# Gujarat Board Textbook Solutions Class 12 Organization of Commerce and Management Chapter 8 Financial Management

**1. Select the correct alternative and write answers to the following questions :**

**Question 1. By which other name is the objective of wealth maximization known?**
(A) Social welfare
(B) Capital investment
(C) Net present value
(D) Trading on equity
Answer:
(C) Net present value

**Question 2. On which concept is the approach to the wealth maximization based?**
(A) Profitability
(B) Social responsibility
(C) Present value of wealth
(D) Cash flow
Answer:
(C) Present value of wealth

**Question 3. With what is financial management related?**
(A) Finance function
(B) Finance market
(C) Capital market
(D) Stock exchange
Answer:
(A) Finance function

**Question 4. Decisions of investment means**
(A) Capital cost
(B) Capital budgeting
(C) Capital structure
(D) Ploughing back of profit
Answer:
(B) Capital budgeting

**Question 5. Capital structure having proper ratio of equity and debts means**
(A) Optimum capital structure
(B) Simple capital structure
(C) Working capital structure
(D) Equilibrium capital structure

Answer:
(A) Optimum capital structure

**Question 6. Which of the following statements is not true with reference to the concept of net working capital?**
(A) Excess of current assets over current liabilities
(B) Does not show the liquidity position of the company
(C) Provides proper measurement for working capital
(D) Increase in current liability does not increase net working capital
Answer:
(A) Excess of current assets over current liabilities

**Question 7. How many types of capital structure are there?**
(A) Two
(B) Three
(C) Four
(D) Five
Answer:
(C) Four

**Question 8. From which capital is dividend paid?**
(A) Paid up capital
(B) Authorized capital
(C) Called up capital
(D) Working capital
Answer:
(A) Paid up capital

**Question 9. Which statement is true with reference to fixed capital?**
(A) Invested upto 5 years in business
(B) Components are debtors, bill receivable, bank balance, etc.
(C) Ratio of liquidity is less
(D) Investment can be withdrawn easily
Answer:
(C) Ratio of liquidity is less

**Question 10. With whom has the foreign institution investor need to registered?**
(A) Company registrar
(B) Court
(C) Stock exchange
(D) SEBI
Answer:
(D) SEBI

**Question 11. Excess of current assets over current liabilities means**
(A) Positive working capital
(B) Negative working capital
(C) Equilibrium working capital
(D) Gross working capital
Answer:
(A) Positive working capital

## 2. Answer the following questions in one sentence each :

**Question 1. Financial management is related with which type of financial decision making?**
Answer:
[New investment, capital structure, dividend policy, etc.]

**Question 2. Which are the approaches adopted by financial management to achieve maximum economic welfare of the owner?**
Answer:
(A) Profit maximization and
(B) Wealth maximization

**Question 3. Which objective is acceptable for financial management?**
Answer:
The objective of current value of net wealth of financial management.

**Question 4. What does capital structure consist of?**
Answer:
Various securities issued by the company such as equity share, preference share, debenture, etc.

**Question 5. In which form dividend can be paid to the shareholders?**
Answer:
Cash or cheque on paid-up capital of share.

**Question 6. Which type of shares must be issued by a company procuring capital fund by issuing securities?**
Answer:
Equity shares

**Question 7. For which type of security issue the expense is comparatively less?**
Answer:
Debenture

**Question 8. With whom foreign investment insitution has to register itself?**
Answer:
SEBI

**Question 9. What are the components of fixed capital?**
Answer:
Land, machinery, plant, vehicles, furniture, computers and printers, etc.

**Question 10. Why depreciation is not charged on the assets in which working capital is invested?**
Answer:
Working capital is invested in current assets and it is circulating in the business. As a result its form keep on changing and so depreciation is not calculated on it.

**3. Answer the following questions in short :**

**Question 1. What does the objective of owner's maximum economic welfare mean?**
Answer:
The objective of focusing on maximum profit as well as maximum wealth is called ……….

**Question 2. What are the factors affecting investment decision?**
Answer:
**Factors affecting investment decision:**

- Need of total capital
- Estimated rate of return and profitability from investment
- Estimated net cash receivable from investment
- Element of risk involved in investment
- Requirement of working capital after investment
- Useful economic life of investment and its estimated life
- Significance of investment
- Capital rationing
- Certainty or uncertainty of earning in future

**Question 3. "Capital structure is a mixture of owner's capital and debt." – Explain.**
Answer:

- While setting up the capital structure, the finance manager has to take decision regarding the portion to be maintained between equity and debt in capital structure.
- A fine balance between equity capital and debt is necessary so as to maximize the returns of the company.
- If the structure maintains an optimum balance between the two, several risks can be avoided and maximum returns can be ensured.

