less working capital
c. no working capital
d. more fixed capital

Q 32. **Statement I: Debt is more risky as compared to equity.**
Statement II: Payment of dividend and return of principal amount is obligatory for the business in case of equity.
Choose the correct option from the options given below:

a. Statement I is true and II is false.
b. Statement II is true and I is false.
c. Both the statements are true.
d. Both the statements are false.

Q 33. **Statement I: Collaboration of an organisation with another organisation reduces the need of fixed capital.**
Statement II: Availability of leasing facilities reduces the fixed capital requirement of company.
Choose the correct option from the options given below:

a. Statement I is true and II is false.
b. Statement II is true and I is false.
c. Both the statements are true.
d. Both the statements are false.

Q 34. **Statement I: Less working capital is required in a highly competitive market.**
Statement II: Competition forces a firm to adopt strict credit terms.
Choose the correct option from the options given below:

a. Statement I is true and II is false.
b. Statement II is true and I is false.
c. Both the statements are true.
d. Both the statements are false.

Q 35. Statement I: Financial management process begins with the financial planning and decisions.

Statement II: Financial management process does not need feedback system.

Choose the correct option from the options given below:

a. Statement I is true and II is false.
b. Statement II is true and I is false.
c. Both the statements are true.
d. Both the statements are false.

Assertion & Reason Type Questions

Directions (Q. Nos. 36-45): *There are two statements marked as Assertion (A) and Reason (R). Read the statements and choose the appropriate option from the options given below:*

a. Both Assertion (A) and Reason (R) are true and Reason (R) is the correct explanation of Assertion (A).
b. Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
c. Assertion (A) is true, but Reason (R) is false.
d. Assertion (A) is false, but Reason (R) is true.

Q 36. Assertion (A): Effective and efficient management of finance enables the firm to prosper and grow.

Reason (R): Without adequate finance, business can survive only for a short time.

Q 37. Assertion (A): A sound financial plan should be rigid.

Reason (R): In a financing programme, flexibility for future should not be allowed.

Q 38. Assertion (A): Financial planning means estimating the requirements of a business and determining source of funds.

Reason (R): Capital structure refers to the combination of owners and borrowed funds.

Q 39. Assertion (A): Business finance refers to the money required for carrying out business activities.

Reason (R): Financing decisions involves careful selection of assets, in which funds are to be invested.

Q 40. Assertion (A): Primary aim of financial management is to maximise shareholder's wealth.

Reason (R): Company's funds belong to the shareholders and the return earned by them determine their market value and price.

Q 41. Assertion (A): Trading on equity raises the return of equity shareholder.

Reason (R): Cost of debt is lower than cost of equity and interest paid on debt is a deductible expense.

Q 42. Assertion (A): The primary objective of financial management is to maximise wealth of equity shareholders.

Reason (R): Investment decision is concerned with investment of firm's funds in different assets.

Q 43. Assertion (A): Higher the lead time, lower is the amount of working capital requirement.

Reason (R): If the raw material is available freely and continuously, then less working capital is needed as less inventory has to be maintained.

Q 44. Assertion (A): A transport service provider needs less working capital.

Reason (R): A service firm sells more on cash basis and do not have to maintain inventory.

Q 45. Assertion (A): More working capital is required in highly competitive market.

Reason (R): Competition forces a firm to adopt strict credit terms.

Answers

1. (c) investment decision
2. (a) higher current ratio, higher risk and higher profits
3. (b) less
4. (c) Financing decision
5. (b) Stability of dividend
6. (b) investment in current assets
7. (c) high earnings, high cash flows, stable earnings and lower growth opportunities
8. (b) equity
9. (d) Amount receivable from debtors
10. (b) ROI is higher than cost of debt
11. (b) ROI>Cost of Debt
12. (c) rise, increase
13. (c) partly from both types *i.e.*, long and short-term liabilities
14. (c) $\frac{\text{EBIT}}{\text{Total Investment}} \times 100$
15. (a) debt, equity
16. (c) Contractual constraints
17. (a) Trading on equity
18. (d) Favourable financial leverage, as return on investment is higher than cost of debt.
19. (a) Operating cycle
20. (c) ₹4,00,000
21. (c) Trading on equity
22. (c) Dividend decision
23. (c) Cash Flow Position
24. (a) A-(i), B-(iv), C-(ii), D-(iii)
25. (a) A-(ii), B-(i), C-(iv), D-(iii)
26. (a) cash
27. (b) 7%
28. (c) investment, financing
29. (b) Financing decision
30. (a) less fixed capital
31. (b) less working capital
32. (a) Statement I is true and II is false.
33. (c) Both the statements are true.
34. (d) Both the statements are false.
35. (a) Statement I is true and II is false.

36. (c) Assertion (A) is true, but Reason (R) is false.

37. (b) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).

38. (b) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).

39. (c) Assertion (A) is true, but Reason (R) is false.

40. (a) Both Assertion (A) and Reason (R) are true and Reason (R) is the correct explanation of Assertion (A).

41. (a) Both Assertion (A) and Reason (R) are true and Reason (R) is the correct explanation of Assertion (A).

42. (b) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).

43. (d) Assertion (A) is false, but Reason (R) is true.

44. (a) Both Assertion (A) and Reason (R) are true and Reason (R) is the correct explanation of Assertion (A).

45. (c) Assertion (A) is true, but Reason (R) is false.

Case Study Based Questions

Case Study 1

Read the extract given below and answer the questions on the basis of the same:

'Shubhi Consumer Goods' is a leading consumer goods chain with a network of 50 stores primarily across Kolkata, Delhi and Mumbai. It was started by Shubhi in 1998. It has a large market share in Kolkata, Delhi and Mumbai. Looking for an opportunity to expand, it has decided to open a new branch in Kerala. It has to decide on what new resources it will invest in so that it is able to earn the highest possible returns. It also has to decide on how this project will get funded. Fund requirements from various sources will be ascertained in such a way that there strikes a balance between them so as to increase the shareholders wealth. Sunny, after assessing the cash flow position of the company, evaluated the cost of different sources of finance and compared the risk associated with each source as well as the cost of raising funds. Thus, he arranged the funds after taking all this into consideration.

The new branch finally got opened in Kerala. It did very well in its initial years. It has successfully completed 5 years of excellent performance.

It has also generated good profits in the 6th year of its operation. There is availability of enough cash in the company and good prospects for growth in future.

It has many shareholders who prefer to receive a regular income from their investments. The company, thus, has to decide how much of the profits should be retained and how much has to be distributed to the shareholders.

Q 1. Which financial decision is highlighted in the lines: "It has to decide .... returns."

a. Investment decision b. Financing decision
c. Dividend decision d. None of these

Q 2. Which financial decision is mentioned in the lines: "Sunny .... into consideration."

a. Investment decision b. Financing decision
c. Dividend decision d. None of these

Q 3. Which financial decision is mentioned in the lines: "The company, thus, has .... shareholders."

a. Investment decision b. Financing decision
c. Dividend decision d. None of these

Q 4. Which decision is also called 'Capital Budgeting Decision'?

a. Investment decision b. Financing decision
c. Dividend decision d. None of these

Answers

1. (a) **2.** (b) **3.** (c) **4.** (a)

Case Study 2

Read the extract given below and answer the questions on the basis of the same:

Mr A. Bose is running a successful business. Mr Bose is owner of RK Cement Ltd. Mr Bose decided to expand his business by acquiring a Steel Factory. This required an investment of ₹ 80 crore. To seek advice in this matter, he called his financial advisor, Mr T. Ghosh, who advised him about the judicious mix of equity (40%) and debt (60%). Employ more of cheaper debt may enhance the EPS. Mr. Ghosh also suggested him to take loan from a financial institution as the cost of raising funds from financial institutions is low. Though, this will increase the financial risk but will also raise the return to equity shareholders. He also appraised him that issue of debt will not dilute the control of equity shareholders. At the same time, the interest on loan is a tax-deductible expense for computation of tax liability. After due deliberations with Mr Ghosh, Mr Bose decided to raise funds from a financial institution.

Q 1. Identify the concept of financial management as advised by Mr Ghosh in the above situation.

a. Capital budgeting
b. Capital structure
c. Dividend decision
d. Working capital decision

Q 2. In the above case, Mr. Ghosh suggested to raised more fund from debt. Higher debt-equity ratio results in:

a. lower financial risk
b. higher degree of operating risk
c. higher degree of financial risk
d. higher earning of profit

Q 3. "Mr T. Ghosh who advised him about the judicious mix of equity (40%) and debt (60%)." The proportion of the debt in the overall capital is called:

a. Working capital b. Finance leverage
c. Total assets d. None of these

Q 4. **Employ more of cheaper debt may enhance the EPS. Such practice is called:**

a. Equity trading b. Financial leverage
c. Investment decision d. Trading on equity

Answers

1. (b) 2. (c) 3. (b) 4. (d)

Case Study 3

Read the extract given below and answer the questions on the basis of the same:

Supercool 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 ₹90,00,000 for replacing machines with modern machinery of higher production capacity. It involves committing the finance on a long-term basis. These decisions are very crucial for any business since they affect its earning capacity in the long run. 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 ₹ 9,00,000 and total capital investment was ₹ 2,00,00,000. Instead of issuing 10% debenture, the company can issue equity shares for raising the fund. The financial manager of the company would normally opt for a source which is the cheapest.

Q 1. **What is the other name of long-term decision?**

a. Working capital
b. Gross working capital
c. Financial management
d. Capital budgeting

Q 2. **A decision for replacing machines with modern machinery of higher production capacity is a:**

a. Investment decision
b. Working capital decision
c. Financing decision
d. None of the above

Q 3. **A decision for raising fund of ₹90,00,000 either from 10% debenture or equity shares is a:**

a. Dividend decision b. Financial decision
c. Investment decision d. None of these

Q 4. **The financing decisions are affected by various factors. Which one of the following factor is discussed in the above case? Choose the correct option.**

a. Cash flow position of the company
b. Amount of earning
c. Cost
d. Taxation policy

Answers

1. (d) 2. (a) 3. (b) 4. (c)

Case Study 4

Read the extract given below and answer the questions on the basis of the same:

Chetna and Alveera, who are young fashion designers, left their job with a famous fashion designer chain to set-up a company Trends Pvt. Ltd. They decided to run a boutique during the day and coaching classes for entrance examination of National Institute of Fashion Designing in the evening. For the coaching centre, they took on lease the first floor of a nearby building. Their major expense was money spent on photocopying of notes for their students. They thought of buying a photocopier knowing fully that their scale of operations was not sufficient to make full use of the photocopier.

In the basement of the building of Trends Pvt. Ltd., Rahul and Sudeep were carrying on a printing and stationery business in the name of Fine Prints Pvt. Ltd. Chetna approached Rahul with the proposal to buy a photocopier jointly which could be used by both of them without making separate investment. Rahul agreed to this.

