Understanding-based Questions

[1 mark]

Q.1. 'Tax benefit is available only in case of payment of interest and not on the payment of preference dividend.' Why?

Ans. The reason is that the payment of interest is considered an expense while preference dividend is the division of profit.

Q.2. Clarify EBIT-EPS Analysis.

Ans. With the help of this analysis it can be found out as to what will be the effect of various combinations of long-term financial sources on the EPS at a certain EBIT level.

Q.3. Why is capital structure decision important?

Ans. Because it influences cost of capital and market price of shares.

Q.4. Which component of capital structure determines the overall financial risk? *[CBSE Sample Paper 2015]*

Ans. Debt.

Q.5. How 'scale of operations' affect the requirement of fixed capital?

Ans. Larger the spread of business activities, greater is the need for fixed capital.

Q.6. Name that portion of current assets which is financed by fixed liabilities.

Ans. It refers to the net working capital.

Q.7. Why is working capital needed? Give any one reason.

Ans. To pay the daily expenses.

Q.8. How are 'Growth Prospects' related with the requirement of working capital?

Ans. The organisations which have sufficient possibilities of growth require more working capital, while the case is different in respect of companies with low growth prospects.

Q.9. Amit is running an 'Advertising agency' and earning a lot by providing this service to big industries. State whether the working capital requirement of the firm will be 'less' or 'more. Give reason in support of your answer. *[CBSE Sample Paper 2015]*

Ans. Less working capital is required as service industries which usually do not have to maintain inventory require less working capital.

Q.10. Explain how ‘cost of debt’ affects the choice of capital structure of a company.
[CBSE 2015]

Ans. A company’s ability to borrow at a lower rate increases its capacity to employ more debt.

Q.11. How does ‘cost of equity’ affect the choice of capital structure of a company? Explain.
[CBSE 2015]

Ans. Use of higher debt increases the cost of equity as the financial risk faced by equity shareholders increases, hence debt should be used upto a level.

[3 marks]

Q.1. What is meant by ‘Financial Management’? State the primary objective of financial management.
[CBSE 2012]

Ans. Meaning of Financial Management: It refers to that part of the management activity which is concerned with the efficient planning and controlling of financial affairs of the enterprise. **Primary Objective:** The primary objective of the financial management is to maximise the wealth of shareholders. According to this approach, owners’ interest can be served by wealth maximisation. Wealth Maximisation means to increase the capital invested in the business by the shareholders. Market price of the shares is the index of the capital invested. If the market price of the shares increases, it can be said that capital (wealth) invested by the shareholders has been appreciating. On the contrary, fall in the market price of the shares has an adverse effect on their wealth.

Q.2. What is Financial Risk? Why does it arise?

Ans. It refers to the risk of the company not being able to cover its fixed financial costs. The higher levels of risks are attached to higher degrees of financial leverage. With the increase in fixed financial costs, the company is also required to raise its operating profit (EBIT) to meet financial charges. If the company cannot cover these financial charges, it can be forced into liquidation.

Q.3. What do you mean by Financial Leverage?

Ans. The inclusion of the fixed cost capital (debt capital and preference share capital) along with equity share capital in the capital structure is called financial leverage. With the increase of financial leverage the ratio of cheap capital in the total capital of the company increases. Consequently, the total capital cost decreases and the company is in a profitable situation.

[4 marks]

Q.1. How do 'Choice of Technique' and 'Nature of Business' affect the 'Fixed Capital' requirements of a company? Explain.
[CBSE 2012]

Ans.

i. **Choice of Technique:** Those manufacturing enterprises which make use of modern and automatic machines, need large amount of fixed capital. On the other hand, those enterprises in which production is carried out mainly through labourer, need for fixed capital is very little.
ii. **Nature of Business:** Need of fixed capital depends upon the nature of business. Usually, nature of business is of two kinds: Manufacturing Business and Trading Business. In case of manufacturing business, large investment is made in land, building, machinery, etc. Thus, there is need for large amount of fixed capital. On the contrary, in case of trading business in which finished goods are bought and sold, less amount of fixed capital is needed.

[6 marks]

Q.1. Explain the following as factors affecting dividend decision.
[CBSE 2014]

Q. Stability of earnings

Ans. Stability of earning: A company having stable earning is in a position to declare more dividends and vice versa.

Q. Growth opportunities

Ans. Growth opportunities: If the company has more opportunities for growth, it will require more finance. In such a situation, a major part of the income should be retained and a small part of it should be paid as dividend.

Q. Cash flow position and

Ans. Cash flow position: The payment of dividend results in outflow of cash. It is possible that the company may have enough income but it is equally possible that it may not have sufficient cash to pay dividend. In this way, the cash flow position of the company is a factor that determines the dividend decision. The better the cash flow position of the company, the better will be the capacity of the company to pay dividend.

