Financial Management

PART 1

Objective Questions

• Multiple Choice Questions

1. Financial management helps in ....
(a) reducing the cost of funds
(b) keeping the risks under control
(c) achieving effective deployment of funds
(d) All of the above

Ans. (d) Financial management determines the financial health of a business. It helps in raising funds at a minimum cost. It is concerned with optimal procurement as well as usage of funds which helps in keeping the risk under control and achieving effective deployment of funds.

2. REI Agro Food Ltd. is a famous multinational company. Mr. SK Nagi is its finance manager. He is making efforts to increase the market value of capital invested by the equity shareholders.
He already knew it could be possible only when price of the shares increases and price of shares increase only if financing, investment and dividend decisions are taken optimally. He did the same and achieved success.

Which objective of financial management has been referred here?
(a) Maximising the wealth of equity shareholders
(b) Effective utilisation of funds
(c) Ensures safety of funds
(d) Avoiding idle finance

Ans. (a) Maximising the wealth of equity shareholders

3. Decisions related to investment in fixed assets are popularly known as ....
(a) Business finance decisions
(b) Financial management
(c) Capital budgeting decisions
(d) None of the above

Ans. (c) Capital budgeting decisions

4. Bharti Ltd. is a leading mobile company. It is planning to acquire Queen Ltd. (its close competitor) business worth ₹1,000 crore. Which financial decision is involved in it?
(a) Investment (b) Financing
(c) Dividend (d) None of these

Ans. (a) Investment

5. Avik is the finance manager of Mars Ltd. in the current year, the company earned high profit. However, Avik thinks that it is better to declare smaller dividend as he is unsure about the earning potential of the company in the coming years.

Avik's choice of dividend decision is based on which of the factor that affect it?
(a) Amount of earnings
(b) Stability in earnings
(c) Stability of dividends
(d) Growth opportunities

Ans. (d) Low dividend should be declared by the company if the company has growth and expansion projects and even not sure about future earnings.

6. Financial decisions impact which of the following items of profit and loss account?
(a) Interest (b) Profit
(c) Tax (d) All of these

Ans. (d) Financial decision impacts all those transactions which are related with financial transactions and profit, interest and tax all are financial transactions.

7. Dividend is that portion of profit, which is distributed to the shareholders and undistributed profit is that portion which remains in the business is known as
(a) Earning
(b) Equity
(c) Retained earnings
(d) Interest

Ans. (c) Retained earnings

8. During AGM of Prakash Ltd. CEO, Mr. Rajnesh put the expansion plan for the coming year before shareholders and asked for suitable source of finance to finance manager. Finance manager, Mr. Kant proposed issue of debentures than equity with a plan that they can be paid back whenever requirement of funds is over.

In this case, which component is affecting financing decision?

(a) Flotation cost (b) Flexibility
(c) Return of investment (d) Risk

Ans. (b) In this case, finance manager proposed to issue debentures as their cash flow position is better and as and when required, they can repay the amount.

9. The fund raising exercise also costs something. This cost is called

(a) Fixed cost (b) Flotation cost
(c) Bearing cost (d) Variable cost

Ans. (b) When a company raises the funds it includes some costs like brokerage, commission, etc. which is known as flotation cost.

10. Short-term plans are also known as ……… and are made for a period of ……… .

(a) capital budgeting programmes, two years
(b) capital budgeting programmes, one year or less
(c) budgets, two years
(d) budgets, one year or less

Ans. (d) budgets, one year or less

11. Though the dividends are free of tax in the hands of shareholders, which tax is levied on the companies for the dividend?

(a) Dividend payout tax (b) Dividend allocation tax
(c) Dividend distribution tax (d) None of these

Ans. (c) When a company distributes the dividends to its shareholders, the dividend is free of tax in the hands of shareholders, but the company has to pay the tax on the dividend distribution which is called as 'dividend distribution tax'.

12. Which of the following statements is not true?

(a) Maintaining adequate liquidity is a secondary objective of financial planning.
(b) Stock market reaction is an important factor while making dividend decisions.
(c) Companies with lower ICR can borrow more funds.
(d) None of the above

Ans. (c) ICR refers to interest coverage ratio, i.e., the number of times EBIT covers interest obligations. Therefore, companies with lower ICR should not borrow more funds.

13. Debt is considered to be cheeper than equity because for borrowers, interest on debentures is a ……… while dividend on equity is not.

(a) exempt from tax (b) deductible expenditure
(c) non-deductible expenditure
(d) None of the above

Ans. (b) deductible expenditure

14. During negative leverage effect, firm prefers ……… .

(a) debenture (b) equity
(c) preference share (d) borrowed funds

Ans. (b) When RoI is less than the cost of debt, company prefers more equity than debt.

15. Which of the following statements is not correct?

(a) Debt is considered as cheaper to equity.
(b) Interest on debt is deductible for tax purpose
(c) Issue of more equity may dilute shareholder's control over the business.
(d) If RoI is more than the cost of debt, the company should prefer equity to debt.