Q 1. **"They decided to run a boutique during the day and coaching classes for entrance examination of National Institute of Fashion Designing in the evening." This statement represents which factor affecting the fixed capital requirements of Trends Pvt. Ltd.?**

a. Scale of operations b. Choice of technique
c. Growth prospects d. Diversification

Q 2. **"For the coaching centre, they took on lease the first floor of a nearby building." This statement represents which factor affecting the fixed capital requirements of Trends Pvt. Ltd.?**

a. Nature of business b. Financing alternatives
c. Growth prospects d. Scale of operations

Q 3. **"They thought of buying a photocopier knowing fully that their scale of operations was not sufficient to make full use of the photocopier." This statement represents which factor affecting the fixed capital requirements of Trends Pvt. Ltd.?**

a. Scale of operations
b. Level of collaboration
c. Growth prospects
d. Choice of technique

Q 4. **"Chetna approached Rahul with the proposal to buy a photocopier jointly which could be used by both of them without making separate investment." This statement represents which factor affecting the fixed capital requirements of Trends Pvt. Ltd.?**

a. Technology upgradation
b. Diversification
c. Level of collaboration
d. Financing alternatives

Answers

1. (d) 2. (b) 3. (a) 4. (c)

Case Study 5

Read the extract given below and answer the questions on the basis of the same:

Moon 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. It involves committing the finance on a long-term basis. These decisions are very crucial for any business since they affect its earning capacity in the long run. 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. Instead of issuing 10% debenture, the company can issue equity shares for raising the fund. The financial manager of the company would normally opt for a source which is the cheapest.

Q 1. Explain the concept of capital budgeting.

Ans. It refers to the amount of capital required for investment in fixed assets or long-term projects which will yield return and influence the earning capacity of business over a period of time.

Q 2. Which financial decision is mentioned in the following sentence?
"A decision for raising funds ₹80,00,000 either from 10% debenture or equity shares."

Ans. These are decisions related to raising of funds from various long-term sources.

Financing decisions involve determining various sources of finance, funds to be raised from each source and cost associated with each source like fixed capital.

Case Study 6

Read the extract given below and answer the questions on the basis of the same:

Mac Ltd. is a company manufacturing textiles. It has a share capital of ₹65 lakh. In the previous year, its earning per share was ₹ 0.60. For diversification, the company requires additional capital of ₹ 40 lakh. The company raised funds by issuing 10% debentures for the same. During the year, the company earned profit of ₹8 lakh on capital employed. It paid tax @ 40%.

Q 1. State whether the shareholders gained or lost, in respect of earning per share on diversification. Show your calculations clearly.

Ans.

		(₹)
Profit before Interest and Tax	=	8,00,000
(–) Debentures Interest $\left(40{,}00{,}000 \times \frac{10}{100}\right)$	=	(4,00,000)
Profit after Interest	=	4,00,000
(–) Tax $\left(40{,}00{,}000 \times \frac{40}{100}\right)$	=	(1,60,000)
Profit after Tax		2,40,000

$$\text{Earning per Share (EPS)} = \frac{\text{Profit After Tax}}{\text{Number of Shares}}$$

$$= \frac{2{,}40{,}000}{6{,}50{,}000} = ₹\,0.37$$

Since, earning per share has fallen from ₹0.60 to ₹0.37, therefore, the shareholders stand to lose on diversification.

TiP

In the absence of any information, shares are assumed to be of ₹ 10 each.

$$\text{So, Number of Shares} = \frac{\text{Share Capital}}{\text{Face Value Per Share}}$$

$$= \frac{65{,}00{,}000}{10} = 6{,}50{,}000$$

Q 2. State any three factors that favour the issue of debentures by the company as part of its capital structure.

Ans. Three factors that favour the issue of debentures by the company as part of its capital structure are:

(i) Debenture interest payable is a charge to the profits. Hence, a company stands to gain in terms of tax-benefits.

(ii) Issue of debentures help the shareholders of the company to gain through 'Trading on Equity'.

(iii) Debenture is a cheaper source of finance as compared to equity.

Case Study 7

Read the extract given below and answer the questions on the basis of the same:

Dipali, after acquiring a degree in Hotel Management and Business Administration, took over her family food processing company of manufacturing pickles, jams and squashes. The business was established by her great grandmother and was doing reasonably well. However, the fixed operating costs of the business were high and the cash flow position was weak. She wanted to undertake modernisation of the existing business to introduce the latest manufacturing processes and diversify into the market of chocolates and candies. She was very enthusiastic and approached a finance consultant, who told her that approximately ₹ 60 lakh would be required for undertaking the modernisation and expansion programme. He also informed her that the stock market was going through a bullish phase.

Q 1. Keeping the above considerations in mind, name the source of finance Dipali should not choose for financing the modernisation and expansion of her food processing business. Give one reason in support of your answer.

Ans. Debt, due to weak cash flow position, the firm may not be able to honour fixed cash payment obligations.

Q 2. Explain any two other factors, apart from those stated in the above situation, which Dipali should keep in mind while taking this decision.

Ans. Factors affecting capital structure are:

(i) Cash Flow Position.

(ii) Interest Coverage Ratio.

Very Short Answer Type Questions

Q 1. What is meant by financial management'?

Ans. Financial management includes those business activities that are concerned with acquisition and conservation of capital funds in meeting the financial needs and overall objectives of a business enterprise.

Q 2. "Cost of debt is lower than the cost of equity share capital." Give reason why even then a company cannot work only with the debt.

Ans. A company cannot work only with debt because a company cannot be formed or exit without equity.

Q 3. Name the financial decision which will help a businessman in opening a new branch of its business.

Ans. Investment decision.

Q 4. What are the two types of sources of finance?

Ans. (i) Owners' funds (Equity) (ii) Borrowed funds (Debts).

Q 5. Besides the dividend decision, the finance function is concerned with two other broad decisions. Name these decisions.

Ans. Besides the dividend decision, the two broad decisions concerned with finance function are: (i) Investment decision (ii) Financing decision.

Q 6. What is the primary objective of financial management?

Ans. The primary objective of financial management is to maximise the wealth of owners in long run.

Q 7. How do growing opportunities as a factor affect dividend decision? State.

Ans. A firm having higher growth opportunities may decide to retain more earnings and declare less dividends.

Q 8. Which type of dividend policy should be followed by a company having growth opportunities?

Ans. Conservative dividend policy, *i.e.* such company should pay less dividend.

Q 9. Which type of companies can declare higher dividend?

Ans. A company having stable earnings is in a position to declare higher dividends.

Q 10. Name the aspect of financial management that provides a link between investment and financing decisions.

Ans. Financial planning.

Q 11. Define capital structure.

Ans. Capital structure refers to proportion of debt and equity used for financing business operations.

Q 12. Which component of capital structure determines the overall financial risk?

Ans. Debt component.

Q 13. How does cost of equity affect the choice of capital structure of a company? Explain.

Ans. When the company uses more debt, the financial risk faced by equity holders increase so their desired rate of return increases.

Q 14. When is financial leverage favourable?

Ans. When return on investment is higher than cost of debt.

Q 15. "EPS always rises with increase in debt." Comment.

Ans. The above statement is not correct. Because EPS rises with increase in debt only when return on investment is more than cost of debt.

Q 16. Name the type of investment decision which relates to short-term and affects day-to-day operations of a company.

Ans. Working capital decision.

Q 17. Name any two essential ingredients of sound working capital management.

Ans. (i) Inventory management.

(ii) Receivable management.

Q 18. Due to the festive season, a company manufacturing gift items plans to open some more stores in the city. Will it affect the requirement for working capital?

Ans. Company will require higher working capital for new stores to meet higher inventory, production and sale.

Q 19. What is meant by trading on equity?

Ans. Trading on equity means increase in profit earned by the equity shareholders due to the presence of fixed financial charges.

Q 20. How does technical upgradation affect the fixed capital requirement of an organisation? State.

Ans. Organisations using assets which become obsolete faster require more fixed capital as compared to other organisation.

Short Answer Type-I Questions

Q 1. What is meant by financial management? State the primary objective of financial management.

Ans. Financial Management: It includes those business activities that are concerned with acquisition and conservation of capital funds in meeting the financial needs and overall objectives of a business enterprise.

TiP

Wealth maximisation is the objective of financial management. It should not be included in the importance.

The primary objective of financial management is to maximise shareholder's wealth which means maximisation of market value or price of shares of the company.

Market price of shares increases if

Return from Investment	>	Cost Involved in Investment

i.e. if Profit increases ↑, then Market price of shares also increases ↑

Maximisation of shareholder's wealth is the primary objective of Financial Management because company's funds belong to shareholders and the manner in which they are invested determines the market price of shares.

Q 2. Somnath Ltd. is engaged in the business of export of garments. In the past, the performance of the company had been up to the expectations. In line with the latest technology, the company decided to upgrade its machinery. For this, the Finance Manager, Dalmia, estimated the amount of funds required and the timings. This will help the company in linking the investment and the finance decisions on a continuous basis. Dalmia, therefore, began with the preparation of a sales forecast for the next four years. 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.

Identify the financial concept discussed in the above para. Also state the objectives to be achieved by the use of financial concept, so identified. *(CBSE 2017)*

Ans. The financial concept discussed in the above case is financial planning.

The objectives that the management seeks to achieve by using financial planning are:

(i) **To Ensure Availability of Funds Whenever these are Required:** If adequate funds are not available, the firm will not be able to honour its commitments and carry out its plans. So, it needs to do planning as to how much funds are to be raised, when they are to be raised and from which source.

(ii) **To See that the Firm does not Raise Funds unnecessarily:** If excess funds are available, it will unnecessarily add to the cost and may encourage wasteful expenditure.

Q 3. Amit is a renowned businessman involved in export business of leather goods. As a responsible citizen, he chooses to use jute bags for packaging instead of plastic bags. Moreover, on the advice of his friends, he decides to use jute for manufacturing aesthetic handicrafts, keeping in view the growing demand for natural goods. In order to implement his plan, after conducting a feasibility study, he decides to set up a separate manufacturing unit for producing varied jute products.

In the context of the above paragraph:

(i) Identify the type of investment decision taken by Amit by deciding to set up a separate manufacturing unit for producing jute products.

(ii) State any two factors that he is likely to consider while taking this decision.

Ans. (i) Capital budgeting decision has been taken by Amit.

(ii) The factors affecting capital budgeting decision are:

(a) **Rate of Return:** It is the most important criteria affecting capital budgeting decision. A project with higher rate of return must be selected.

Example: Company X Ltd.

	Project A	Project B
Rate of Return	10%	15%

Assumption: Same risk in Project A and Project B.

Out of these two projects, Project B carrying higher rate of return (15%) must be selected.

(b) **Cash Flows of the Project:** While taking decision as to which project should be selected, company must select a project which has regular cash flows as huge amount of funds are involved in projects.

Example: Investment in a project = ₹ 15 lakh.

Cash Inflow	Year 1	Year 2	Year 3	Year 4
Project 1	5 lakh	5 lakh	5 lakh	5 lakh
Project 2	—	2 lakh	9 lakh	9 lakh

Project 1 should be selected as it has regular cash flows in all the years.

Q 4. Explain following factors affecting the financing decision of the company:

(i) Control Considerations

(ii) State of Capital Markets

Ans. (i) **Control Considerations:** In case, the existing shareholders want to retain the complete control of business, then finance can be raised through borrowed funds but when they are ready for dilution of control over business, equity can be used for raising finance.

(ii) **State of Capital Markets:** During boom period, finance can easily be raised by issuing shares but during depression period, raising finance by means of debt is easy.

Q 5. State any three importance of financial planning.

Ans. The importance of financial planning are:

(i) It ensures smooth running of a business enterprise by ensuring availability of funds at the right time.

(ii) It helps in anticipating future requirements of funds and evading business shocks and surprises.

(iii) It facilitates coordination among various departments of an enterprise, like marketing and production functions, through well-defined policies and procedures.