**Question 4. What is meant by optimum capital structure?**
Answer:
Capital structure which has proper ratio of equity share capital and debt.

**Question 5. "Working capital means circulating capital in business." – Explain.**
Answer:

- A human being remains alive as long as blood keeps circulating his body. Moreover, if any part of the body is devoid of sufficient quantity of blood then that part or organ may start functioning abnormally.
- Capital does the same job for the business. If the business lacks blood, it will start functioning abnormally and eventually die.
- Capital must be provided in order to see that all the department and functions of the business work smoothly. Absence of capital means death of business.
- Hence it is rightly said that working capital is the life-blood of business.

**Question 6. What is production cycle?**
Answer:
The time period between the procurement of raw materials and manufacturing finished goods is called the production cycle

**4. Answer the following questions in brief :**

**Question 1. Explain the concept of financial management through various definitions.**
Answer:
**Finance:**

- In layman language, management of finance is called financial management.
- Finance is the blood of business.
- Business can neither be started without finance nor can it sustain without it. Thus, finance is the foundation stone of business.

**Financial management:**

- The activity done at managerial level for planning and controlling financial resources for the business enterprise is called financial management.
- Under financial management, the managers try to optimally manage the financial resources so that the business earns a satisfactory return.

**Various definitions of financial management:**

- According to F. W. Paish, "In the modern economy, based on utilization of funds, financial management means acquiring of required funds at the required time."

- According to Raymond J. Chambers, “Financial management means to take decisions about financial matters to implement then smoothly and to review, them.”
- According to Prof. M. Kimbal, “Financial management means acquisition of fund, its optimum utilization and its appropriate allocation.”
- From all these definitions we can conclude that the scope of financial management is so wide that it covers all the financial decisions of business, right from the inception.

**Question 2. Explain the objectives of financial management.**
Answer:

- The objective of financial management is maximization of the owner’s economic welfare.
- To achieve this objective, the financial management adopts following two approaches:
  (A) Objective of profit maximization and
  (B) Objective of wealth maximization

**(A) Objective of profit maximization:**

- The objective of maximizing income of the company is called profit maximization.
- In market, investors purchase the shares of company with a hope of earning maximum dividend. As a result, company should earn maximum profit out of its available resources. Moreover, its dividend policy should be based on maximization of profit.
- In addition, this approach suggests that company should take up only those business projects which can earn good profits i.e. which aims at profit maximization.
- This approach increases the share price of the company. This in turn increases company’s per-share earning.

**(B) Objective of wealth maximization:**

- The concept of increasing the value of the business in order to increase the value of the shares held by the shareholders is called wealth maximization.
- A term called Net Present Value (NPV) is used to measure the profit of the company. Profit under NPV is obtained by subtracting the present value of wealth from the investment required over a period of time.
- Wealth maximization focuses on building a profitable NPV. The net present value creates wealth for the shareholders.
- Owing to this calculation, the organization should take up only such decisions which increase the net present value and hence the wealth.
- A drawback of wealth maximization approach is that it is based only on the concept of cash flow. It does not consider actual profit booked by the business.
- Only cash flow is considered as a measurement and the accounting profit is ignored.

- The net present value of wealth is the difference between present value of wealth and investment required.
  Net present value of wealth = Present value of wealth – Investment required
- Financial management should take such financial decisions by which wealth of the company is maximized. If the wealth of the company is maximized, it will be reflected in the price of the share of the company in the stock exchange.
- Market price,of the share will increase in the share market. This will result in maximization of the wealth of shareholders.
- The objective of wealth maximization is appropriate and universally accepted. Moreover, it is considered superior to profit maximization. Prof. Solomon has favoured the objective of wealth maximization.

**Question 3. Write Notes:**
**(1) Decisions related to investment**
Answer:
**Decisions related to investment:**

- Business requires capital investment in various assets that too for a long and fixed term. This includes investment in machinery, land, etc.
- It is always a risky and tricky task for the financial manager to identify the best asset in which investment should be made. Hence it is very crucial that decision of investment is evaluated in terms of expected return and risk.
- Investment decision is called capital budgeting. There are several methods of capital budgeting brought in use by the finance manager for deciding the investment decision to be taken for the company. Few of these methods are pay-back method, rate of return method, discounted cash flow method, etc.

**(2) Decisions related to dividend**
Answer:
**Decisions related to dividend:**

- Dividend is a part of profit of a company which is distributed among its shareholders. Dividend is a return to shareholders on their investment.
- The financial manager has to tactfully decide what part of profit should be distributed as dividend and what part of profit should be retained in business.