Ans. (d) If RoI is more than the cost of debt, the company should prefer more debt than equity.

16. ABC Ltd. has debt to equity ratio of 3 : 1, whereas XYZ Ltd. has debt to 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

Ans. (a) Trading on equity

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

(a) Will increase with diversification of business activity
(b) Will decrease with diversification of business activity
(c) No effect on fixed capital
(d) None of the above

Ans. (a) Will increase with diversification of business activity

18. Rizul Bhattacharya, after leaving his job, wanted to start a Private Ltd. Company with his son. His son was keen that the company may start manufacturing of mobile phones with some unique features. Rizul 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 to choose furniture business over mobile phones.

(a) Choice of techniques
(b) Technology upgradation
(c) Collaboration
(d) Growth prospects and diversification

Ans. (b) Technology upgradation

19. In the paint industry, various raw materials are mixed in different proportions with petroleum for manufacturing different kind of paints. One specific raw material is not readily available to the manufacturing company.

Bonter paints company is also facing this problem and because of this there is a time lag between placing the order and the actual receipt of the material.

But once it receives the raw material, it takes less time in converting it into finished goods. Identify the factor affecting working capital requirements of this industry.

(a) Nature of business
(b) Seasonal factors
(c) Operating efficiency
(d) Availability of raw material

Ans. (d) Availability of raw material

20. A company has net working capital = ₹ 20,000. If current assets are, Stock = ₹ 10,000, Debtors = ₹ 12,000, Cash = ₹ 6,000 and Bills Receivables = ₹ 22,000. Calculate current liabilities.

(a) ₹ 50,000 (b) ₹ 1,20,000
(c) ₹ 20,000 (d) ₹ 30,000

Ans. (d) Net Working Capital = Current Asset − Current Liabilities

In this question, Total of Current Assets
= 10,000 + 12,000 + 6,000 + 22,000 = ₹50,000

Therefore, Current Liabilities
= Current Assets − Net Working Capital
= 50,000 − 20,000 = ₹ 30,000

• Assertion-Reasoning MCQs

Direction (Q. No. 1 to 8) *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

1. Assertion (A) Shareholders Wealth Maximisation (SWM) and not the profit maximisation is an appropriate and operationally feasible financial management goal.

Reason (R) There exists a principal agent relationship between the shareholders and the management of the company.

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

2. Assertion (A) Finance is the life blood of business.

Reason (R) Finance is very essential for the smooth running of the business.

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

3. Assertion (A) Financial management is an imaginative function.

Reason (R) Financial management is one of the functional areas of management.

Ans. (d) Financial management is a most important real function of management.

4. 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.

Ans. (c) Without adequate finance, business can't survive even only for a short time. Finance is the life blood of any business, for its survival and growth.

5. Assertion (A) A sound financial plan should be rigid.

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

Ans. (b) A sound financial plan gives best result to the organisation.

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

Reason (R) Capital structure refers to the mix between owners and borrowed funds.

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

7. 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.

Ans. (c) Investment decision involves careful selection of assets, in which funds are to be invested.

8. 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.

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

• Case Based MCQs

1. **Direction** *Read the following text and answer the question no. (i) to (vi) on the basis of the same.*

AVP is renowned multiplex operator in India. It own around 560 screens in 110 properties at 80 locations in the country. Considering the fact that there is more growing trend among the people to spend more of there disposable income on entertainment, company planned to add more screen at existing locations and start at new locations also.

Further, they plan to add food chain also at their locations. The company planned to float equity shares in market to raise the desired capital. The issue was fully subscribed and paid. Over the year, the sale and the profit of the company have increased tremendously and it has been declaring higher dividend and the market price of its share has increased manifolds.

(i) Which financial decision is highlighted in the lines, "Considering the fact that there is more growing trend among the people to spend more of there disposable income on entertainment, company planned to add more screen at existing locations and start at new locations also"?

(a) Investment decision (b) Financing decision
(c) Dividend decision (d) None of these

Ans. (a) Investment decision

(ii) Identify the decision involved in the lines, "The company planned to float equity shares in market to raise the desired capital. The issue was fully subscribed and paid."

(a) Financing decision (b) Investment decision
(c) Dividend decision (d) None of these

Ans. (a) Financing decision

(iii) The above case highlights the fulfillment of one of the prime objectives of financial management by AVP company. Identify the objective.

(a) Profit maximisation (b) Increasing customer base
(c) Wealth maximisation of shareholders
(d) None of the above

Ans. (b) Increasing customer base

(iv) "Over the years, the sale and the profit of the company have increased tremendously and it has been declaring higher dividend and the market price of its share has increased manifolds." The quoted lines highlighted one of the factors affecting dividend decision. Identify the factor.