Q 6. Explain the following factors affecting dividend decision:

(i) Stock Market Reaction

(ii) Access to Capital Market

Ans. (i) **Stock Market Reaction:** If a company wants positive reactions at stock market, it is likely to pay higher dividends.

(ii) **Access to Capital Market:** A large company can access funds easily from capital market as per its requirements, therefore, it is likely to retain lesser profits and is likely to pay higher dividends.

Q 7. Distinguish between financing decisions and investment decisions.

Ans. The differences between Financing Decisions and Investment Decisions are:

S. No.	Basis of Difference	Financing Decisions	Investment Decisions
(i)	Meaning	It tells about the source from where the capital can be raised.	The decisions regarding the investment of funds for getting maximum benefits for the firm.
(ii)	Sources	Owner's funds and borrowed funds.	Long-term and short-term capital.
(iii)	Functions	Financing decisions includes an inflow of cash.	Investment decisions include outflow of cash.

Q 8. Wireworks Ltd. is a company manufacturing different kinds of wires. Despite fierce competition in the industry, it has been able to maintain stability in its earnings and as a policy, uses 30% of its profits to distribute dividends. The small investors are very happy with the company as it has been declaring high and stable dividend over past five years.

In the context of the above paragraph:

(i) State any one reason because of which the company has been able to declare high dividend by quoting line from the paragraph.

(ii) Why do you think small investors are happy with the company for declaring stable dividend?

TiP

In this type of questions, read the paragraph very carefully and reference line from the paragraph while writing factors affecting dividend decision.

Ans. (i) **Stability in Earnings:** The company has been able to declare high dividend because its earnings are stable.

Lines Quoted: *"Despite fierce competition in the industry, it has been able to maintain stability in its earnings."*

(ii) The small investors are happy with the company for declaring stable dividend as they enjoy a regular income on their investment.

Q 9. Explain with the help of any three points how proper financial planning enables the companies to tackle the uncertainty in respect of availability and timing of the funds and helps in smooth functioning of the organisation. *(CBSE 2019)*

Ans. Financial planning is an important part of overall planning of any business enterprise. It aims at enabling the company to tackle the uncertainty in respect of the availability and timing of the funds and helps in smooth functioning of an organisation. The importance of finance planning can be explained as follows:

(i) It helps in avoiding business shocks and surprises and helps the company in preparing for the future.

(ii) It helps in coordinating various business functions, *e.g.*, sales and production functions, by providing clear policies and procedures.

(iii) Detailed plans of action prepared under financial planning reduce waste, duplication of efforts and gaps in planning.

Q 10. Explain the objectives of financial planning.

OR *(CBSE 2019)*

Harish is working as a finance manager in Kozee Softwares Ltd. He has been awarded 'Best Employee of the Year Award' because of his foresightedness. He always aims at smooth operations of all the financial activities by focusing on fund requirements and their availability in the light of financial decisions. He takes into consideration the growth, performance, investments and requirement of funds for a given period so that financial resources are not left idle and don't unnecessarily add to the cost.

By doing all this Harish strives to achieve the two main objectives of an important concept of financial management. Identify the concept and explain its two objectives. *(CBSE 2023)*

Ans. Financial planning strives to achieve the following two objectives:

(i) It includes estimation of the funds required for different purposes (long-term assets/working capital requirement):

(a) Estimate the time at which these funds need to be made available.

(b) Specify sources of these funds.

(ii) To see that the firm does not raise resources unnecessarily:

(a) Shortage of funds ⇒ firm cannot meet its payment obligations.

(b) Surplus funds ⇒ do not earn returns but adds to costs.

Q 11. The Return on Investment (ROI) of a company ranges between 10-12% for the past three years. To finance its future fixed capital needs, it has the following options for borrowing debt:

Option 'A' : Rate of interest 9%

Option 'B' : Rate of interest 13%

Which source of debt, Option 'A' or Option 'B', is better? Give reason in support of your answer. Also state the concept being used in taking the decision. *(CBSE 2018)*

Ans. **Option 'A'** *i.e.,* rate of interest @ 9%, is a better source of debt that should be used by the company.

Reason: Rate of return on investment *i.e.,* 12% should be higher than a rate of interest on debt *i.e.,* 9% in case of option A.

The concept that is being used in taking the decision is trading on equity. Trading on equity refers to the increase in profit earned by the equity shareholders due to the presence of fixed financial charges like interest.

Q 12. Indian equity markets are going through a phase of boom. There is a huge growth potential for innovative technologies. This has resulted in lots of new ventures vying for a market share and old enterprises trying to keep up with the pace with which changes are taking place in the economy. This technological innovation has helped even smaller businesses to compete on a global scale. Identify and explain the three factors highlighted above which affect the working capital requirements of such enterprises. *(CBSE 2019)*

Ans. Three factors that affecting the working capital requirements highlighted in the given case are:

(i) Business Cycle: In the time of boom, more production will be undertaken and so more working capital will be required during that time as compared to depression.

(ii) Growth Prospects: In case, growth potential of enterprise is higher, higher working capital is required. To meet higher production and sales target, higher investment in current assets is required. In case, growth potential of enterprise is lower, lower working capital is required. Lower investment in current assets is required.

(iii) Level of Competition: In case, level of competition is high, working capital requirement is also high. Higher level of competitiveness may necessitate higher stocks of finished goods to meet urgent orders from customers. In case, level of competition is low, working capital requirement is also low. No need for the stocks of finished goods.

TiP

Students should learn separately, factors affecting fixed capital, working capital and the capital structure.

Q 13. State any three factors affecting the capital budgeting decision of a company.

(CBSE 2022, Term-2)

Ans. The factors affecting the capital budgeting decision of a company are:

(i) Choice of Technique: An organisation using capital intensive techniques requires more investment in plant and machinery as compared to an organisation using labour intensive techniques.

(ii) Technology Upgradation: Organisations using assets which become obsolete faster require more fixed capital as compared to other organisations.

(iii) Growth Prospects: Companies having more growth plans require more fixed capital. In order to expand production capacity, more plant and machinery are required.

Q 14. Yogesh, a businessman, is engaged in the purchase and sale of ice-creams. Identify his working capital requirements by giving reasons to support your answer. Now, he is keen to start his own ice-cream factory. Explain any two factors that will affect his fixed capital requirements.

Ans. The working capital requirements of Yogesh will be less as he is engaged in trading business.

The two factors that will affect his fixed capital requirements when he will start his own ice-cream factory are described below:

(i) Financing Alternatives: In case of high risk line business and developed financial market, fixed capital requirement is low. Learning option is available apart from purchase option. Thus, one can opt for lease option and save cost/investment in fixed assets.

In case of low risk line business and less developed financial market, fixed capital requirement is high.

Learning option is not available. Fixed assets needs to be purchased. Thus, investment in fixed assets is high.

(ii) Level of Collaboration:

(a) In case, scale of operations of each business is not sufficient and they want to share each other's facility or want to jointly establish a particular facility. **Example:** A bank may use another's ATM.

Fixed capital requirement is low. Collaboration leads to low level of investment in fixed assets for each business.

(b) In case, business does not want to collaborate. Fixed capital requirement is high. Investment in fixed assets is high.

Q 15. List any three factors affecting the working capital requirement of a company. *(CBSE SQP 2022, Term-2)*

Ans. **Factors affecting Working Capital:** The main factors affecting working capital are:

(i) Nature of Business: A trading organisation needs a lower amount of working capital as compared to a manufacturing organisation, as trading organisation undertakes no processing work.

(ii) Scale of Operations: An organisation operating on large scale will require more inventory and thus, its working capital requirement will be more as compared to small organisation.

(iii) Business Cycle: In the time of boom, more production will be undertaken and so more working capital will be required during that time as compared to depression.

Q 16. Manish is engaged in the business of manufacturing garments. Generally, he used to sell his garments in Delhi. Identify the working capital requirements of Manish giving reason in support of your answer. Further, Manish wants to expand and diversify his garments business. Explain any two factors that will affect his fixed capital requirements.

Ans. The working capital requirements of Manish will be relatively more as he is engaged in the business of manufacturing garments. This is because the length of production cycle is longer *i.e.*, it takes time to convert raw material into finished goods.

The factors affecting the fixed capital needs for his business are:

(i) Scale of Operations: Large organisation operating at higher scale. Fixed capital requirement is high. Requires higher investment in fixed assets.

Small organisation operating at lower scale. Fixed capital requirement is low. Requires lower investment in fixed assets.

(ii) Technology Upgradation: Industries in which assets become obsolete soon and their replacement becomes due faster. *e.g.*, computer industry. Fixed capital requirement is high.

Investment in fixed assets is high.

Industries in which assets become obsolete later and their replacement does not become due faster. *e.g.*, furniture industry.

Fixed capital requirement is low. Investment in fixed assets is low.

Q 17. Harish is engaged in the warehousing business and his warehouses are generally used by businessmen to store fruits. Identify the working capital requirements of Harish giving reasons in support of your answers. Further, Harish wants to expand and diversify his warehousing business. Explain any two factors that will affect his fixed capital requirements.

Ans. The working capital requirements of Harish will be relatively less as he is engaged in providing warehousing service wherein there is no need to maintain inventory.

The factors affecting the fixed capital needs of his business are:

(i) Scale of Operations: Large organisation operating at higher scale. Fixed capital requirement is high. Requires higher investment in fixed assets. Small organisation operating at lower scale. Fixed capital requirement is low. Requires lower investment in fixed assets.

(ii) Diversification: A firm wants to diversify its operations. Fixed capital requirements will be high. Investment in fixed assets is high. A firm does not want to diversify its operations. Fixed capital requirement is low. Investment in fixed assets is low.

Q 18. After pursuing a course of event management, Koyal and her brother Kavish promoted an event management company under the name Koyal Entertainment Private Limited. They strive together as dedicated and dynamic professionals managing different kinds of formal and informal events across all major cities in India and abroad. They design the event idea and coordinate the different aspects of the event to make it a grand success. As a policy, they take fifty percent of the payment as advance from the client before the start of an event and received the balance charges after the successful completion of the event.

In the context of the above paragraph:

(i) Comment upon the working capital needs of the company keeping in mind its nature of business.

(ii) Identify the other factor mentioned in the paragraph which is likely to affect the working capital requirement of their business.

Ans. (i) The working capital requirements of Koyal Entertainment Private Limited will be relatively less as they are engaged in providing event management services, wherein there is no need to maintain inventory.

(ii) The other factor mentioned in the paragraph which is likely to affect the working capital requirement of their business is 'Credit availed.' Since as a policy, they take fifty percent of the payment as advance from the client before the start of an event, their requirement of working capital is reduced.

Q 19. MM Ltd. is manufacturing small cars at its manufacturing unit in Pune. The demand of its cars is increasing at the rate of 20% annually. It is planning to set up a new car manufacturing unit at Indore. For this, the company will require approximately ₹ 1,500 crore as fixed capital and

₹ 400 crore as working capital. The company has already arranged for its working capital. State any three factors that the finance manager should keep in mind while arranging its fixed capital. *(CBSE 2016)*

Ans. Three factors that the finance manager should keep in mind while arranging its fixed capital are:

(i) **Nature of Business:** Manufacturing organisation require huge investment in fixed assets and thus huge fixed capital is required for them but trading organisation need less fixed capital as they are not required to purchase plant and machinery.