Q. Taxation policy

Ans. Taxation policy: The dividend decision, to some extent, depends on tax policy. If the tax rate on dividend is higher it would be better to declare less dividend and vice versa. Nowadays in the hands of shareholders the dividend income is tax free. From this angle, shareholders like to get higher dividend.

Q.2. Explain the following as factors affecting dividend decision:
[CBSE 2014]

Q. Stability of dividends

Ans. Stability of dividends: Every company adopts the policy of maintaining the stability of dividend per share. (Here the stability of dividend means that the dividend will, in no case, be allowed to fall. It is always good if the dividend remains stable or increases.) From this point of view, a little change in profit should not be allowed any increase or decrease in the dividend.

Q. Shareholder's preferences

Ans. Shareholders' preference: There are two types of shareholders from the point of view of investment: (*i*) those who invest with the purpose of getting some regular income and (*ii*) those who invest in the company to gain capital profit. If the majority of the shareholders are of the former type, the company must declare dividend according to their expectation. On the contrary, if the majority of the shareholders are of the latter type the company enjoys freedom about declaring dividend.

Q. Access to capital market and

Ans. Access to capital market: In case of need if a company can easily collect finance in the capital market, it should declare dividend at a higher rate otherwise not.

Q. Legal constraints

Ans. Legal constraints: The dividend policy of a company should always remain confined within the limits provided by law. According to the legal provisions, a company cannot make payment of dividend out of paid-up share capital because it will reduce the capital which will adversely affect the security of the debt providers. Therefore, it should be kept in mind that the dividend is not being paid out of the capital. According to Article 205 of the Company Law, dividend can be paid out of the current year's profit or the profits of the previous years after taking into consideration the provisions made for depreciation.

Q.3. Explain the following as factors affecting 'financing decision'.
[CBSE 2014]

Q. Cash flow position of the business

Ans. Cash flow position: If the cash flow position of the company is good, the payment of interest on the debt and the refund of capital can be easily made. Therefore, in order to take advantage of cheap finance, debt can be given priority.

Q. Level of fixed operating cost

Ans. Level of fixed operating costs: In business, there are mainly two types of costs:

i. Fixed operating costs, *e.g.*, rent of the building, payment of salary, insurance premium, etc.
ii. Fixed financial costs, *e.g.*, interest on debt, etc. If the level of fixed operating costs is in excess, it is better to keep the fixed financial costsat their minimum. Therefore, debt capital should not be used. On the contrary, if the level of fixed operating cost is low, the use of debt capital is profitable.

Q. Control consideration and

Ans. Control consideration: The ultimate control of the company is that of the equity shareholders. Greater the number of equity shareholder, the greater will be the control in the hands of more people. This is not a good situation. Therefore, from this point of view the equity share capital should be avoided.

Q. State of capital markets.

Ans. State of capital market: Bullish time brings more profit. Therefore, the people like to invest more in equity shares. On the contrary, the profits are low when there is a bear market. The people give preference to debt capital in order to earn more profits. Therefore, the source of finance should be chosen keeping in view the position of the market.

Q.4. Explain the following as factors affecting the choice of capital structure:

i. Cash flow position
ii. Cost of equity
iii. Floatation costs
iv. Stock-market conditions

OR

Explain any four factors that determine the capital structure of a company.
[CBSE 2014]

Ans. Factors affecting the choice of capital structure:

i. **Cash flow position:** If the cash flow position of the company is good, the payment of interest on the debt and the refund of capital can be easily made. Therefore, in order to take advantage of cheap finance, debt can be given priority.
ii. **Cost:** The cost of all the sources of finance is different. The rate of interest on debt, fixed rate of dividend to be paid on preference share capital and the expectations of the shareholders on the equity share capital are in the form of costs. If the situations happen to be favourable, the benefit of cheap finance can be availed of by choosing debt capital.

iii. **Floatation cost:** From the point of view of floating costs, retained profit is the most appropriate source. Therefore, its use should be made.
iv. **State of capital market:** Bullish time brings more profit. Therefore, the people like to invest more in equity shares. On the contrary, the profits are low when there is a bear market. The people give preference to debt capital in order to earn more profits. Therefore, the source of finance should be chosen keeping in view the position of the market.

Q.5. What is meant by 'Financial Planning'? Explain any five points which highlight its importance.

Ans. Meaning of Financial Planning: It refers to the preparation of a financial blueprint of an organisation's future operations.

Importance:

Refer to Points (1) to (4) of Q. 6 (Remembering-based Questions—4 Marks)

(5) Helps to Link the Present with the Future: It makes efforts to link the present with the future. By doing so, it helps to minimise the risk of future uncertainties.

Q.6. What is meant by capital structure of a company? Describe the factors that determine the capital structure of a company.