(a) Taxation policy (b) Legal restrictions
(c) Stability of earnings (d) None of these

Ans. (c) Stability of earnings

(v) Dividend decisions are affected by various factors. Which one of the following factors is not affected by dividend decision?

(a) Stability of dividend (b) Shareholder's preference
(c) Earnings (d) Flotation cost

Ans. (d) Flotation cost

(vi) "The company planned to float equity shares in market to raise the desired capital." Which capital requirement is highlighted in the given line?

(a) Fixed capital (b) Working capital
(c) Financial capital (d) None of these

Ans. (a) Fixed capital

2. **Direction** *Read the following text and answer the question no. (i) to (vi) on the basis of the same.*

Neelabh Sarin, the finance manager and Atul Chopra the MD of Tata Ltd. were discussing regarding the source of finance to be raised for modernisation of their existing plant. Quoting that 'Sensex has soared by 6,078 points in the last 4 years', Neelabh Sarin suggests that equity should be preferred while Atul Chopra wanted to opt for debt. Company has high operating cost over period.

(i) Keeping in mind the high operating costs of the company, suggest the source of finance that should be used for modernisation of existing plant.

(a) Equity (b) Debt
(c) Both (a) and (b) (d) None of these

Ans. (a) Equity

(ii) Identify the factor highlighted in below lines which affects this decision "Sensex has soared by 6,078 points in last 4 years."

(a) Cash flow position (b) Stock market condition
(c) Taxation policy (d) Legal constraints

Ans. (b) Stock market condition

(iii) Higher debt-equity ratio results in

(a) lower financial risk
(b) higher degree of operating risk
(c) higher degree of financial risk
(d) higher EPS

Ans. (c) higher degree of financial risk

(iv) Stock market condition is a factor related to

(a) financing decision (b) investment decision
(c) dividend decision (d) financial planning

Ans. (a) financing decision

(v) Which one is favourable financial leverage?

(a) RoI > Rate of interest on debt
(b) RoI < Rate of interest on debt
(c) Both (a) and (b)
(d) None of the above

Ans. (a) RoI > Rate of interest on debt

(vi) "Neelabh Sarin, the finance manager and Atul Chopra the MD of Tata Ltd. were discussing regarding the source of finance to be raised for modernisation of their existing plant." Identify the decision involved in the given lines.

(a) Financing (b) Investment
(c) Dividend (d) None of these

Ans. (a) Financing

3. Direction *Read the following text and answer the question no. (i) to (vi) on the basis of the same.*

Raghav is trying to co-ordinate the functioning of various departments like sales and production. He has been trying to do this with the help of a concept of financial management. He quite often calls people of both departments and tells them to work within means he has even prescribed a budget for it.

During the time, when he is doing a lot of analysis, he connects the decision of present with the outcomes of future. This can especially be seen in two of the prominent decisions, one is the investment and the other is the financing decision. So, the interlinking of these two decisions is assumed by him.

When the year ends, it is easy for him to take some strong decisions. This happens because he is able to evaluate the performance of various departments in terms of revenue generated and the expense incurred. No business is risk proof.

However, he knows that at least business shocks which a business can suffer can be minimised, thus laying foundation for a better future. Less involvement in the work is definitely appreciable.

(i) Which concept of financial management has been highlighted in above case?

(a) Financial management (b) Capital budgeting
(c) Capital structure (d) Financial planning

Ans. (d) Financial planning

(ii) Which importance of financial planning is discussed in below lines?

"Raghav is trying to coordinate the functioning of various departments like sales and production."

(a) Helps in avoidance of business shocks and surprises.
(b) Helps in coordinating various business functions.
(c) Helps in reducing waste and duplication of efforts.
(d) Provides link between investment and financing decision.

Ans. (b) Helps in coordinating various business functions.

(iii) "During the time, when he is doing a lot of analysis, he connects the decision of present with the outcome of future."

Which importance of financial planning is discussed in above lines?

(a) Helps in coordinating various business activities
(b) Helps in reducing waste and duplication of work.
(c) Tries to link between present with the future.
(d) Helps in forecasting what may happen in future under different situation.

Ans. (c) Tries to link between present with the future.

(iv) "However, he knows that at least business shocks ……………… for a better future."

Which importance of financial planning is given in above lines?

(a) Helps in safety of funds
(b) Avoidance of waste and duplication of efforts
(c) Helps in forecasting what may happen in future
(d) Helps in avoiding business shocks and surprises and helps the company in preparing for the future.

Ans. (d) Helps in avoiding business shocks and surprises and helps the company in preparing for the future.

(v) "One is the investment and the other one is financing …… assumed by him."

Which importance of financial planning is discussed in above paragraph?

(a) Helps in coordinating various business functions
(b) Helps in linking the present with the future
(c) Helps in linking the investment decision with the financing decision.
(d) Helps in valuation of actual performance easier.

Ans. (c) Helps in liking the investment decision with the financing decision.

(vi) Which type of financial planning is focused in the above case?