(ii) **Scale of Operations:** An organisation operating on large scale requires more fixed capital as compared to an organisation operating on small-scale.

(iii) **Technology Upgradation:** Organisations using assets which become obsolete faster require more fixed capital as compared to other organisations.

COMMON ERROR

Students give factors affecting the fixed capital instead of the factors affecting the capital structure.

Q 20. Pinnacle Ltd. deals in the sale of stationery and office furniture. They source the finished products from reputed brands who give them four to six months credit. Seeing the demand for electronic items, they are also planning to market these items by opening outlets throughout India. For this, they have decided to join hands with a Japanese electronic goods manufacturer.

Identify and state any two factors that would affect fixed capital requirement of Pinnacle Ltd. as discussed above. *(CBSE 2017)*

Ans. Two factors that would affect the fixed capital requirements are:

(i) **Nature of Business:** Manufacturing organisation require huge investment in fixed assets and thus huge fixed capital is required for them but trading organisation need less fixed capital as they are not required to purchase plant and machinery.

(ii) **Level of Collaboration:** If companies are under collaboration, joint venture, then they need less fixed capital as they share plant and machinery with their collaborators.

Q 21. Radhika and Vani who are young fashion designers, left their job with a famous fashion designer chain to set-up a company Fashionate Pvt. Ltd. They decided to run a boutique during the day and coaching classes for the entrance examination of National Institute of Fashion Designing in the evening. For the coaching centre, they hired the first floor of a nearby building. Their major expense was the money spent on photocopying of notes for their students. They thought of buying a photocopier knowing fully that their scale of operations was not sufficient to make full use of photocopier.

In the basement of the building of Fashionate Pvt. Ltd., Praveen and Ramesh were carrying on a printing and stationery business in the name of Neo Prints Pvt. Ltd. Radhika approached Praveen with the proposal to buy a photocopier jointly which could be used by both of them without making separate investment. Praveen agreed to this.

Identify and explain the factor affecting the fixed capital requirements of Fashionate Pvt. Ltd.

Ans. The factor affecting the fixed capital requirement of Fashionate Pvt. Ltd. is the level of collaboration. It is explained below:

Level of Collaboration:

(i) In case, scale of operations of each business is not sufficient and they want to share each other's facility or want to jointly establish a particular facility. *e.g.*, a bank may use another's ATM. Fixed capital requirement is low. Collaboration leads to low level of investment in fixed assets for each business.

(ii) In case, business does not want to collaborate. Fixed capital requirement is high. Investment in fixed assets is high.

In the above case, Radhika shared the expenses of buying a photocopier jointly with Praveen. So, fixed capital requirements will be low as explained in above case I.

Q 22. Safe Warehouses Ltd. is a large warehousing network company operating through a chain of warehouses at 40 different locations across India. The company now intends to undertake computerisation of its owned warehouses as it seeks to provide better value added and cost effective solutions for scientific storage and preservation services to the market participants dealing in agricultural products including farmers, traders, etc.

In the context of the above paragraph:

(i) How is the decision to undertake computerisation of owned warehouses likely to affect the fixed capital requirements of its business?

(ii) Name any two sources that company may use to finance the implementation of this plan.

Ans. (i) The decision to undertake computerisation of owned warehouses will increase the fixed capital requirements of its business both in present and future as after sometime, the technology being used will become obsolete and need upgradation.

(ii) The company may use retained earnings and take loans from financial institutions to implement this plan.

Q 23. Studio 12 Pvt. Ltd. is the largest hair salon chain in the Mumbai, with over a franchise of 300 salons. The company is now planning to set up a manufacturing unit in Delhi for production of various kinds of beauty products under its own brand name.

In the context of the above paragraph:

(i) Comment upon the fixed capital needs of the company.

(ii) How will the requirement of fixed capital of the company change when it implements its plan to set up a manufacturing unit?

Ans. (i) The fixed capital needs of the company are low as its salons have been promoted in the form of franchises.

(ii) The requirement of fixed capital of the company will increase when it implements its plan to set up a manufacturing unit because it will have to make investments in buying land, building, machinery, etc.

Short Answer Type-II Questions

Q 1. Explain the two types of risk in a business.

Ans. Two types of risk in a business are:

(i) Financial Risk: Financial risk means that a company is unable to meet its debt service commitment *i.e.*, payment of interest and repayment of capital.

(ii) Operating Risk: Operating risk depends upon fixed operating costs (*e.g.*, building rent, salary, etc.).

Higher fixed operating costs result in higher business risk and *vice-versa*.

Total Business Risk ⇒ Financial Risk + Operating Risk

Q 2. Give the meaning of 'Investment' and 'Financing Decisions' of financial management.

Ans. Investment Decision: This decision relates to how the firm's funds are invested in different assets so that the firm is able to earn the highest possible return on investments.

These may relate to investment in short-term/ current assets (working capital management) or long-term/fixed assets (capital budgeting decisions).

Financing Decision: It is concerned with the decisions about how much funds are to be raised from which long-term source *i.e.*, shareholders funds or borrowed funds.

Shareholders funds (or Equity) refers to share capital reserves and surplus and retained earnings. Borrowed funds (or Debt) refers to the finance raised as debentures, long-term loans, public deposits, etc. Financial decision determines the overall cost of capital and the financial risk of the enterprise.

Q 3. State any four factors affecting the financial decision that is concerned with raising of finance using shareholders funds and borrowed funds. *(CBSE SQP 2022-23)*

OR

State any four factors affecting the decision that determines the overall cost of capital and the financial risk of the enterprise. *(CBSE 2023)*

Ans. The factors which affect financing decision are:

(i) Cost: The cost of raising funds from different sources are different. The cheapest source should be selected.

(ii) Risk: The risk associated with different sources is different. More risk is associated with borrowed funds as compared to owners fund.

(iii) Floatation Cost: The costs involved in issuing securities such as broker's commission, underwriter's fees, expenses on prospectus, etc., are called flotation costs. Higher the floatation cost, less attractive is the source of finance.

(iv) Cash Flow Position of the Business: In case, the cash flow position of a company is good enough, then it can easily use borrowed funds and pay interest on time.

Q 4. State any four factors that affect the decision related to how much profit is to be distributed and how much profit is to be retained in the business. *(CBSE 2023)*

Ans. The factors which affect the dividend decision are as follows:

(i) Amount of Earnings: If the earnings of the company are high, dividends are paid at a higher rate and *vice-versa*.

(ii) Stability of Earnings: If the earnings of a company are stable, it is likely to pay higher dividends.

(iii) Stability of Dividend: A company is more likely to maintain a stable dividend rate over a period of time, unless there is a significant change in its earnings. If the shareholders prefer regular income in the form of dividends, the company is likely to maintain a stable dividend payout rate.

(iv) Taxation Policy: If the tax rate is high, the company is likely to pay less dividend.

Q 5. What is meant by investment decision? State how long-term investment decision and short-term investment decision affect the business. *(CBSE 2023)*

Ans. Meaning of Investment Decision: This decision relates to how the firm's funds are invested in different assets so that the firm is able to earn the highest possible return on investments.

These may relate to investment in short-term/ current assets (working capital management) or long-term/fixed assets (capital budgeting decisions).

Long-term investment decision affects the value of assets, competitiveness and profitability of business, whereas short-term investment decision affects both liquidity and profitability of business.

Q 6. Explain the following as factors affecting dividend decision:

(i) Stability of earnings

(ii) Growth opportunities

(iii) Cash flow position

(iv) Taxation policy

OR

State any four factors affecting the decision which relates to how much of the profits earned by a company will be distributed and how much will be retained in the business. *(CBSE 2023)*

OR

Explain the following factors affecting the dividend decision of the company:

(i) Taxation policy

(ii) Cash flow position *(CBSE SQP 2023-24)*

Ans. (i) **Stability of Earnings:** A company having stable earnings can declare higher dividend. On the contrary, a company having unstable earnings is likely to pay smaller dividend.

(ii) **Growth Opportunities:** Companies having good growth opportunities generally pay less dividend and retain more money out of profits to invest in profitable projects.

On the other hand, non-growth companies can pay higher dividend, provided that they have enough earnings and cash.

(iii) **Cash Flow Position:** Payment of dividend involves outflow of cash. So, availability of enough cash in the company is necessary for distribution of dividend.

(iv) **Taxation Policy:** Dividend are tax-free in the hands of shareholders. So, they prefer higher dividends. But, a dividend distribution tax is levied on companies. So, if tax rate on dividend is higher, it would be better for a company to pay less dividend.

As against this, higher dividend may be declared if tax rate is lower.

Q 7. Explain the following as factors affecting dividend decision:

(i) Stability of dividends

(ii) Shareholders' preferences

(iii) Access to capital market

(iv) Legal constraints

OR

Explain the following factors affecting dividend decision:

(i) Stability of dividends

(ii) Shareholders' preferences

OR

Explain the following factors affecting dividend decision:

(i) Access to capital market

(ii) Legal constraints

Ans. (i) **Stability of Dividends:** Many companies follow a policy of fixed amount of dividend per share. The increase in dividends is made only when they are confident that their earning potential has increased and not just the earnings of the current year.

(ii) **Shareholders' Preferences:** Some shareholders (like retired persons) want a regular income (dividend) from their investments. The company should always, consider the preference of such shareholders' while declaring dividend.

(iii) **Access to Capital Market:** Blue chip companies can raise funds easily from the capital market to finance their growth. So, they can pay higher dividend than the smaller companies which have low access to the capital market. So, they can pay lesser dividend as compared to blue chip companies.

(iv) **Legal Constraints:** Certain provisions of the Companies Act put restrictions on payouts as dividends.

For example, depreciation for the entire year has to be provided before declaring dividend.

Before declaring dividend, some part of the profit has to be transferred. Compulsorily to the reserves and these provisions of the Companies Act may be adhered to while declaring dividend.

Q 8. Shalini, after acquiring a degree of Hotel Management and Business Administration, took over her family food processing company of manufacturing pickles, jams and squashes. The business had been established by her great grandmother and was doing reasonably well. However, the fixed operating costs of the business were high and the cash flow position was weak. She wanted to undertake modernisation of the existing business to introduce the latest manufacturing processes and diversify into the market of chocolates and candies. She was very enthusiastic and approached a finance consultant, who told her that approximately ₹ 50 lakh would be required for undertaking the modernisation and expansion programme. He also informed her that the stock market was going through a bullish phase.

(i) Keeping the above considerations in mind, name the source of finance. Which Shalini should not choose for financing the modernisation and expansion of her food processing business. Give one reason in support of your answer.

(ii) Explain any two other factors, apart from those stated in the above situations, which Shalini should keep in mind while taking this decision.

Ans. (i) Shalini should not choose debt capital for financing the modernisation and expansion of her food processing business because the fixed operating cost of the company is high. It cannot take the additional burden of fixed commitments in terms of payment of interest and repayment of capital by issuing debt.

(ii) The other two factors that Shalini must keep in mind while taking this decision are stated below:

(a) **Risk Consideration:** The business risk comprises of financial risk as well as operating risks.

Financial risk means that a company is unable to meet its debt service commitment *i.e.*, payment of interest and repayment of capital.

Operating risk depends upon fixed operating costs (*e.g.*, building, rent, salary, etc.).

So, Total Business Risk = Financial Risk + Operating Risk

Debt is more risky than equity as it is compulsory to pay interest on debt and principal amount.

So, if total business risk is lower its capacity to use debt is higher and *vice-versa*.