**Question 4. State the factors affecting working capital.**
Answer:
**Following factors affect working capital of an organization:**
**1. Type and nature of business:**

- How much working capital will be needed depends on type and nature of business. For example, trading units maintaining large stock of goods and selling the goods on credit require more working capital compared to small trading units.

- The need of working capital also changes as per the nature of industry. For example, electricity providing company, require less working capital whereas labour intensive industry requires large working capital (Note: Electricity company requires huge fixed capital but does not need large working capital to maintain it. On the other hand labour intensive industry has large number of workers. So, the need of working capital is more for paying salaries, incentives, etc. to large number of employees.)

**2. Size of business:**
Smaller the size of business unit, lesser the need of working capital and vice versa.

**3. Production cycle:**

- The time period between the procurement of raw materials and manufacturing finished goods is called the production cycle.
- As the production cycle gets longer, the need of working capital increases. For example, cotton industry and jute industry require larger working capital because the production cycle of manufacturing cloth from raw crops is long. On the other hand, industries such as bakery and dairy require less working capital because the production cycle is short.

**4. Production policy and type of demand:**
A business needs large working capital to run the operation if the goods produced are in demand only for few months whereas the production is round the year. For example, units manufacturing woolen clothes continue the production mostly for 12 months but the sales take place only in winter season.

**5. Stockpile of raw materials:**
If a business needs raw material that is available in limited quantity or whose supply is irregular or is available jn certain season only, then such raw material need to be kept in stock for continuous production. Under such cases, the business needs large working capital for keeping extra stock of such raw material.

**6. Credit policy:**

- If the business sells its good mostly in cash, then it does not require much working capital since it can get cash immediately on sales. But, if the business adopts certain credit policy such as payment to be made in 60 days, then the business needs more working capital as it will receive payment only after 60 days.
- In yet another method, if the raw material is easily available on credit, then the business can do with less working capital but if the business has to purchase raw material only in cash then it requires large working capital.

**7. Conversion of current assets into cash:**
Less working capital is required if there is prompt collection from the debtors, sales of

finished goods is done on cash, collection of bills receivable on the date of maturity, etc. Large working capital is required if the case is reverse.

**8. Stock turnover ratio:**
If the stock turnover ratio of a business is higher it requires less working capital. On the other hand if stock turnover ratio is lower the business requires more working capital. This is because if the company cannot sell its stock in stipulated time then its working capital remains blocked up in unsold finished goods.

**9. Operating efficiency:**
If the business operates with good efficiency then it can reduce waste and also make optimal use of resources. By doing so, the business will require less working capital.

**10. Distribution of profit:**

- If the distribution of profit as dividend is done in cash then it affects the cash because dividend is paid in cash.
- If company allots a major part of its profit as dividend it will require more working capital due to larger outflow of cash.

**5. Answer the following questions in detail:**

**Question 1. Explain the importance of financial management.**
Answer:
**Importance of financial management:**
**1. Estimation of financial needs:**
Financial management estimates how much long term capital and short term capital will be required for the business.

**2. Acquiring finance:**
Financial management acquires finance needed for the business at the minimum cost.

**3. Planning and controlling:**
Planning is combined with effective controlling to make economic utilization of finance.

**4. Distribution of finance:**
Financial management distributes finance among different departments in such a way that every department gets adequate finance.

**5. Maintaining liquidity:**
It maintains liquidity by preparing cash flow statement and cash budget so that a definite cash balance can be maintained on hand.

**6. Distribution of income:**
It determines what part of profit is to be distributed as dividends among the shareholders and what part of profit is to be reinvested in the business.

**7. Management of current assets:**
Current assets for the business include cash, debtors, inventory, marketable securities, bank balance, etc. Financial management formulates investment policy for managing these current assets properly.

**8. Financial decisions:**
Financial management takes important decisions regarding capital budget, dividend policy, reinvestment of profit, etc. It also co-ordinates various financial decisions such as co-ordination between dividend policy and reinvestment of profit, etc.

**9. Raising credit of business:**
Financial management significantly contributes in the progress and development of business. Efficient financial management generates financial infrastructure. This helps in timely payment of salary of employees, payment to creditors, etc. As a result, credit of the business increases in the market.

**Question 2. Discuss the factores affecting the capital structure.**
Answer:
**External factors that affect the capital structure of the company:**
**1. Condition of boom-depression in capital market:**

- When the market is low i.e. depressed, the investors prefer to invest safely in debentures rather than in risky equity. This earns them reasonable returns. On the other hand, when market is in boom, the investors invest in equity shares so as to earn higher dividends and profits.
- Thus, how the capital structure will be formed is also decided by the trends prevailing outside the company in the capital market.