(a) Short-term financial planning
(b) Long-term financial planning
(c) Medium-term financial planning
(d) None of the above

Ans. (a) Short-term financial planning

PART 2

Subjective Questions

• Short Answer (SA) Type Questions

1. Give any four points explaining the role of financial management. **(CBSE 2020)**

Ans. Role of financial management can be explained as follows

(i) **The Size and the Composition of Fixed Assets of the Business** Financial management plays a significant role in determining the size and composition of fixed assets of the business. Decision to invest a sum of ₹ 500 crore in fixed assets would raise the size of fixed assets blocked by this amount.

(ii) **Quantum of Current Assets** The quantum of current assets is also influenced by financial management decisions. With an increase in the investment in fixed assets, there is a commensurate increase in the working capital requirement.

(iii) **Break-up of Long-term Financing into Debt and Equity** Financing decision involves decision regarding procurement of finance from debt as well as equity. Thus, it affects the proportion of equity and debt to make up the capital structure.

(iv) **All Items of Profit and Loss Account** Capital budgeting decisions, i.e., investment in fixed assets affect the profit and loss statement, e.g. more debt requires more interest payment. Thus, we can see the impact of financial decisions on various items of financial statement such as interest, profit, tax, etc.

2. What are the main objectives of financial management? Briefly explain. **(NCERT)**

Ans. The main objectives of financial management are

(i) Effective utilisation of funds, by ensuring that benefits of an investment exceeds its cost.

(ii) To raise funds at minimum cost and minimum risk, through effective financing decision.

(iii) To ensure safety of funds by creating reserves, reinvesting profits, etc.

(iv) To maintain financial liquidity and profitability through working capital decision.

3. "Financial management is concerned with inflow and outflow of money." Do you agree? If yes, How?

Ans. Yes, financial management is concerned with inflow and outflow of money as it is concerned with taking decisions regarding optimal procurement and utilisation of funds.

For the effective procurement of funds, different available sources of finance are identified and compared in terms of cost and risk associated with them. Procurement of funds is done for both long-term needs as well as short-term needs.

For long-term financing needs, the funds can be sourced through debt and equity. Short-term financing involves management of working capital.

Now, the funds so procured have to be invested in a manner that the returns are higher than the cost of funds. The outflow of money is through purchase of fixed assets, current assets, working capital needs, distribution of dividends, etc.

4. Financial management is based on three broad decisions. What are these? **(NCERT)**

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

Ans. Financial management is concerned with optimum procurement as well as usage of finance.

It aims at mobilisation of funds at a lower cost and deployment of these funds in the most profitable activities. Three broad decisions are

(i) **Investment Decision** It relates to how the firm's funds are invested in different assets, so that the firm is able to earn the highest possible returns on investment. Investment decisions can be long-term or short-term.

(ii) **Financing Decision** It is concerned with the decisions of how much funds are to be raised from which long-term source, i.e., by means of shareholders' funds or borrowed funds. Shareholders' funds include share capital, reserves and surplus and retained earnings, whereas borrowed funds include debentures, long-term loans and public deposits.

(iii) **Dividend Decision** It relates to how much of the company's net profit is to be distributed to the shareholders and how much of it should be retained in the business for meeting the investment requirements. This decision should be taken, keeping in view the overall objective of maximising shareholders' wealth.

5. Dividends declared by the companies are taken as a positive note by the investors. Stock markets react positively to such decisions and share prices tend to show an upward trend. But, at the same time, it is restricted to certain extent by the Companies Act as well as the financial condition of the concern. Franco, the financial manager of Sunlight Ltd. declared in the Annual General Meeting (AGM) that "It is costly to reinvest the retained earnings." After considering his statement, what decision is taken by the board?

Ans. Company's net earnings are divided into two parts, retained earnings and dividend. If the company has profitable investment options then, it would like to retain the earnings and reinvest rather than distribute it as dividend. But in the given case, the condition is not favourable for reinvesting. Thus, the board may take the residual decision which means the company will pay dividends as the reinvestment is not profitable.

6. 'G Motors' is the manufacturer of sophisticated cranes. The production manager of the company, reported to the chief executive officer, Ashish Jain that one of the machines used in manufacturing sophisticated cranes had to be replaced to compete in the market, as other competitors were using automatic machines for manufacturing cranes.

After a detailed analysis, it was decided to purchase a new automatic machine having the latest technology. It was also decided to finance this machine through long-term sources of finance. Ashish Jain compared various machines and decided to invest in the machine which would yield the maximum returns to its investors.

(i) Identify the financial decision taken by Ashish Jain.

(ii) Explain any three factors affecting the decision identified in (i) above. **(CBSE 2019)**

Ans. (i) Financial decision taken by Ashish Jain is investment (Long-term/Capital budgeting) decision.

(ii) The factors affecting investment decision are given below

(a) **Cash Flow of the Project** When a firm takes an investment decision involving huge amount, it expects to generate some cash flows (inflow or outflow) over a period.