Ans. Meaning: Capital structure refers to relative proportion of different sources of long-term finance. **Determining Factors:** Some of the chief factors affecting the choice of the capital structure are the following:

i. **Cash Flow Position:** While making a choice of the capital structure, the future cash flow position should be kept in mind. Debt capital should be used only if the cash flow position is really good because a lot of cash is needed in order to make payment of interest and refund of capital.
ii. **Interest Coverage Ratio—ICR:** With the help of this ratio, an effort is made to find out how many times is the Earning Before Interest and Tax (EBIT) available to the payment of interest. The capacity of the company to use debt capital will be in direct proportion to this ratio. This ratio can be found out with the help of the following formula: $ICR = \frac{EBIT}{Interest}$ It is possible that inspite of better ICR the cash flow position of the company may be weak. Therefore, this ratio is not a proper or appropriate measure of the capacity of the company to pay interest. It is equally important to take into consideration the cash flow position.
iii. **Debt Service Coverage Ratio—DSCR:** This ratio removes the weakness of ICR. This shows the cash flow position of the company. It is calculated in the following way: $$DSCR = \frac{\text{Profit After Tax + Depreciation + Interest + Non-cash Expenses Written Off}}{\text{Preference Dividend + Interest + Repayment Obligation}}$$
This ratio tells us about the cash payments to be made (e.g., preference

dividend, interest and debt capital repayment) and the amount of cash available. Better ratio means the better capacity of the company for debt payment. Consequently, more debt can be utilised in the capital structure.

iv. **Return on Investment—ROI:** The greater return on investment of a company increases its capacity to utilise more debt capital. The calculation of return on investment is made with the help of the following formula: $\text{ROI} = \frac{\text{EBIT}}{\text{Total Investment}}$

v. **Cost of Debt:** The capacity of a company to take debt depends on the cost of debt. In case the rate of interest on the debt capital is less, more debt capital can be utilised and vice-versa.

Q.7. The Board of Directors has asked you to design the capital structure of the company. Explain any six factors that you would consider while doing so.

Ans. Refer to Points (*i*) to (*v*) of Q. 6 above.

(*vi*) Floatation Costs: Floatation costs are those expenses which are incurred while issuing securities (*e.g.*, equity shares, preference shares, debentures, etc.). Their examples are— commission of underwriters, brokerage, stationery expenses, etc. Generally, the cost of issuing debt capital is less than the share capital. This attracts the company towards debt capital.

Q.8. Explain the following as factors affecting the requirements of fixed capital:

[CBSE 2014]

Q. Scale of operations

Ans. Scale of operations: Larger the spread of business activities, greater is the need for fixed capital. If a manufacturing enterprise is operating on a small scale, it will require less amount of fixed capital. On the other hand, a large-scale manufacturing enterprise will need relatively more amount of fixed capital.

Q. Choice of technique

Ans. Choice of technique: Those manufacturing enterprises which make use of modern and automatic machines, need large amount of fixed capital. On the other hand, those enterprises in which production is carried out mainly through manual labour, need for fixed capital is very little.

Q. Technology upgradation and

Ans. Technology upgradation: There are some businesses where fixed asset is used and which does require immediate change. These days computer technology is undergoing rapid changes. Therefore, those companies whose business is computer based need more fixed capital.

Q. Financing alternatives

Ans. **Financing alternatives:** Generally, for making investment in fixed assets long-term capital sources are used (e.g., equity share capital, preferential share capital, debenture, etc.). However, another source of finance has emerged these days. This is called leasing. If a company makes use of this source, it acquires fixed assets on lease rather than buying them. In such a situation the need for fixed capital decreases.

Q.9. Explain the following as factors affecting the requirements of working capital:
[CBSE 2014]

Q. Business Cycle

Ans. Business cycle: The need for the working capital is affected by various stages of the business cycle. During the boom period, the demand of a product increases and sales also increase. Therefore, more working capital is needed. On the contrary, during the period of depression, the demand declines and it affects both the production and sales of goods. Therefore, in such a situation less working capital is required.

Q. Operating efficiency

Ans. Operating efficiency: Operating efficiency means efficiently completing the various business operations. Operating efficiency of every organisation happens to be different. Some such examples are: (*a*) converting raw material into finished goods at the earliest, (*b*) selling the finished goods quickly, and (*c*) quickly getting payments from the debtors. A company which has a better operating efficiency has to invest less in stock and the debtors. Therefore, it requires less working capital, while the case is different in respect of companies with less operating efficiency.

Q. Availability of raw material

Ans. Availability of raw material: Availability of raw material also influences the amount of working capital. If the enterprise makes use of such raw material which is available easily throughout the year, then less working capital will be required, because there will be no need to stock it in large quantity. On the contrary, if the enterprise makes use of such raw material which is available only in some particular months of the year whereas for continuous production it is needed all the year round, then large quantity of it will be stocked. Under the circumstances, more working capital will be required.

Q. Level of competition

Ans. Level of competitions: Higher competition requires large stocks to meet urgent orders from customers and thus higher working capital.