**2. Current rate of interest in capital market:**

- If the current rate of interest is high in capital market, companies prefer to raise capital by issuing equity shares rather than borrowing capital since borrowing at high interest proves costly for the company.
- If the interest rate is less, companies also prefer debentures.

**3. Cost of capital expenses of issuing securities:**

- When a company issues securities for raising the capital, it has to incur several expenses. The expenses include releasing prospectus, underwriting commission, brokerage, etc. As a result, the cost of capital increases.

- The expense on issuing debenture is lesser then issuing securities.

**4. Legal restrictions:**

- There are various legal restrictions which a company has to follow and hence they affect its capital structure.
- As per Companies Act, the company raising capital fund through securities has to compulsorily issue equity shares. In addition to this, rules of SEBI and RBI and provision of Companies Act are also to be considered while formulating the capital structure.

**5. Taxation policy:**

- When the taxation is high, the companies prefer to issue debentures for acquiring capital. By doing so, the income tax gives deduction of interest paid on the debentures to the company.
- Naturally, equity shares become more popular if the income of dividend is tax free or the rate is lower on the dividend income.

**6. Institutional investors:**

- Insurance companies, banks, financial institutions of state and central government, etc. invest in shares and debentures of the companies as per their established rules and conditions.
- Trends and conditions of all these institutions are considered at the time of formulating capital structure or at the time of alteration of capital structure.

**7. Foreign institutional investor:**

- A financial institution established and registered outside India and whose objective is to invest in prescribed securities in India in primary and secondary markets is known as foreign institutional investor (FII).
- Foreign institutional investors have to get registered with SEBI. Then, such institutions are permitted to purchase shares and debentures of Indian company.
- Involvement of these institutions in the capital market of India affects the capital structure of the companies.

**Question 3. Giving the definition explain the concept of working capital.**
Answer:

- Capital needed in the business to run day-to-day expenses is known as working capital.

**Working capital can be classified into**
1. Gross working capital and 2. Net working capital.

**1. Gross working capital:**
Gross working capital = Total current assets
Gross working capital includes current assets such as bill receivables, debtors, short term marketable securities, bank balance, cash, etc.

**2. Net working capital:**
Net working capital means current assets minus current liabilities.
Therefore, Net working capital = Current assets – Current liabilities

- If current assets > current liabilities, it is called positive working capital.
- If current assets < current liabilities, it is called negative working capital.

**Question 4. Distinguish between :**
**(i) Gross working capital and net working capital.**
**(ii) Fixed capital and working capital.**
Answer:

| Points of differences | Gross working capital | Net working capital |
|---|---|---|
| **1. Meaning** | It is the sum total of current assets such as bill receivables, debtors, short term marketable securities, bank balance, cash, etc. | It is current assets minus current liabilities. |
| **2. Liquidity position** | This concept does not give an idea about the liquidity position of the company. | This concept gives an idea how much liquidity the company has. |
| **3.Finacial position and measurement** | Does not give a true idea of the financial position of the company. | Gives the true idea of financial position of the company. |
| **4.Increase in current liabilities** | Increase in current liabilities does not increase the gross working capital. (Reason: Gross working capital is only | Increase in current liabilities decreases net working capital. |

| | | |
|---|---|---|
| | concerned with current assets and not liabilities.) | |

**(ii) Fixed capital and working capital.**
Answer:

| Points of Differences | Working Capital | Fixed Capital |
|---|---|---|
| **1. Meaning** | Capital invested in current assets such as stock of raw materials and finished goods, debtors, bills receivable etc. is called working capital. | Capital invested in fixed assets such as land, building, machinery, furniture is called fixed capital. |
| **2. Period** | Blocked up for a short period in business. | Blocked up for a long period in business. |
| **3. Liquidity** | Ratio of liquidity is high because working capital can be easily converted into cash. | Ratio of liquidity is less because fixed capital is invested for a long period in fixed assets. |
| **4. Risk** | Ratio of risk is low. | Ratio of risk is high. |
| **5. Requirement** | It is required for day-to-day expenses like wages, salary, purchasing raw materials, etc. | It is required to purchase fixed assets such as land, building, plant and machinery. |
| **6. Sources** | Sources of raising working capital include trade credit, bank overdraft, indigenous bankers, etc. | Sources of raising fixed capital include issue of shares and debentures, financial institutions, etc. |
| **7. Depreciation** | Depreciation is not calculated on working capital | Depreciation is calculated on fixed assets |