INDIAN SCHOOL MUSCAT

Senior Section

Department of Commerce and Humanities

Class : 12

SOLVED SUPPORT MATERIAL

CHAPTER :9 : FINANCIAL MANAGEMENT

Reference: KVS Question Bank/ NCERT

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BUSINESS STUDIES (054)

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1 Define Financial Management.
Financial Management is concerned with optimal procurement as well as usage of finance.

2 What is wealth maximisation concept?
Primary aim of financial management is to maximise shareholder's wealth, which is referred to as the wealth maximisation concept.

3 What is Financial planning? Explain its objectives.
Financial planning is essentially preparation of a financial blueprint of an organisation's future operations.
The objective of financial planning is to ensure that enough funds are available at right time. Financial planning strives to achieve the following twin objectives.
(a) To ensure availability of funds whenever these are required
(b) To see that the firm does not raise resources unnecessarily.

4 State the importance of Financial planning.
(i) It tries to forecast what may happen in future under different business situations.
(ii) It helps in avoiding business shocks and surprises and helps the company in preparing for the future.
(iii) If helps in coordinating various business functions e.g., sales and production functions, by providing clear policies and procedures.
(iv) Detailed plans of action prepared under financial planning reduce waste, duplication of efforts, and gaps in planning.
(v) It tries to link the present with the future.
(vi) It provides a link between investment and financing decisions on a continuous basis.
(vii) By spelling out detailed objectives for various business segments, it makes the evaluation of actual performance easier.

5 Define Capital Structure.
Capital structure refers to the mix between owners and borrowed funds. These shall be referred as equity and debt in the subsequent text.

6 Define Fixed Capital. What are the factors affecting the requirement of Fixed Capital.

Fixed capital refers to investment in long-term assets.

Factors affecting the requirement of Fixed Capital

1. Nature of Business: The type of business has a bearing upon the fixed capital requirements

2. Scale of Operations: A larger organisation operating at a higher scale needs bigger plant, more space etc. and therefore, requires higher investment in fixed assets when compared with the small organisation.

3. Choice of Technique: Some organisations are capital intensive whereas others are labour intensive. A capital-intensive organisation requires higher investment in plant and machinery as it relies less on manual labour.

4. Technology Up gradation: In certain industries, assets become obsolete sooner. Consequently, their replacements become due faster. Higher investment in fixed assets may, therefore, be required in such cases.

5. Growth Prospects: Higher growth of an organisation generally requires higher investment in fixed assets. Even when such growth is expected, a business may choose to create higher capacity in order to meet the anticipated higher demand quicker. This entails higher investment in fixed assets and consequently higher fixed capital.

6. Diversification: A firm may choose to diversify its operations for various reasons, With diversification, fixed capital requirements increase.

7. Financing Alternatives: A developed financial market may provide leasing facilities as an alternative to outright purchase. When an asset is taken on lease, the firm pays lease rentals and uses it.

8. Level of Collaboration: At times, certain business organisations share each other’s facilities. For example, a bank may use another’s ATM or some of them may jointly establish a particular facility.

7 Name the three broad decisions that are part of the finance function.

a. Investment decision

b. Financing decision

c. Dividend Decision.

8 What is Financial Leverage?

The proportion of debt in the overall capital is called Financial Leverage.

9 Define Investment Decision and discuss the factors affecting it.

(a) Earnings: Dividends are paid out of current and past earning. Therefore, earnings is a major determinant of the decision about dividend.

(b) Stability of Earnings: Other things remaining the same, a company having stable earning is in a position to declare higher dividends. As against this, a company having unstable earnings is likely to pay smaller dividend.

(c) Stability of Dividends: It has been found that the companies generally follow a policy of stabilising dividend per share. The increase in dividends is generally made when there is confidence that their earning potential has gone up and not just the earnings of the current year.

(d) Growth Opportunities: Companies having good growth opportunities retain more money out of their earnings so as to finance the required investment. The dividend in growth

companies is, therefore, smaller, than that in the non– growth companies.
(e) Cash Flow Position: Dividends involve an outflow of cash. A company may be profitable but short on cash. Availability of enough cash in the company is necessary for declaration of dividend by it.
(f) Shareholder Preference: While declaring dividends, managements usually keep in mind the preferences of the shareholders in this regard. If the shareholders in general desire that at least a certain amount is paid as dividend, the companies are likely to declare the same.
(g) Taxation Policy: The choice between payment of dividends and retaining the earnings is, to some extent, affected by difference in the tax treatment of dividends and capital gains. If tax on dividend is higher it would be better to pay less by way of dividends.
(h) Stock Market Reaction: Investors, in general, view an increase in dividend as a good news and stock prices react positively to it. Similarly, a decrease in dividend may have a negative impact on the share prices in the stock market.

