CLASS 12 BUSINESS STUDIES
CHAPTER-9
FINANCIAL MANAGEMENT

IMPORTANT QUESTIONS

VERY SHORT ANSWER QUESTIONS (1 or 2 Marks)

QUESTION 1.

'Reliable Transport Services Ltd.' specializes in transporting fruits and vegetables. It has a good reputation in the market as it delivers the fruits and vegetables at the right time and at the right place.'
State with reason whether the working capital requirements of 'Reliable Transport Services' will be high or low.

(CBSE BOARD 2015)

Answer:
The working capital requirement of Reliable Transport Services Ltd. will be low, because fruits and vegetables are perishable in nature and thus there is no need of maintaining a large amount of stock.

QUESTION 2.

How do 'Floatation costs' affect the choice of capital structure of a company? State.
(CBSE BOARD 2015)

Answer:
Floatation cost refers to the cost of raising funds. Higher the flotation cost of a particular source, lower is its preference in the capital structure and vice versa.

QUESTION 3.

What is meant by 'financial management'?

(CBSE BOARD 2017)

Answer. 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.

QUESTION 4.

Besides the investment decision the finance function is concerned with two other broad decisions. Name these decisions.

(CBSE BOARD 2015)

Answer. Two other broad decisions are:
(i)Financing decision: This decision is about the quantum of finance to be raised from various long-term sources and short-term sources and selecting the cheapest one.

(ii) Dividend decision: Dividend is that portion of divisible profits that is distributed to the shareholders. It results in current income for the shareholders.

QUESTION 5.

A textile company is diversifying and starting a steel manufacturing plant. State with reason the effect of diversification on the fixed capital requirements of the company.

(CBSE BOARD 2015)

Answer. With diversification, the fixed capital requirements will increase as the investment in fixed capital will increase.

QUESTION 6.

Rizul Bhattacharya after leaving his job wanted to start a Private Limited Company with his son. His son was keen that the company may start manufacturing of Mobile- phones with some unique features. Rizul Bhattacharya felt that the mobile phones are prone to quick obsolescence and a heavy fixed capital investment would be required regularly in this business. Therefore, he convinced his son to start a furniture business. Identify the factor affecting fixed capital requirements, which made Rizul Bhattacharya to choose furniture business over mobile phones.

(CBSE BOARD 2016)

Answer. The factor affecting fixed capital requirements is "Technology Upgradation".

QUESTION 7.

The size of assets, the profitability and competitiveness are affected by one of the financial decisions. Name and state the decision.

(CBSE BOARD 2016)

Answer. The size of assets, profitability and competitiveness are all affected by capital budgeting decision/ investment decision.

QUESTION 8.

Why does financial risk arise?

Answer: Interest on borrowed fund have to be paid regardless of whether or not the firm has made a profit. Moreover borrowed fund have to be repaid after a fixed period of time and it carries a charge on assets. This gives rise to financial risk.

QUESTION 9.

How does production cycle effect working capital?

Answer: Working capital requirement will be higher with longer production cycle.

QUESTION 10.

Enumerate two objectives of financial management?

Answer:
(a) Primary objective: Is to maximize wealth of owners in the long run – Wealth Maximization concept.

(b) The objective of financial management is to maximize the current price of equity shares of the company.

QUESTION 11.

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 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 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 'Fashionate Pvt. Ltd.' Praveen and Ramesh were carrying on a printing and stationery business in the name on '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 the factor affecting fixed capital requirements of 'Fashionate Pvt. Ltd.'

Answer. The factor affecting the fixed capital requirements of 'Fashionate Pvt.Ltd.' is level of **collaboration:** At times, business organisations undergo collaboration with each other and jointly establish certain facilities. In such cases, an individual organisation's requirement for fixed capital reduces.

QUESTION 12.

What is meant by 'Capital Structure'?

(CBSE BOARD 2017)

Answer. Capital Structure refers to a judicious combination of the debt and equity in an organisation. One of the important decisions under financial management, that relates to the financing pattern or the proportion of the use of different sources in raising funds.

QUESTION 13.

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

(CBSE BOARD 2016)

Answer. Financial Planning provides a link between investment and financing decisions. Financial Planning involves designing the blueprint of the financial operations of a firm.

QUESTION 14.

Name and state the aspect of financial management that enables to foresee the fund requirements both in terms of 'the quantum' and 'in terms of the timings'.

(CBSE BOARD 2016)

Answer. The aspect of financial management that enables to foresee the fund requirements both in terms of 'the quantum' and in terms of 'the timings' is "Financial Planning". Financial planning involves designing the blueprint of the overall financial operations of a company such that right amount of funds are available for various operations at the right time.

SHORT ANSWER QUESTIONS (3 or 4 Marks)

QUESTION 15.