(b) Flexibility: If a firm used its debt potential to the full, it loses flexibility to issue further debt. To maintain flexibility, it must maintain some borrowing power to take care of unforeseen circumstances.

Q 9. 'Metalap' is a company enjoying market leadership in the food brands segment. It's portfolio includes three categories in the foods business namely; Snack Foods, Juices and Confectionery. Keeping in line with the growing demand for packaged food, They are now plans to introduce Ready-to-Eat Foods. Therefore, the company has planned to undertake investments of nearly ₹ 450 crore for its new line of business. As per the current financial report, the interest coverage ratio of the company and return on investment is higher. Moreover, the corporate tax rate is high.

In the context of the above paragraph:

(i) As a financial manager of the company, which source of finance will you opt for debt or equity, to raise the required amount of capital? Explain by giving any two suitable reasons in support of your answer.

(ii) Why are the shareholders' of the company like to gain from the issue of debt by the company?

Ans. (i) As a financial manager of the company, I will opt for debt to raise the required amount of capital. I support my decision by giving the following reasons:

(a) Interest Coverage Ratio: The ICR refers to the number of time earnings before interest and taxes of a company covers the interest obligation.

$$\text{Formula of ICR} = \frac{\text{EBIT}}{\text{Interest}}$$

$\uparrow$ ICR = $\downarrow$ Risk of failure to meet payment obligations of interest.

In the above case, the interest coverage ratio of the company is high, so it can easily meet its fixed commitment of payment of interest and repayment of capital.

(b) Tax Rate: Interest on debt is a tax deductible expense. Therefore, a higher tax rate makes debt relatively cheaper.

e.g., borrowings @ 10% and tax rate 30%, means after tax cost of debt is only 7%. So, more debt can be used.

In the above case, the tax rate is high which makes debt relatively cheaper as the amount of interest paid on debt is treated as a tax deductible expense.

(ii) The shareholders of the company are likely to gain from the issue of debt by the company because the return on investment is higher. It helps a company to take advantage of trading on equity to increase the earnings per share.

If ROI > Rate of interest on debt, then company can use trading on equity and enhances its EPS.

Q 10. Ananta Ltd. is a company dealing in readymade garments from last many years. Recently, the profit of the company have started increasing. The finance manager decided to retain the profit instead of distributing it among shareholders.

(i) Identify and state the financial decision taken by finance manager in the above case.

(ii) State any three factors affecting the decision identified in point (i) above.

OR

Ravi has joined as a finance manager in MTA Ltd. He had to arrange funds of rupees one crore for the company. The Chief Executive Officer of the company wants to arrange the funds by a public issue whereas the finance manager wants to have a mix of debt and equity as this will determine the overall cost of capital and the financial risk of the enterprise.

(i) Identify and give the meaning of the financial decision suggested by the finance manager in the above case.

(ii) State any three factors affecting the decision identified in point (i) above.

(CBSE 2022, Term-2)

Ans. (i) Dividend decision has taken by Finance manager.

Meaning of Dividend Decision: Dividend decision relates to disposal of profit by deciding the proportion of profit which is to be distributed among shareholders and the proportion of profit which is to be retained in the business for meeting the investment requirements.

(ii) The three factors affecting dividend decision are:

(a) Amount of Earnings: If the earnings of the company are high, dividends are paid at a higher rate and *vice- versa*.

(b) Stability of Earnings: If the earnings of a company are stable, it is likely to pay higher dividends.

(c) Stability of Dividend: A company is more likely to maintain a stable dividend rate over a period of time, unless there is a significant change in its earnings. If the shareholders prefer regular income in the form of dividends, the company is likely to maintain a stable dividend payout rate.

Q 11. **TVR Ltd. is renowned multiplex operator in India. Presently, it owns 234 screens in 45 properties at 20 locations in the country. Considering the fact that there is a growing trend among the people to spend more of their disposable income on entertainment, two years back the company had decided to add more screens to its existing set up and increase facilities to enhance leisure, food chains, etc. It had then floated an initial public offer of equity shares in order to raise the desired capital. The issue was fully subscribed and paid. Over the years, the sales and profits of the company have increased tremendously and it has been declaring higher dividend and the market price of its shares has increased manifolds.**

In the context of the above paragraph:

(i) Name the different kinds of financial decisions taken by the company by quoting lines from the paragraph.

(ii) Do you think the financial management team of the company has been able to achieve its prime objective? Why or why not? Give a reason in support of your answer.

Ans. (i) The different kinds of financial decisions taken by the company are:

(a) Investment Decision:

Lines Quoted: "*Two years back the company had decided to add more screens to its existing set up and increase facilities to enhance leisure, food chains, etc.*"

(b) Financing Decision:

Lines Quoted: "*It had then floated an initial public offer of equity shares in order to raise the desired capital.*"

(c) Dividend Decision:

Lines Quoted: "*Over the years, the sales and profits of the company have increased tremendously and it has been declaring higher dividend.*"

(ii) Yes, the financial management team of the company has been able to achieve its prime objective i.e., wealth maximisation of the shareholders by maximising the market price of the shares of the company.

Q 12. **"Capital structure decision is essentially optimisation of risk-return relationship." Comment.**

Ans. Capital structure decision relates to proportion of debt and equity. Debt and equity differ significantly in their risk and return.

Debt is more risky as compared to equity because payment of interest and repayment of principal is obligatory for business.

However, debt component in the total capital generates higher return for equity shareholders as interest payable on debt is deductible from earnings before tax payment.

Thus, capital structure decision affects risk as well as return. So, it is rightly said that capital structure decision is essentially optimisation of risk-return relationship.

Q 13. **Padmini Industries needs to raise funds of ₹ 20,00,000. Its expected Earning Before Interest and Taxes (EBIT) are ₹ 1,50,000. The company wishes to use more of debt content as compared to equity to raise Earning Per Share (EPS) of equity shareholders. The debt is available at interest of 12%. As a finance manager, advise whether the company should prefer more of debt or more of equity to have higher EPS. Give reasons in support of your answer.**

Ans. Total Investment = ₹ 20,00,000

EBIT = ₹ 1,50,000

Rate of interest on debt = 12%

$$\text{Return on Investment (ROI)} = \frac{\text{EBIT}}{\text{Total Investment}} \times 100$$

$$= \frac{1{,}50{,}000}{20{,}00{,}000} \times 100 = 7.5\%$$

As ROI < Rate of interest on debt, 7.5% < 12%.

So, this is a case of unfavourable financial leverage, wherein the Earning Per Share (EPS) will decrease with increase use of debt in capital structure.

So, Padmini Industries should use less debt (preferably no debt) to have higher EPS.

So, company should prefer more of equity to have higher EPS.

Q 14. **Krish limited is in the business of manufacturing and exporting carpets and other home decor products. It has a share capital of ₹ 70 lakh at the face value of ₹ 100 each. Company is considering a major expansion of its production facilities and wants to raise ₹ 50 lakh. The finance manager of the company Mr Prabhakar has recommended that the company can raise funds of the same amount by issuing 7% debentures. Given that earning per share of the company after expansion is ₹ 35 and tax rate is 30%, did Mr Prabhakar give a justified recommendation? Show the working.**

(CBSE SQP 2022-23)

Ans. Earning per share = ₹ 35

EPS = Earning after tax/No. of equity shares

35 = Earning after tax/70,000

Earning after tax = ₹ 24,50,000

Interest = 50,00,000 × 7/100

= ₹ 3,50,000

Let the Earning Before Tax (EBT) = x

EBT – TAX = EAT

x – 0.30x = 24,50,000

0.70x = 24,50,000

x = 24,50,000/0.70

x = 35,00,000

Earning before tax (EBIT)

= ₹ 35,00,000

Earnig Before Interest and Tax (EBIT)

= Earning before tax + Interest

= 35,00,000 + 3,50,000

= ₹ 38,50,000

ROI = EBIT/Total Investment × 100

= 38,50,000/1,20,00,000 × 100

= 32.08%

As RoI (32.08%) > Rate of interest (7%).

The company can choose to use trading on equity to increase its EPS. The finance manager was justified in making this recommendation.

Q 15. "Company can pay any amount of dividend without any restriction." Comment.

Ans. The given statement is incorrect. It is because of two reasons:

(i) Every company has to comply with provisions of the Companies Act while declaring the dividend.

According to provisions, company has to provide for present and past depreciation on assets and create statutory reserves before declaring dividend.

(ii) If the company has borrowed some loan, then lender may also put certain restrictions on the company on payment of dividends. In such case, company is required to ensure that payment of dividend does not violate the terms and conditions of the lender.

Q 16. Sunrise Ltd. dealing in readymade garments, is planning to expand its business operations in order to cater to international market. For this purpose, the company need 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 debentures would be considered a rational decision by the company. Give reason to justify your answer.

Ans. Returns for equity shareholders is measured by Earning Per Share (EPS) and EPS rises with increase in debt only when Return on Investment (ROI) > Cost of Debt.

However, if ROI < Cost of debt, then EPS will fall with increased used of debt. So, in the given case, issue of debentures would not be considered a rational decision by the company as ROI of 8% is less than Cost of Debt (10%).

Q 17. Ramit is using ICR (Interest Coverage Ratio) as the indicator of the interest paying capacity of his company. However, one of his school days' friend Shobit tells him to use DSCR (Debt Service Coverage Ratio) as the indicator to judge it. Do you agree with his friend? Give reason for your answer.

Ans. Yes, I agree with him.

DSCR is a better indicator of company's ability to pay fixed financial charges like interest because it overcomes the shortcomings of ICR.

$$\text{Formula of ICR} = \frac{\text{EBIT}}{\text{Interest}}$$

Formula of DSCR =

$$\frac{\text{PAT} + \text{Depreciation} + \text{Interest} + \text{Non-cash expenses}}{\text{Preference dividends} + \text{Interest} + \text{Repayment obligation}}$$

Shortcomings of ICR are given below:

(i) ICR is unable to show the situation of cash balance. A firm may have higher EBIT but of a low cash balance.

(ii) It covers only the obligation of interest.

DSCR overcomes these shortcomings as:

(i) In DSCR, cash profits generated by operations are compared with total cash required for service of debt.

(ii) It covers other repayment obligations like preference dividend, etc., along with interest.

Q 18. Briefly explain the process of financial planning.

Ans. Financial planning usually begins with preparations of a sales forecast. Based on sales forecast for a given time period, say 5 years, the financial statements are prepared keeping in mind the requirement of funds for investment in current and fixed assets. Then, the expected profits during the period are estimated so that an idea can be made of how much of funds requirements can be met from retained earnings and how much will have to be raised from external sources.

Q 19. Explain the following as factors affecting the requirements of fixed capital:

(i) Scale of operations

(ii) Choice of technique

(iii) Technology upgradation

(iv) Finance alternatives

Ans. (i) **Scale of Operations:** Large organisation operating at higher scale. Fixed capital requirement is high. Small organisation operating at lower scale. Fixed capital requirement is low.

(ii) **Choice of Technique:** In capital intensive organisations, fixed capital requirement is high. Investment in fixed assets is also high. In labour intensive organisations, fixed capital requirement is low. Investment in fixed assets is also low.

(iii) **Technology Upgradation:** Industries in which assets become obsolete soon and their replacement becomes due faster. *e.g.*, computer industry. Fixed capital requirement is high.

Industries in which assets become obsolete later and their replacement does not become due faster. *e.g.*, furniture industry. Fixed capital requirement is low.