Thus, the inflows and outflows of cash in the business should be considered before making capital budgeting decisions.

(b) **Rate of Return** Each project is selected after comparing expected returns of different projects and the degree of risk involved in them.

(c) **The Investment Criteria Involved** 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.

7. Sana is a young professional employed in a multinational company. Her annual package is of ₹6 lakh. Since she lives with her parents, therefore she is able to save a major part of her earnings.

Her friends are constantly advising her to invest in shares. But, she is not aware about the nitty-gritties regarding the functioning of the stock-exchange.

So, she decided to invest in equity through the primary market, assuming that this will help her to earn stable dividends. But her father, who was a retired bank officer told her that even dividends are not stable as they are affected by several factors.

(i) Is Sana's father right in his assertion?

(ii) Explain the following as factors affecting 'dividend decision'.

(a) Stability of dividend (b) Legal constraints

(c) Access to capital market

Ans. (i) Yes, Sana's father is correct in his assertion.

(ii) Factors affecting dividend decision are

(a) **Stability of Dividend** Every company adopts the policy of maintaining the stability of dividend per share. From this point of view, a little change in profit should not be allowed to increase or decrease the dividend.

(b) **Legal Constraints** Certain provisions of the Companies Act put restrictions on payouts as dividend. Such provisions must be adhered to while declaring the dividend.

(c) **Access to Capital Market** Large and reputed companies generally have easy access to the capital market and therefore may be depended less on retained earnings to finance their growth. These companies tend to pay higher dividends than the smaller companies.

8. "Financial planning is a financial blueprint of an organisation's future operations." Explain the twin objectives of financial planning in the light of this statement.

Ans. Financial planning means estimating the requirements of a business and determining the sources of funds. Financial planning includes both short-term and long-term planning. Objectives of financial planning are

(i) **To ensure Availability of Funds whenever Required** If adequate funds are not available, the business unit will not be able to honour its commitments and plans.

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

9. Name the process which helps in estimating the future finance requirements of an organisation. Also, give four importance of that process.

Ans. Financial planning is the process of estimating the future finance requirements of an organisation.

Importance of financial planning are

(i) By forecasting what may happen in future, company prepares plans for future through financial planning.

(ii) It helps in avoiding business shocks and surprises by preparing a blueprint of organisation's future preparations.

(iii) Financial planning helps in linking the present with the future.

(iv) Through financial planning, wastage of human as well as physical resources is reduced.

10. The finance manager of Aerial Automobiles has made a detailed plan analysing the minutest financial needs of the firm in the coming six months. He also analyses the sources from where such fund requirement will be met.

(i) Name the process the finance manager is involved in.
(ii) Explain any two essential requirements of a sound financial plan.

Ans. (i) The finance manager is involved in financial planning.
(ii) Following are the two essential elements of a sound financial plan
(a) A sound financial plan should help in facilitating the collection of optimum funds.
(b) It should be able to tap appropriate sources at the appropriate time. Thus, it helps in fixing the most appropriate capital structure.

11. Surya Ltd. is manufacturing steel at its plant in India. It is enjoying a buoyant demand for its products as economic growth is about 7% to 8% and the demand for steel is growing. Therefore, it is planning to set-up a new steel plant to take benefit of such trends in demand. It is estimated that such an expansion will require about ₹ 5,000 crore to set-up and about ₹ 500 crore of working capital. As the finance manager of the company, state any three factors that would be considered while determining the capital structure for the new venture.

Ans. In this case, the various factors that are to be considered in determining the capital structure for the new venture will be
(i) **Cost of Debt** If the rate of interest on debt is high, the company should use less debt in its capital structure and vice-versa.
(ii) **Cost of Equity** When a company interest debt, the financial risk faced by equity shareholders increases. Thus, debt can be used upto a limit. Beyond that point, cost of equity may go up and share prices may decrease.
(iii) **Interest Coverage Ratio** (ICR) It refers to the number of times earnings before interest and tax covers the interest obligation. Higher the ICR, the company can borrow more funds and vice-versa.

12. 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. The company should use 'Option A' as in this case the return on investment (10-12%) will be more than the cost of debt (9%).

The concept being used in the above case is Trading on Equity. The use of debt alongwith equity increases Earnings Per Share (EPS). This use of fixed financial charge, i.e., interest, increases the profit earned by shareholders. This concept is known as trading on equity.

If the company opts for Option A, it will lead to favourable trading on equity as in this case RoI > CoD, where

RoI—Return on Investment (10-12%)

CoD—Cost of Debt (9%)

13. There are two companies B and D. Total contribution of capital is ₹ 40 lakh each. The ratio of equity to total capital in company B is ₹ 10 lakh and debt is ₹ 30 lakh while in company D, the total equity capital is ₹ 40 lakh, sourced through equity. EBIT is ₹ 8 lakh, the interest rate on debt is @ 10% and the tax rate is 30%.