State any four factors which affects the requirements of working capital requirements of a company.

Answer. Factors which affect the requirements of working capital are:

1. Nature of Business: The basic nature of a business enterprise influences the amount of working capital required by it. For e.g. A trading organization needs a lower amount of working capital as compared to a manufacturing organization.

2. Scale of Operations: An organization which is operating on large scale will require more inventory as its working capital requirement will be more, compared to small organization.

3. Business Cycle: When there is a boom in the economy, more production will be undertaken and so more working capital will be required during that time as compared to depression in the economy.

4. Seasonal Factors: In peak season, demand for a product will be high and thus high working capital requirements will be more as compared to lean season.

QUESTION 16.

'Best Bulbs Pvt. Ltd. was manufacturing good quality LED bulbs and catering to local market. The current production of the company in 800 bulbs a day. Sumit, the marketing manager of the company surveyed the market and decided to supply the bulbs to five-start-hotels also. He anticipated the higher demand in future and decided to buy a sophisticasted machine to further improve the quality and quantity of the bulbs produced.

Identify the factor affecting fixed capital requirements of the company.

Answer. The factor affecting fixed capital requirements of a company is 'Growth Prospects'. Higher growth and expansion of a company is associated with higher production, more sales, more inputs, etc. This requires higher level of machinery. Thus, organisations with high growth prospects require higher amount of fixed capital and vice versa.

High growth prospects→ Large fixed capital requirement. Low growth prospects→ Low fixed capital requirement

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QUESTION 17.

Every manager has to take three major decisions while performing the finance function. Explain them.

Answer. A manager take three following major decisions:-

1) Financing Decision: This decision is about the quantum of finance to be raised from various long-term sources and short-term sources and selecting the cheapest one.

2) Investment Decision: Investment decision means judicious investment of firm's resources, from the available alternative proposals and choosing the cheapest one, which earns highest possible return for the investors.

3) Dividend Decision: Dividend decision is whether to distribute earnings to shareholder as dividends or to retain earnings to finance long-term projects of the firm.

LONG ANSWER TYPE QUESTIONS (5 OR 6 MARKS)

QUESTION 18.

Sakshi Ltd. is a company manufacturing electronic goods. It has a share capital of Rs. 120 lakhs. The earning per share in the pervious years was Rs 0.5. For diversification the company requires additional capital of Rs 80 lakhs. The company raised funds by issuing 10% debentures for the same. During the current year the company earned profit of Rs 16 lakhs on capital employed, It paid tax of 40%.

(a) State whether the shareholders gained or loss in respect of earning per share on diversification. Show your calculations clearly.

(b) Also state any three factors that favour the issue of debentures by the company as part of its capital structure.

(CBSE BOARD 2016)

Answer.

$$(a)\ Profit\ before\ Interest\ \&Tax = Rs\ 16,00,000\ (Given)$$

$$Interest\ on\ 10\%\ debentures = Rs\ 8,00,000\left(80,00,000 \times \frac{10}{100}\right)$$

Profit before Tax=Profit before Interest and Tax−Interest =16,00,000−8,00,000=Rs 8,00,000

$$Tax\ @40\% = Rs\ 3,20,000\left(8,00,000 \times \frac{40}{100}\right)$$

Profit after Tax=Profit before Tax−Tax =8,00,000−3,20,000=Rs 4,80,000

$$EPS = \frac{Profit\ after\ Tax}{Number\ of\ Equity\ Shares} = \frac{4,80,000}{12,00,000} = 0.4$$

Note: The face value of equity shares is assumed to be Rs 10 each. Hence, number of equity shares is 12,00,000.

(b) The three factors that favour the issue of debentures by the company as part of its capital structure are given below.

1. Tax deductibility: Interest paid by the company to its debentures is tax deductible. In the above scenario, the company is paying tax @ 40%. Thus, it is beneficial for the company to issue debentures

2. Say in management: Issuing more shares will dilute the control of management. Thus, companies that are apprehensive of the dilution of control opt for more of debt and less of equity.

3. Relatively low cost: For a company, cost of raising capital through debentures is relatively lower than that through equity. This is due to assurance (of rate of returns) and guaranteed repayment (of debenture amount at maturity) that debenture holders require lower rate of returns. Besides this, interest amount payable to debenture holders is deductible expense. This is to say that interest amount is deducted from the company's earnings and then the net amount is used for calculation of tax liabilities. Hence, companies prefer to opt for debentures, as higher use of debt, lowers the over-all cost of capital with cost of equity remaining unaffected.

QUESTION 19.