(iv) **Financing Alternatives:** In case of high risk line business and developed financial market, fixed capital requirement is low. Leasing option is available apart from purchase option. Thus, one can opt for lease option and save cost/investment in fixed assets.

In case of low risk line business and less developed financial market, fixed capital requirement is high. Leasing option is not available. Fixed assets needs to be purchased. Thus, investment in fixed assets is high.

Q 20. Explain the following as factors affecting the requirements of fixed capital:

(i) Nature of business

(ii) Growth prospects

(iii) Diversification

(iv) Level of collaboration

Ans. (i) **Nature of Business:** Nature of business affects fixed capital requirements. In trading business, fixed capital requirement is low. Investment in fixed assets is low. In manufacturing business, fixed capital requirement is high. Investment in fixed assets is high.

(ii) **Growth Prospects:** In case, an organisation wants to grow, fixed capital requirement is high. Higher capacity needs to be created by doing higher investment in fixed assets. In case, an organisation does not want to grow, fixed capital requirement is low, lower investment in fixed assets.

(iii) **Diversification:** A firm wants to diversify its operations. Fixed capital requirements will be high. Investment in fixed assets is high. A firm does not want to diversify its operations. Fixed capital requirement is low. Investment in fixed assets is low.

(iv) **Level of Collaboration:** In case, scale of operations of each business is not sufficient and they want to share each other's facility or want to jointly establish a particular facility. *e.g.*, a bank may use another bank's ATM. Fixed capital requirement is low. Collaboration leads to low level of investment in fixed assets for each business. In case, business does not want to collaborate. Fixed capital requirement is high. Investment in fixed assets is high.

Q 21. Furniture House Pvt. Ltd. is counted among the top furniture companies in Delhi. It is known for offering innovative designs and high quality furniture at affordable prices. The company deals in a wide product range of home and office furniture through its eight showrooms in Lucknow. The company is now planning to open five new showrooms each in Delhi and Bengaluru. In Bengaluru, it intends to take the space for the showrooms on lease whereas for opening showrooms in Delhi, it has collaborated with a popular home furnishing brand, 'Decor'.

(i) Identify the factors mentioned in the paragraph which are likely to affect the fixed capital requirements of the business for opening new showrooms both in Bengaluru and Delhi separately.

(ii) "With an increase in the investment in fixed assets, there is a commensurate increase in the working capital requirement." Explain the statement with reference to the case above.

Ans. (i) Factors mentioned in the paragraph which are likely to affect the fixed capital requirements of the business are:

(a) **Financing Alternatives:** In case of high risk line business and developed financial market, fixed capital requirement is low.

In case of low risk line business and less developed financial market, fixed capital requirement is high.

Fixed assets needs to be purchased. Thus, investment in fixed assets is high.

In the above case, the fixed capital requirements of Furniture House Pvt. Ltd. for opening new showrooms in Bengaluru will be relatively less as its taking space on lease, so only rentals have to be paid.

(b) **Level of Collaboration:** In case, scale of operations of each business is not sufficient and they want to share each other's facility or want to jointly establish a particular facility. *e.g.*, a bank may use another bank's ATM. Fixed capital requirement is low.

Collaboration leads to low level of investment in fixed assets for each business.

In case, business does not want to collaborate. Fixed capital requirement is high. Investment in fixed assets is high.

In the above case, the fixed capital requirement for opening showrooms in Delhi will be reduced as its going to share the costs with another company through collaboration.

(ii) It's true that, "With an increase in the investment in fixed assets, there is a commensurate increase in the working capital requirement." Like in the above case, Furniture House Pvt. Ltd. is planning to invest in new showrooms. Consequently, its requirement of working capital will increase as it will need more money to stock goods, pay electricity bills and salaries to staff. Also, it intends to take the space for the showrooms in Delhi on lease so it will have to pay rentals.

Q 22. 'Technology upgradation' and 'Level of collaboration' affect one of the types of capital requirements of the company. Identify the type of capital requirement affected with reference to the above statement. Also, explain any other two factors, apart from the ones stated above affecting the type of capital requirement identified.

(CBSE 2022, Term-2)

Ans. The requirement of fixed capital depends upon various factors which are explained below:

(i) **Technology Upgradation:** Industries in which assets become obsolete soon and their replacement becomes due faster. *e.g.*, computer industry. Fixed capital requirement is high.

Industries in which assets become obsolete later and their replacement does not become due faster. *e.g.*, furniture industry. Fixed capital requirement is low.

(ii) **Financing Alternatives:** In case of high risk line business and developed financial market, fixed capital requirement is low. Leasing option is available apart from purchase option. Thus, one can opt for lease option and save cost/investment in fixed assets.

In case of low risk line business and less developed financial market, fixed capital requirement is high. Leasing option is not available. Fixed assets needs to be purchased. Thus, investment in fixed assets is high.

Q 23. Kaveri is busy in preparing the financial blueprint for her organisation's future operations. She feels that detailed plans of action reduce waste and duplication of efforts. However, her friend, Sana feels that in an uncertain and dynamic world, this type of planning may not work. Kaveri again stresses on her statement and explains why this financial blueprint important.

Identify the concept and state three points of its importance in addition to those explained in the above para. *(CBSE 2023)*

Ans. Financial Planning

Importance of financial planning are:

(i) It ensures smooth running of a business enterprise by ensuring availability of funds at the right time.

(ii) It helps in anticipating future requirements of funds and evading business shocks and surprises.

(iii) It facilitates coordination among various departments of an enterprise, like marketing and production functions, through well-defined policies and procedures.

(iv) It increases the efficiency of operations by curbing wastage of funds, duplication of efforts and gaps in planning.

Q 24. Dhaval Acharya, after acquiring a bachelor's degree in Hotel Management joined his father's chain of vegetarian restaurants in Ahmednagar. Being young and enterprising, he suggested his father to add a new section of vegetarian bakery items which required an investment of ₹ 5 crores. His father Mr Aariketh Acharya suggested him to take the decision with caution and understood everything comprehensively as bad decision may damage the financial fortune of business.

Identify the decision suggested by Mr Aariketh Acharya. State by giving any three reasons as to why he must have advised his son to take decision with caution. *(CBSE SQP 2023-24)*

Ans. Mr Aariketh Acharya has suggested capital budgeting decision.

The reasons why he must have advised his son to take decision with caution are:

(i) Through the capital budgeting process, funds invested in the company are protected to some extent from any future uncertainty.

(ii) Capital budgeting assists organisations in taking decisions and achieving long-term goals as it provides insight regarding future costs and growth.

(iii) Capital budgeting decisions affect the returns of the firm, therefore influence the overall business risk complexion of the firm.

Long Answer Type Questions

Q 1. After completing his education in travel and tourism, Dev started Curly Tails Pvt. Ltd. along with his twin brother Ram. Their company seeks to provide travel solutions to its clients like ticket booking for airways, railways and roadways, hotel booking, insurance, etc. Although the business is doing well both of them have realised that they are not good in managing finance, and feel confused and frustrated sometimes due to financial crises that may suddenly arise. In order to avoid such situations in the future, they hire Sohan and Rohan as financial managers, who have done a degree certification course in financial management.

In the context of the above para:

(i) Give the meaning of financial management.

(ii) Outline the role of Sohan and Rohan as the financial management team of the Curly Tails Pvt. Ltd. by giving any five suitable points.

Ans. (i) Financial Management is concerned with optimal procurement as well as the usage of finance.

(ii) Sohan and Rohan will play a very important role as the financial management team of the Curly Tails Pvt. Ltd. in managing the financial health of the company. This can be understood through the following points:

(a) To determine the capital requirements of business both long-term and short-term.

(b) To determine the capital structure of the company and determine the sources from where required capital will be raised keeping in view the risk and return matrix.

(c) To ensure efficient management of cash in order to ensure both liquidity and profitability.

(d) To exercise overall financial control in order to promote safety, profitability and conservation of funds.

(e) To decide about the allocation of funds into profitable avenues, keeping in view their safety as well.

Q 2. 'Vivah' is a popular online matrimonial portal. It seeks to provide personalised match making service. The company has 80 offices in India, and is now planning to open offices in US, Dubai and China to cater to its customers beyond the country. The company has decided to opt for the sources of equity capital to raise the required amount of capital.

In the context of the above paragraph:

(i) Identify and explain the type of risk which increases with the higher use of debt.

(ii) Explain briefly any four factors because of which you think the company has decided to opt for equity capital.

Ans. (i) Financial Risk of the company increases with the higher use of debt.

Financial Risk: It refers to a situation when a company is not able to meet its fixed financial charges such as interest payment, preference dividend and repayment obligations.

(ii) The factors because of which the company has decided to opt for equity capital are as follows:

(a) Cash Flow Position of the Company: A strong cash flow position may make debt financing more viable than funding through equity.

But in the above case, the cash flow position of the company is weak so, it cannot meet the fixed obligations involved in issue of debt.

(b) Risk: The risk associated with each source is different. Debt is more risky than equity because it has fixed payment obligations of interest and principal amount.

In above case, the proportion of debt in its capital structure is already high, so it cannot issue further debt, thereby endangering the solvency of the company.

(c) Fixed Operating Cost: If a business has high fixed operating costs (*e.g.*, building rent, salaries), it must reduce fixed financing costs. Hence, lower debt financing is better.

Similarly, if fixed operating cost is less, more of debt financing may be preferred.

In the above case, the fixed operating cost of company is high so, it cannot take the further burden of fixed commitment in terms of payment of interest and repayment of capital by issuing debt.

(d) State of Capital Market: During the period, when stock market is rising, more people invest in equity. However, depressed capital market may make issue of equity shares difficult for any company.

In the above case, the state of capital market is bullish, so people are likely to invest more in equity.

Q 3. Abhishek Ltd. is manufacturing cotton clothes. It has been consistently earning good profits for many years. This year too, it has been able to generate enough profits. There is availability of enough cash in the company and goods prospects for growth in future. It is a well managed organisation and believes in quality, equal employment opportunities and good remuneration practices. It has many shareholders who prefer to receive a regular income from their investments.

It has taken a loan of ₹ 50 lakh from ICICI Bank and is bound by certain restrictions on the payment of dividend according to the terms of the loan agreement.

The above discussion about the company leads to various factors which decide how much of the profits should be retained and how much has to be distributed by the company.

Quoting the lines from the above discussion, identify and explain any four such factors. *(CBSE 2015)*

Ans. Factors affecting dividend decision are:

(i) Stability of Earning: A company having stable earnings can declare higher dividend. On the contrary, a company having unstable earnings is likely to pay smaller dividend.

Lines Quoted: *"It has been consistently earning good profits for many years."*

(ii) Cash Flow Position: Payment of dividend involves outflow of cash. So, availability of enough cash in the company is necessary for distribution of dividend.

Lines Quoted: *"There is availability of enough cash in the company."*

(iii) Growth Opportunities: Companies having good growth opportunities generally pay less dividend and retain more money out of profits to invest in profitable projects.

On the other hand, non-growth companies can pay higher dividend, provided they have enough earnings and cash.

Lines Quoted: *"Goods prospects for growth in future."*

(iv) Shareholder's Preference: Some shareholders (like retired persons) want a regular income (dividend) from their investments. The company should always consider the preference of such shareholders while declaring dividend.