Which company enjoys favourable financial leverage?

Ans. As per the given details, company enjoying the favourable financial leverage can be identified as below

Particulars	Company B (₹)	Company D (₹)
Equity @ ₹ 100 each	10,00,000	40,00,000
Loan @ 10% p.a.	30,00,000	—
Total Capital	40,00,000	40,00,000
EBIT	8,00,000	8,00,000
(–) Interest @ 10%	(3,00,000)	—
EBT	5,00,000	8,00,000
(–) Tax @ 30%	(1,50,000)	(2,40,000)
	3,50,000	5,60,000
EPS	35%	14%

Company B is in the position of favourable financial leverage as use of debt increases the EPS and thus, the situation is considered as favourable for trading on equity.

14. 'Smart Stationery Ltd'. wants to raise funds of ₹ 40,00,000 for its new project. The management is considering the following mix of debt and equity to raise this amount.

Capital Structure	Alternative		
	I (₹)	II (₹)	III (₹)
Equity	40,00,000	30,00,000	10,00,000
Debt	0	10,00,000	30,00,000

Other details are as follows

Interest Rate on Debt	9%
Face Value of Equity Shares	₹ 100 each
Tax Rate	30%
Earning Before Interest and Tax (EBIT)	₹ 8,00,000

(i) Under which of the three alternatives will the company be able to take advantage of trading on equity?

(ii) Does Earning Per Share (EPS) always rise with increase in debt? **(CBSE 2019)**

Ans. (i) The company will be available to take advantage of trading on fquity in alternative III. This is because of higher earning per share in Alternative III as calculated below

Calculation of Earning Per Share (EPS) **Alternative**

Particulars	**I (₹)**	**II (₹)**	**III (₹)**
EBIT	8,00,000	8,00,000	8,00,000
(–) Interest	–	(90,000)	(2,70,000)
	8,00,000	7,10,000	5,30,000
(–) Tax @ 30%	(2,40,000)	(2,13,000)	(1,59,000)
Profit After Tax	5,60,000	4,97,000	3,71,000
EPS	$\frac{5,60,000}{40,000}$ = ₹ 14	$\frac{4,97,000}{30,000}$ = ₹ 16.56	$\frac{3,71,000}{10,000}$ = ₹ 37.10

(ii) No, Earning Per Shares (EPSs) only rises with increase in debt when the rate of interest on debt is lower than the return on investment.

15. Sunflag Iron Ltd. is manufacturing steel at its plant in India. It is enjoying increased demand for its steel as economic 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 plant 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 (i) above.

Ans. (i) The concept discussed above is capital structure. It refers to the mix between owners funds and borrowed funds or it represents the proportion of debt capital and equity capital to make up the total capital of a firm.

(ii) Two factors affecting capital structure of an organisation are

(a) **Cost of Debt** A firm's ability to borrow at a lower rate of interest increases its capacity to employ higher debt. Thus, more debt can be used if debt can be raised at a lower rate.

(b) **Cost of Equity** When a company increases debt, the financial risk faced by equity shareholders increases. Thus, debt can be used upto a limit. Beyond that point, cost of equity may go up and share prices may decrease.

16. Neelabh is engaged in 'transport business' and transports fruits and vegetables to different states. Stating the reason in support of your answer, identify the working capital requirements of Neelabh. Neelabh also wants to expand and diversify his transport business, explain any two factors that will affect his fixed capital requirements. **(Delhi 2012)**

Ans. In the transportation business, lower amount of working capital is required as it is a service industry. Working capital requirement of Neelabh would include payment of salaries, fuel charges, maintenance of vehicles, etc. Factors affecting the fixed capital requirements are

(i) **Growth Prospects** Businessman wants to expand his business, in such situation company requires higher investment to meet the anticipated demand in future. Thus, the requirement of fixed capital will be higher.

(ii) **Diversification** If the businessman diversifies his business, this means larger amount of fixed capital is required.

17. Distinguish between fixed capital and working capital.

Ans. Difference between fixed and working capital

Basis	**Fixed Capital**	**Working Capital**
Time Period	Required for long-term.	Required for short-term.
Purpose	Money needed to buy fixed assets.	Money needed to buy current assets.
Nature	Remains sunk in business.	Revolves in business.
Source	Raised through shares, debentures and term loans.	Raised through banks, trade credit, shares and debentures.

18. How does working capital affect both the liquidity as well as profitability of a business? **(NCERT)**

Ans. Working capital means the portion of capital which is invested in current assets. It should neither be less or more than what is required. If it is more than the required amount, it will increase the liquidity but decrease profitability. On the other hand, if the working capital is less, then there would be a difficulty in meeting the current liabilities. Thus, the amount of working capital should be optimum, so that neither profitability nor liquidity is affected.

19. What do you mean by working capital? Explain any three factors affecting the requirement of working capital.

Ans. The capital invested in current assets such as stock of materials and finished goods, accounts receivable, bills receivable and bank balances for meeting day-to-day expenses is known as working capital.