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

Answer. The various factors affecting working capital requirements of a company are discussed below.
(a) Type of business: Organisations that deal in services or trading (having small operating cycle) require less working capital than organisations dealing in manufacturing. This is because in organisations such as service or trading, the raw materials are generally the same as the final outputs and the sales transaction takes place immediately. In contrast, a manufacturing firm involves a large operating cycle and the raw materials need to be converted into finished goods before they are finally sold. Therefore, such firms require large working capital.
Service or trading organisations → Small working capital requirement
Manufacturing organisations → Large working capital requirement.

(b) Extent of credit allowed by the firm: Credit implies allowing sale proceeds without immediate receipt of the cash payment. If a company follows a liberal credit policy, then its number of debtors increases. This in turn increases the requirement of working capital for the business. On the other hand, a stringent credit policy reduces the requirement of working capital.
Liberal credit policy → large working capital requirement.
Stringent credit policy → Small working capital requirement.

(c) Extent of availability of raw material: If the raw materials required by the company are such that they are easily available, then this suggests that the firm need not maintain a large stock of inventories of raw material. In such situations, the company requires less working capital. On the other hand, if the raw materials are not easily available or their supply is not smooth, then the company must maintain a huge stock of raw material to ensure uninterrupted operations, thereby requiring a large working capital.
Easy availability of raw material → Low working capital requirement
Difficulty in obtaining raw material → High working capital requirement.

(d) Scale of operations: Companies operating on a large scale require large working capital. This is because such companies need to maintain high stock of inventory and debtors. In contrast, if the scale of operations is small, the requirement of working capital will be less.
Large scale of operation → Large working capital requirement
Small scale of operation → Low working capital requirement

QUESTION 20.

The board of Directors has asked you to design the capital structure of the company. Explain the factors that you would consider while doing so.

Answer. For design the capital structure of the company six factors are as following:-

1) Cash Flow Position.

2) Interest coverage ration(ICR)

3) Debt Service coverage ratio(DSCR)

4) Return on investment (ROI)

5) Regulatory Framework

6) Tax rate.

QUESTION 21.

The directors of a company have decided to expand their business activities by increasing the stock of raw materials and finished goods at an estimated cost of Rs. 50 lakhs, Describe the various ways open to the company to raise necessary finance for the purpose.

Answer. The company can raise necessary finance for the purpose of expansion through the following function.

(a) Issue of shares

(b) Issue of debentures

(c) Loans from banks and financial institutions.

(d) Retained earnings.

QUESTION 22

Explain briefly any four factors affecting the fixed capital requirements of an organisation.

Answer.

Factors affecting the fixed capital requirements of an organisation:

1. Nature of Business: the type of business is a factor in determining the fixed capital requirements. For e.g. Manufacturing concerns require huge capital investment in fixed assets but trading concerns need less fixed capital investment.

2. Scale of Operations: A larger organization operating on large scale requires more fixed capital investment as compared to an organization operating on small scale.

3. Choice of Technique: An organization using capital-intensive techniques requires more investment in fixed assets as compared to an organization using labour intensive techniques.

4. Technology upgradation: An organization using obsolete assets require more fixed capital as compared to other organizations.

5. Growth Prospects: Companies having higher growth prospects require more fixed capital investments, in order to expand their production capacity.

6. Diversification: If a company goes for diversification then it will require more fixed capital Investment in plant and machinery etc.

7. Financing Alternatives: A developed financial market can provide leasing facilities as an alternative to outright purchase.

8. Level of Collaboration: If companies are under collaboration, Joint venture etc. then they need less fixed capital as they share plant & machinery with their collaborators.

QUESTION 23.

'Silkiya Ltd.' is a company manufacturing silk cloth. 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 good 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 more than 60 lakhs from SBI 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 profit 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.

Answer.

Dividend decision has been discussed in the question.
Quotation for dividend decision: How much of the profits should be retained and how much has to be distributed by the company.

The following factors affect the dividend decision:

1. Stable Earnings: A company with stable and smooth earnings can pay higher dividends to shareholders than a company, which has unstable and uneven earnings.
Quotation for stable earnings: It has been consistently earning good profits for many years.

2. Amount of Earning: A firm decides the dividends to be paid on the basis of its earnings.
If the company has higher earnings, then it would be in a better position to pay dividends.
As against this, if a company has low earnings, it would be able to pay lower dividends.
Quotation for amount of earnings: This year too, it has been able to generate enough profits.

3. Growth Prospects: Companies with higher growth prospects prefer to retain a greater portion of their earnings for future reinvestment. Accordingly, they pay lesser dividends.
Quotation for growth prospects: There is availability of enough cash in the company and good prospects for growth in the future.

4. Preference of Shareholders: The preference of shareholders must also be considered while taking dividend decisions. For instance, if shareholders prefer that a certain minimum amount of dividends be paid, then the company may declare the same.
Quotation for preference of shareholders: It has many shareholders who prefer to receive a regular income from their investments.