10 Discuss the factors affecting choice of capital structure.
Cash Flow Position: Size of projected cash flows must be considered before issuing debt. Cash flows must not only cover fixed cash payment obligations but there must be sufficient buffer also. It must be kept in mind that a company has cash payment obligations for (i) normal business operations; (ii) for investment in fixed assets; and (iii) for meeting the debt service commitments i.e., payment of interest and repayment of principal.
2. Interest Coverage Ratio (ICR): The interest coverage ratio refers to the number of times earnings before interest and taxes of a company covers the interest obligation. This may be calculated as follows:
ICR = EBIT Interest. The higher the ratio, lower is the risk of company failing to meet its interest payment obligations. However, this ratio is not an adequate measure. A firm may have a high EBIT but low cash balance
3. Debt Service Coverage Ratio (DSCR): Debt Service Coverage Ratio takes care of the deficiencies referred to in the Interest Coverage Ratio (ICR). It is calculated as follows: A higher DSCR indicates better ability to meet cash commitments and consequently, the company's potential to increase debt component in its capital structure.
4. Return on Investment (RoI): If the RoI of the company is higher, it can choose to use trading on equity to increase its EPS, i.e., its ability to use debt is greater.
5. Cost of debt: A firm's ability to borrow at a lower rate increases its capacity to employ higher debt. Thus, more debt can be used if debt can be raised at a lower rate.
6. Tax Rate: Since interest is a deductible expense, cost of debt is affected by the tax rate.
7. Cost of Equity: Stock owners expect a rate of return from the equity which is commensurate with the risk they are assuming. When a company increases debt, the financial risk faced by the equity holders, increases.
8. Floatation Costs: Process of raising resources also involves some cost. Public issue of shares and debentures requires considerable expenditure. Getting a loan from a financial institution may not cost so much.
9. Risk Consideration: Financial risk refers to a position when a company is unable to meet its fixed financial charges namely interest payment, preference dividend and repayment obligations.
10. Flexibility: If a firm uses 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.

11. Control: Debt normally does not cause a dilution of control. A public issue of equity may reduce the managements holding in the company and make it vulnerable to takeover.

12. Regulatory Framework: Every company operates within a regulatory framework provided by the law e.g., public issue of shares and debentures have to be made under SEBI guidelines. Raising funds from banks and other financial institutions require fulfillment of other norms

13. Stock Market Conditions: If the stock markets are bullish, equity shares are more easily sold even at a higher price. Use of equity is often preferred by companies in such a situation. However, during a bearish phase, a company, may find raising of equity capital more difficult and it may opt for debt.

11 Define Working Capital. What are the Factors affecting the requirement of Working Capital.

Working Capital refers to the capital required for day to day working of an organisation.

Working capital may be defined as the excess of current assets over current liabilities.

Factors affecting the requirement of Working Capital:

1. Nature of Business: The basic nature of a business influences the amount of working capital required. A trading organisation usually needs a lower amount of working capital compared to a manufacturing organisation.

2. Scale of Operations: For organisations which operate on a higher scale of operation, the quantum of inventory, debtors required is generally high. Such organisations, therefore, require large amount of working capital as compared to the organisations which operate on a lower scale.

3. Business Cycle: Different phases of business cycles affect the requirement of working capital by a firm. In case of a boom, the sales as well as production are likely to be higher and therefore, higher amount of working capital is required. As against this the requirement for working capital will be lower during period of depression as the sales as well as production will below.

4. Seasonal Factors: Most business have some seasonality in their operations. In peak season, because of higher level of activity, higher amount of working capital is required. As against this, the level of activity as well as the requirement for working capital will be lower during the lean season.

5. Production Cycle: Production cycle is the time span between the receipt of raw material and their conversion into finished goods. Some businesses have a longer production cycle while some have a shorter one. Duration and the length of production cycle, affects the amount of funds required for raw materials and expenses. Consequently, working capital requirement is higher in firms with longer processing cycle and lower in firms with shorter processing cycle.

6. Credit Allowed: Different firms allow different credit terms to their customers. These depend upon the level of competition that a firm faces as well as the credit worthiness of their clientele. A liberal credit policy results in higher amount of debtors, increasing the requirement of working capital.

7. Credit Availed: Just as a firm allows credit to its customers it also may get credit from its suppliers. To the extent, it avails the credit on its purchases, the working capital requirement is reduced.

12 When is financial leverage favourable?

When ROI is higher than cost of Debt.

13 Explain how ‘cost of debt’ affects the choice of capital structure of a company.

A. If the cost of debt is low then the capital structure of the firm will be skewed towards debt.

**********************CHAPTER -9 ***********************