Factors affecting the working capital requirements are

(i) **Nature of Business** A trading organisation and a service industry firm usually needs a smaller amount of working capital as compared to a manufacturing organisation.

(ii) **Scale of Operations** Organisations which operate on a large scale, their quantum of inventory and 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.

(iii) **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 purchase, the working capital requirements are reduced.

20. Steelone Enterprises is manufacturing high quality steel utensils. The demand for steel utensils is rising as people are getting aware that plastic is not good for health. This has led to increase in production of steel utensils.

To encourage sales, Steelone Enterprises declared a liberal credit policy which allows three months credit to its wholesale buyers.

In the light of the above, identify the two factors affecting working capital requirements of Steelone Enterprises. State with reason, whether the factors as identified above, will result in high or low working capital requirement. **(CBSE 2019)**

Ans. Two factor affecting the working capital requirement of Steelone Enterprises are

(i) **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.

(ii) **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 larger and, therefore, larger amount of working capital is required. As against this, the requirement for working capital will be lower during the period of dep- ression, since the sales as well as production will be less.

• Long Answer (LA) Type Questions

1. Give the meaning of financial management. State its main objective. **(CBSE 2019)**

Ans. Financial management is concerned with optimal procurement as well as usage of finance. It aims at reducing the cost of funds procured, keeping the risk under control and achieving effective deployment of such funds. Financial management is an area of financial decision-making harmonising individual motives and enterprise goals.

Objectives of Financial Management

The primary aim of financial management is to maximise shareholders' wealth, which is referred to as the wealth-maximisation concept. The market price of equity share increases, if the benefit from a financial management decision exceeds the cost involved. Therefore, those financial decisions are taken which ultimately prove to be gainful and maximise the current price of equity shares of the company.

With the primary objective of wealth maximisation, following objectives are also achieved

(i) Funds should be deployed in such a way that returns from an investment exceeds its cost.

(ii) To raise funds at minimum cost and minimum risk, through effective financing decision.

(iii) To maintain financial liquidity and profitability, through working capital decision.

(iv) To ensure safety of funds by creating reserves, reinvestment of profits, etc.

2. 'Monisha Consumer Goods' is a leading consumer goods chain with a network of 46 stores primarily across Mumbai, Delhi and Pune. It was started by Monisha Gupta in 1987. It has a large market share in Mumbai, Delhi and Pune. Looking for an opportunity to expand, it has decided to open a new branch in Kerala. She has to decide on what new resources she will invest in so that it is able to earn the highest possible return for its investors. Once the company believes that it will be able to generate higher revenues and profits, it also has to decide on how this project will get funded. The finance manager, Atul was told to have an optimal capital structure by striking a balance between various sources of getting the project funded so as to increase shareholders' wealth. Atul, 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.

(i) State the two financial decisions discussed in the above situation.

(ii) Explain any two factors affecting each of the decisions that still have to be considered by the finance manager. **(CBSE 2019)**

Ans. (i) Two financial decisions being discussed are

(a) **Investment Decisions** It involves careful selection of assets in which funds are to be invested.

Decisions relating to investment in fixed assets are known as capital budgeting, whereas those concerning investment in current assets are called working capital decisions.

A business needs to invest funds for setting up new business, for expansion and modernisation. Investment decision is taken after careful scrutiny of available alternatives in terms of costs involved and expected return.

(b) **Financing Decisions** It is concerned with the decisions of how much funds are to be raised from which long-term source, i.e., by means of shareholders funds or borrowed funds.

Shareholders funds include share capital, reserves and surplus and retained earnings, whereas borrowed funds includes debentures, long-term loans and public deposits.

(ii) Two factors which affect capital budgeting/ investment decisions and needs to be considered are

(a) **Cash Flows of the Project** When a business invests huge amount of money in a certain project, then it expects regular and reasonable cash inflows from such an investment. Cash generated from operations are analysed in selecting the desired project.

(b) **The Rate of Return** Each project is selected after comparing expected returns of different projects and the degree of risk involved in them.

Two factors affecting financing decisions and needs to be considered are

(a) **Fixed Operating Cost** If a firm is having a higher fixed operating burden like payment of interests, premiums, salaries, rent, etc, then it should avoid financing through debt. This is because it will further increase the interest payment burden and the firm can reach an unfavourable position.

(b) **Control Considerations** Issue of more equity may dilute shareholder's control over the business. Therefore, a company afraid of a takeover bid may prefer debt to equity.

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 good prospects for growth in future. It is a well managed organisation and believes in quality, equal employment opportunity 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. The factors identified in the above lines are given below

(i) **Stability in Earnings** A company having higher and stable earnings can declare higher dividends than a company with lower and unstable earnings.

The line "It has been consistently .... many years."

(ii) **Amount of Earnings** Dividends are paid out of current and past earnings. Thus, earnings is a major determinant of dividend decision.