Lines Quoted: *"It has many shareholders who prefer to receive a regular income from their investments."*

Q 4. Sohan inherited a very large area of agricultural land in Haryana after death of his grandfather. He plans to sell this piece of land and use the money to set up a small scale paper factory to manufacture all kinds of stationary items from recycled paper. Being an amateur in business, he decides to consult his friend Suresh who works in a financial consultancy firm, Suresh, helps him to prepare a blueprint of his future business operations on the basis of sales forecast in next five years. Based on these estimates, he helps Sohan to assess the fixed and working capital requirements of business.

In the context of the above paragraph:

(i) Identify and define the type of financial service that Suresh has offered to Sohan.

(ii) Briefly state any four points highlighting the importance of the type of financial service identified in point (i).

Ans. (i) Financial Planning is the type of financial service that Suresh has offered to Sohan.

Financial Planning: It is a financial blueprint of an organisation's future operations. It helps in smooth functioning of the organisation as it helps to tackle the uncertainty in respect to availability and timing of funds.

The process of estimating the funds requirements of a business and specifying the sources of funds is called financial planning.

(ii) The four points highlighting the importance of financial planning are:

(a) It ensures smooth running of a business enterprise by ensuring availability of funds at the right time.

(b) It helps in anticipating future requirements of funds and evading business shocks and surprises.

(c) It facilitates coordination among various departments of an enterprise, like marketing and production functions, through well-defined policies and procedures.

(d) It increases the efficiency of operations by curbing wastage of funds, duplication of efforts and gaps in planning.

Q 5. Organica Ltd. is a company engaged in production of organic foods. Presently, it sells its products through indirect channels of distribution. But, considering the sudden surge in the demand for organic products, the company is now inclined to start its online portal for direct marketing. The financial managers of the company are planning to use debt in order to take advantage of trading on equity. In order to finance its expansion plans, it is planning to raise a debt capital of ₹ 40 lakh through a loan @ 10% from an industrial bank. The present capital base of the company comprises of ₹ 9 lakh equity shares of ₹ 10 each. The rate of tax is 30%.

In the context of the above paragraph:

(i) What are the two conditions necessary for taking advantage of trading on equity?

(ii) Assuming the expected rate of return on investment to be same as it was for the current year *i.e.*, 15%, do you think the financial managers will be able to meet their goal. Show your working clearly.

Ans. (i) The two conditions necessary for taking advantage of trading on equity are:

(a) The rate of return on investment should be more than the rate of interest.

(b) The amount of interest paid should be tax deductible.

(ii)

Sources	Situation 1 Amount (in ₹)	Situation 2 Amount (in ₹)
Equity shares	90,00,000	90,00,000
(+) 10% Debentures	NIL	40,00,000
Total Capital	90,00,000	1,30,00,000
EBIT	13,50,000	19,50,000
(–) Interest	—	(4,00,000)
EBT	13,50,000	15,50,000
(–) Tax @ 30%	(4,05,000)	(4,65,000)
EAT	9,45,000	10,85,000
No. of shares of ₹ 10 each	9,00,000	9,00,000
EPS	9,45,000 / 9,00,000 = 1.05	10,85,000 / 9,00,000 = 1.21

Yes, the financial managers will be able to meet their goal as the projected EPS, with the issue of debt, is higher than the present EPS.

Q 6. Explain the term 'Trading on Equity'. Why, when and how it can be used by company?

Ans. 'Trading on equity' refers to the increase in profit earned by the equity shareholders due to the presence of fixed financial charges like interest.

Thus, shareholders are likely to gain with a debt component in the capital employed.

HOW?: The use of more debt with equity increases the rate of return on share capital.

WHY?: This is because debt/loans carry fixed amount of interest, which is a tax deductible expense.

WHEN?: Benefit to shareholders will be realised only if ROI > Rate of Interest on debt.

This can be better understood with the help of an example given below:

Let us consider a company X. It has to make a total investment of ₹ 30 lakh in a project.

It uses debt in varying amounts in hypothetical situation I, II and III. So, as to see the effect of using it an earning per share.

In situation I, it uses no debt.

In situation II, it uses ₹ 10 lakh as debt.

In situation III, it uses ₹ 20 lakh as debt.

Let us compare, how the varying use of debt in the three situations will have a bearing on EPS.

Example:

Given:	Total funds used	:	₹ 30 lakh
	Interest rate	:	10% p.a.
	Tax rate	:	30%
	EBIT	:	₹ 4 lakh

Debt →	Situation I	Situation II	Situation III
	Nil	₹ 10 lakh	₹ 20 lakh

EBIT-EPS Analysis

Sources	Situation I	Situation II	Situation III
EBIT	4,00,000	4,00,000	4,00,000
(–) Interest	Nil	(1,00,000)	(2,00,000)
EBT	4,00,000	3,00,000	2,00,000
(–) Tax	(1,20,000)	(90,000)	(60,000)
EAT	2,80,000	2,10,000	1,40,000
No. of shares of ₹ 10 each	3,00,000	2,00,000	1,00,000

EPS	$\frac{2,80,000}{3,00,000}$ = 0.93	$\frac{2,10,000}{2,00,000}$ = 1.05	$\frac{1,40,000}{1,00,000}$ = 1.4

EPS = < 0.93 < 1.05 < 1.4

$$\text{Return on Investment} = \frac{\text{EBIT}}{\text{Total Investment}} \times 100$$

$$= \frac{4,00,000}{30,00,000} \times 100 = 13.33\%$$

It is clearly seen that as use of debt increases from situation I to situation III, the EPS (profitability) also increases. So, it is a case of favourable financial leverage.

We can also see that this is happening when ROI > Rate of interest on debt.

13.33% > 10%

Thus, here comes up the concept of trading on equity.

Q 7. Debt and equity both are to be used in determining the capital structure of a firm. Make a comparative study of debt and equity on the basis of cost and risk so as to analyse how both of these can be used for attaining an optimal capital structure?

Ans. Debt and equity both are to be used in determining the capital structure of a firm. Debt and equity differ significantly in terms of their cost and risk for the firm.

Comparison of debt and equity to be used in capital structure is given below:

(i) On the Basis of Cost: Debt is more cheaper than equity because:

(a) lenders earn an assumed return (fixed interest) and repayment of capital so therefore, they should require a lower rate of return.

(b) interest paid on debt is a tax-deductible expense whereas dividend are paid out of after tax profits.

↑ Debt ⇒ ↓ Cost of capital

(ii) On the Basis of Risk: Debt is more risky than equity. There is a financial risk (chance that a firm would fail to meet its payment obligations *i.e.*, interest and principal amount) associated with debt because of the reason that interest on debt has to be paid irrespective of whether or not a firm has made a profit.

Moreover, principal amount also has to be repaid on maturity whereas equity is riskless as there is no commitment regarding payment of dividend and repayment of capital.

↑ Debt = ↑ Risk

So, an ideal capital structure is one which has proportion of debt and equity in such a manner that it maximises shareholders wealth by increasing value of equity shares.

Q 8. 'Ziva' is India's second largest manufacturer of branded lifestyle apparel. The company now plans to diversify into personal care segment by launching perfumes, hair care and skin care products. Moreover, it is planning to open ten exclusive retail outlets in various cities across the country in next two years.

In the context of the above paragraph:

(i) Identify the two factors affecting the fixed capital needs of the company by quoting lines from the paragraph.

(ii) Why is the management of fixed capital considered to be an important for a business?

Ans. (i) The factors affecting the fixed capital needs of the company are as follows:

(a) Diversification:

Lines Quoted: '*The company now plans to diversify into personal care segment by launching perfumes, hair care and skin care products.*'

(b) Growth Prospects:

Lines Quoted: '*Moreover, it is planning to open ten exclusive retail outlets in various cities across the country in next two years.*'

(ii) The management of fixed capital is considered to be an important for a business because of the following reasons:

(a) Impact on Long-term Growth: These decisions have bearing on the long-term growth. The funds invested in long-term assets are likely to yield return in the future. These will affect the future prospects of the business.

(b) Large Amount of Funds Involved: These decisions result in a substantial portion of capital funds being blocked in long-term projects. Therefore, these investments are planned after a detailed analysis is undertaken. This may involve decisions like where to procure funds from and at what rate of interest.

(c) Risk Involved: Fixed capital involves investment of huge amounts. It affects the returns of the firm as a whole in the long-term. Therefore, investment decisions involving fixed capital influences the overall business risk complexion of the firm.

(d) Irreversible Decisions: These decisions once taken, are not reversible without incurring heavy losses. Abandoning a project after heavy investment is made, is quite costly in terms of waste of funds. Therefore, these decisions should be taken only after carefully evaluating each detail or else the adverse financial consequences may be very heavy.

Q 9. **Kay Ltd. is a company manufacturing textiles. It has a share capital of ₹ 60 lakh. In the previous year, its earning per share was ₹ 0.50. For diversification, the company requires additional capital of ₹ 40 lakh. The company raised funds by issuing 10% debentures for the same. During the year, the company earned profit of ₹ 8 lakh on capital employed. It paid tax @ 40%.**

(i) State whether the shareholders gained or lost in respect of earning per share on diversification. Show your calculation clearly.

(ii) Also, state any three factors that favour the issue of debentures by the company as part of its capital structure. *(CBSE 2016)*

OR

When the 'Return on Investment' of the company is higher than 'Interest Rate on debt', it can use more debt in the capital structure of the company in order to increase its 'Earning Per Share'. Explain the given situation with the help of a suitable example. *(CBSE 2022, Term-2)*

Ans. (i) **Assumption:** Face value of share is ₹ 10 each.

Computation of profit for equity in the previous year:

$$EPS \Leftrightarrow \frac{\text{Profit for Equity}}{\text{No. of Equity Shares}}$$

$$0.50 = \frac{x}{6,00,000}$$

$$\Rightarrow \quad x = ₹\ 3,00,000$$

⇒ Profit for equity in previous year = ₹ 3,00,000

Computation of profit for equity in the current year:

		(₹)
EBIT	=	8,00,000
(–) Interest on 10% debentures (10% × 40,00,000)	=	(4,00,000)
EBIT	=	4,00,000
(–) Tax @ 40%	=	(1,60,000)
Profit for Equity	=	2,40,000

$$EPS = \frac{2,40,000}{6,00,000} = ₹\ 0.40$$

Loss to the shareholders

= (₹ 3,00,000 – 2,40,000) = ₹ 60,000

Reductions in EPS

= (₹ 0.50 – 0.40) = ₹0.10 per share

(ii) Factors that favours the issue of debentures by the company are:

(a) **Cost:** Debt is cheaper source of finance because interest on debt is a tax-deductible expense. More debt can be used in capital structure if cost of debt is low.

(b) **Control Considerations:** Debt normally does not cause a dilution of control while issue of equity shares may be reduce management control over the business.

(c) **Cash Flow Position of the Company:** A strong cash flow position of the company makes debt financing better than finding through equity because it can generate enough cash inflows to pay interest on debt.

Q 10. **"Determining the relative proportion of various types of funds depends upon various factors." Explain any six such factors.** *(CBSE 2019)*

Ans. Factors affecting the choice of capital structure are:

(i) **Cash Flow Position:** The size of the projected cash flow must be considered before deciding the capital structure of the firm. If there is sufficient cash flow, debt can be used. It must cover fixed payment obligations w.r.t:

(a) Normal business operations.

(b) Investment in fixed assets.

(c) Meeting debt service commitments as well as provide a sufficient buffer.

(ii) **Interest Coverage Ratio:**

(a) Interest Coverage Ratio = EBIT/Interest Expense, where EBIT = Earnings Before Interest and Tax

(b) Higher the interest coverage ratio lower shall be the risk of the company failing to meet its interest payment obligations.

(c) Low interest coverage ratio => debt ≠ used.

(iii) **Debt Service Coverage Ratio:**

(a) Debt Service Coverage Ratio (DSCR) = Profit after tax + Depreciation + Interest + Non-cash expenses + Preference Dividend + Interest + Repayment obligation.

(b) A higher debt service coverage ratio, in which the cash profits generated by the operations are compared with the total cash required for the service of debt and the preference share capital, the better will be the ability of the firm to increase debt component in the capital structure.

(c) Low debt service coverage ratio => debt ≠ used.

(iv) **Return on Investment:** If return on investment of the company is higher, the company can choose to use trading on equity to increase its EPS (Earning Per Share), *i.e.* its ability to use debt is greater.

(v) **Cost of Debt:** More debt can be used if cost of debt is low. However, in case of higher cost of debt, company prefers more of equity.

(vi) **Tax Rate:** A higher tax rate makes debt relatively cheaper and increases its attraction as compared to equity.

(vii) **Cost of Equity:**

(a) When the company uses more debt, the financial risk faced by equity holders increase so their desired rate of return increases.

(b) If debt is used beyond a point, cost of equity may go up sharply and share price may decrease in spite of increased EPS.

(viii) **Floatation Cost:**

(a) Cost of public issue is more than the floatation cost of taking a loan.

(b) The floatation cost may affect the choice between debt and equity and hence the capital structure.

(ix) **Risk Consideration:** The total risk of business depends upon both the business risk and financial risk. If a firm's business risk is lower, its capacity to use debt is higher and *vice-versa*.

Q 11. Explain briefly any four factors that affect the working capital requirement of a company. *(CBSE 2017)*

Ans. Four factors that affect the working capital requirement of a company are:

(i) **Business Cycle:** In the time of boom, more production will be undertaken and so more working capital will be required during that time as compared to depression.

(ii) **Credit Availed:** If a firm is able to purchase raw materials on credit from its suppliers, then less working capital will be required.

(iii) **Nature of Business:** A trading organisation needs a lower amount of working capital as compared to a manufacturing organisation, as trading organisation undertakes no processing work.

(iv) **Scale of Operations:** An organisation operating on large scale will require more inventory and thus, its working capital requirement will be more as compared to small organisation.

Q 12. New Delhi has been declared as the most polluted city in the world. Bengaluru, Mumbai, Patna, Ahmedabad, Lucknow, Kanpur and Ludhiana are also the highly polluted Indian cities. This has resulted into a dramatic increase in the sale of some air purifiers. The prices of these devices range from ₹ 2,000 to ₹ 25,000 depending upon the type of pollutant these purifiers remove. Looking at the increasing demand of these air purifiers, 'Pure Air Technology India Ltd.' has developed a low cost home air purifiers in its R & D Lab. The company has estimated that a commercial production of 1,00,000 units per year may cost the company ₹500 per unit. For this, capital of ₹ 100 crore will be required. The company decided to have both equity and debt in its capital structure. Explain any four factors that the company should consider while deciding its capital structure. *(CBSE 2016)*

Ans. Factors that the company should consider while deciding its capital structure are:

(i) **Cash Flow Position:** If the cash flow position of the company is strong, debt financing is better than funding through equity because it can generate enough cash inflows to pay interest on debt.

On the contrary, it would be quite risking to use more debt if cash inflows are unstable.

(ii) **Control:** Debt normally does not cause a dilution of management's control over the business while issue of more equity may reduce the management's holding in the company. There is a risk of takeover also.

So, this factor also affects the choice between debt and equity.

(iii) **Cost of Debt:** A business can raise more money from debt if it can raise it at a lower interest rate.

A firm's ability to borrow at a lower rate increases its capacity to employ higher debt.

(iv) **Debt Service Coverage Ratio (DSCR):** This ratio takes care of the deficiencies referred to in the Interest Coverage Ratio.

In this, the cash profits generated by the operations are compared with the total cash required for service of debt and preference share capital.

Formula:

$$\frac{\text{PAT} + \text{Depreciation} + \text{Interest} + \text{Non-cash Expenses}}{\text{Preference Dividends} + \text{Interest} + \text{Repayment Obligation}}$$

$\uparrow$ DSCR $\Rightarrow$ $\uparrow$ ability to meet cash commitments

i.e., company can use more debt in its capital structure.

Q 13. Vansh Limited is a large and reputed company which manufactures ventilators. After the outbreak of COVID-19 in 2020, the company witnessed an increase in revenue by 40%. It has plans to further increase its production capacity and also start production of PPE kits, sanitisers and masks in 2022. The finance manager of the company Mr. Rajiv feels confident about the future of the company and its liquidity position. Discuss the meaning of dividend decision and in the light of the above statement explain any two factors which should be considered by Vansh Limited while formulating the dividend policy of the company.

OR

Vedansh Limited has a share capital of ₹10,00,000 divided into shares of ₹100 each. For expansion purpose, the company requires additional funds of ₹5,00,000. The management is considering the following alternatives for raising funds:

Alternative 1: Issue of 5000 Equity shares of ₹100 each

Alternative 2: Issue of 10% Debentures of ₹5,00,000

The company's present Earnings Before Interest and Tax (EBIT) is ₹4,00,000 p.a. Assuming that the rate of return on investment remains the same after expansion, which alternative should be used by the company in order to maximise the returns of the equity shareholders. The tax rate is 50%. Show the working.

Ans. The decision involved here is how much of the profit earned by the company (after paying tax) is to be distributed to the shareholders and how much of it should be retained in the business.

The factors affecting dividend decision are:

(i) Amount of Earnings: If the earnings of the company are high, dividends are paid at a higher rate and *vice-versa*.

(ii) Access to Capital Market: A large company can access funds easily from capital market as per its requirements, therefore, it is likely to retain lesser profits and is likely to pay higher dividends.

OR

Rate of Return on Investment is

$= 4,00,000/10,00,000 \times 100 = 40\%$

EBIT after expansion $= 40\% \times 15,00,000$

$= ₹6,00,000$

Calculation of EPS:

Sources	Alternative-1	Alternative-2
EBIT	6,00,000	6,00,000
(–) Interest	–	50,000
EBT	6,00,000	5,50,000
(–) Tax (50%)	3,00,000	2,75,000
EAT	3,00,000	2,75,000
No. of Shares	15,000	10,000
EPS	20	27.5

Working Note:

$$EPS = \frac{EAT}{\text{No. of shares}}$$

Alternative-1

$$= \frac{3,00,000}{15,000} = 20$$

Alternative-2

$$= \frac{2,75,000}{10,000} = 27.5$$

The company should use alternative 2 in order to increase the return of the equity shareholders.

Chapter Test

Multiple Choice Questions

Q 1. ICR = ...

a. EBIT/Interest
b. EBIT × Interest
c. EBIT – Interest
d. Interest/EBIT

Q 2. Opening a new branch of its business by a company is a/an .... decision.

a. investment
b. financing
c. dividend
d. All of these

Q 3. Financial planning takes into consideration which of the following:

a. Growth
b. Performance
c. Investments
d. All of these

Q 4. Statement I: Financial management provide the base for success of promotion.
Statement II: Sound financial plan is very necessary for the success of business enterprise.
Choose the correct option from the options given below:

a. Statement I is true and II is false.
b. Statement II is true and I is false.
c. Both the statements are true.
d. Both the statements are false.

Assertion and Reason Type Questions

Directions (Q. Nos. 5-6): *There are two statements marked as Assertion (A) and Reason (R). Read the statements and choose the appropriate option from the options given below:*

a. Both Assertion (A) and Reason (R) are true and Reason (R) is the correct explanation of Assertion (A).
b. Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
c. Assertion (A) is true, but Reason (R) is false.
d. Assertion (A) is false, but Reason (R) is true.

Q 5. Assertion (A): Capital budgeting decisions are very crucial and must be taken with utmost care.
Reason (R): Investment decisions affect the earning capacity of firm over the long run and are irreversible except at a huge cost.

Q 6. Assertion (A): A company having easy access to the capital market follows a strict dividend policy.
Reason (R): Such company can raise capital by approaching capital market.

Case Study Based Questions

Q 7. Read the extract given below and answer the questions on the basis of the same:

Mr Rohit is running a successful business. Mr. Rohit is the owner of H.L Ltd. Mr Rohit decided to expand his business by acquiring a Steel Factory. This required an investment of ₹80 crore. To seek advice in this matter, he called his financial advisor, Mr Suresh, who advised him about the judicious mix of equity (35%) and debt (65%). Employ more of cheaper debt may enhance the EPS. Mr Suresh also suggested him to take loan from a financial institution as the cost of raising funds from financial institutions is low. Though, this will increase the financial risk but will also raise the return to equity shareholders. He also appraised him that issue of debt will not dilute the control of equity shareholders. At the same time, the interest on loan is a tax-deductible expense for computation of tax liability. After due deliberations with Mr Suresh, Mr Rohit decided to raise funds from a financial institution.

(i) Identify the concept of Financial Management as advised by Mr Suresh in the above situation:
a. Dividend Decision
b. Capital Budgeting
c. Capital Structure
d. Working Capital Decision

(ii) In the above case, Mr Suresh suggested to raised more fund from debt. Higher debt-equity ratio results in:
a. High degree of financial risk
b. Higher degree of operating risk
c. Lower financial risk
d. Higher earning of profit

(iii) "Mr Suresh who advised him about the judicious mix of equity (35%) and debt (65%)". The proportion of debt in the overall capital is called:
a. Total Assets
b. Working Capital
c. Financial Leverage
d. None of the above

(iv) Employ more of cheaper debt may enhance the EPS. Such practice is called:
a. Equity Trading
b. Trading on Equity
c. Investment Decision
d. Financial Leverage

Q 8. Read the extract given below and answer the questions on the basis of the same:

Sunflag Iron Ltd. is manufacturing steel at its plant in India. It is enjoying increased demand for its steel as economics growth of the country is about 8%. It is planning to set up a new plant to avail the benefits of increased demand. It is estimated that it will require about ₹4,000 crore for setting up of plants and about ₹600 crore for other expenses to start the new plant. To collect the above mentioned funds, the sources to be used and the quantity to be collected from different sources had to be considered.

(i) Identify the above discussed concept and give its meaning.

(ii) Explain any two factors that affect the concept identified in paragraph above.

Very Short Answer Type Questions

Q 9. Explain how cost debt affects the choice of capital structure of a company.

Q 10. State the two objectives of financial planning.

Q 11. What is meant by trading on equity?

Short Answer Type-I Questions

Q 12. What are the main objectives of financial management?

Q 13. Explain three factors affecting dividend decision.

Short Answer Type-II Questions

Q 14. Name the decision taken by a financial manager which determines the overall cost of capital and the financial risk of the enterprise. Explain any two factors which affect this decision.

Q 15. "Financial planning tries to link the present with future." Explain the importance of financial planning in the light of this statement.

Long Answer Type Questions

Q 16. You are the finance manager of a newly established manufacturing company. Explain any six factors that you will consider while determining the fixed capital requirement of a firm.

Q 17. Explain, in brief, any six factors that should be taken into consideration while determining the requirements of working capital for a business.