The line "This year too ………… enough profits."

(iii) **Growth Opportunities** Companies having good growth opportunities retain more money out of their earnings so as to finance the required investment. Therefore, the dividend declared in growth companies is smaller than that in the non-growth companies.

The line "There is availability ……… in future."

(iv) **Shareholders Preference** While declaring dividends, management must keep in mind the preferences of the shareholders.

Some shareholders in general desire that atleast a certain amount is paid as dividend.

The companies should consider the preferences of such shareholders.

The line "It has many share ……… their a investments".

4. India Inc. issues Bonus Shares and Dividends Corporate India has opened its purse strings to shareholders with interim dividends and bonus shares. Atleast 60 companies have declared interim dividend or announced plans to do so in the first three weeks of January. In addition, around 12 companies have announced bonus share issues this month, about three times more than January 2006.

There are range of things that a company can do for maximising shareholder value and dividend is the most direct and simple form of it. Ideally companies need to balance it up between paying cash and building value of the stock for total shareholder returns.

This trend of dividends and bonuses is in synchronisation with the good profits being posted by companies. It's a way of rewarding shareholders.

A number of companies have also announced plans of bonus shares for their shareholders.

Most of the companies who have already declared bonus issues or announced that they would be taking it up in their next board meeting are small or mid-sized companies.

(i) Identify the financial decision involved in this case. Explain.

(ii) What factors are considered while taking this decision? **(NCERT)**

Ans. (i) **Dividend Decision** This decision relates to the amount of profit that the company would retain for future and the amount that would be distributed among the shareholders.

(ii) Factors affecting dividend decision are

(a) **Amount of Earnings** Dividends are paid out of current and past earnings. Thus, earnings is a major determinant of dividend decision.

(b) **Stability in Earnings** A company having higher and stable earnings can declare higher dividends than a company with lower and unstable earnings.

(c) **Growth Opportunities** Companies having good growth opportunities retain more money out of their earnings so as to finance the required investment.
The dividend declared in growth companies is therefore, smaller than that in the non-growth companies.

(d) **Cash Flow Position** Dividend involves an outflow of cash. Availability of enough cash is necessary for payment or declaration of dividends.

(e) **Taxation Policy** If the tax on dividends is higher, it is better to pay less by way of dividends. But if the tax rates are lower, higher dividends may be declared. This is because as per the current taxation policy, a dividend distribution tax is levied on companies. However, shareholders prefer higher dividends as dividends are tax free in the hands of shareholders.

(f) **Access to Capital Market** Large and reputed companies generally have easy access to the capital market and therefore, may depend less on retained earnings to finance their growth. These companies tend to pay higher dividends than the smaller companies.

5. "Sound financial planning is essential for the success of any enterprise." Explain this statement by giving any six reasons. **(CBSE 2019)**

Ans. "Sound financial planning is essential for the success of any enterprise." The following points explain the importance of financial planning

(i) It helps in forcasting what may happen in future under different business situations. By doing so, it helps the firms to face the eventual situation in a better way. In other words, it makes the firm better prepared to face the future. By preparing a blueprint of these situations, the management may decide what must be done in each of these situations. This preparation of alternative financial plans to meet different situations is clearly of immense help in running the business smoothly.

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

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

(iv) It provides a link between investment and financing decisions on a continuous basis.

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

(vi) By spelling out detailed objectives for various business segments, it makes the evaluation of actual performance easier.

6. From last many years, in the monthe of November, due to sudden rise in the pollution level in Delhi and other parts of Northern India, there has been an increase in the demand for air purifiers. Inderprastha Technologies Ltd. a manufacturer of air purifiers wants to encash this opportunity and wants to raise its investment in stock.

It is expected that this decision would increase the rate of profitability of the business. Due to this many competitors have recently entered in this industry.

In order to increase the sales, the company has started selling air purifiers on liberal credit terms. It is not affecting the profits of the company since the production cycle of the product is short.

Identify and state any two factors that Inderprastha Technologies Ltd. will keep in mind before deciding its working capital requirements. Also state four other factors which should be kept in mind while deciding the working capital requirements of a company.

Ans. (i) Factors that Indusprastha Technology Ltd. will keep in mind before deciding its working capital requirements are

(a) **Seasonal Factors** In peak season, large amount of working capital is required because of higher level of activity. While during lean season, less amount of working capital is required.

(b) **Level of Competition** High competition may necessitate the company to keep large stock of finished goods to meet urgent orders from customers. Thus, this will increase the working capital requirement.

(ii) Other factors affecting working capital requirement of a company are

(a) **Nature of Business** A trading business needs less amount of working capital because there is no processing of good. However, working capital requirement of a manufacturing business is more as raw materialneds to be converted into finished goods.

(b) **Scale of Operations** A large scale organisation require large amount of working capital as its inventory level, debtors, etc are generally high. However, firms operating at small scale need less working capital.

(c) **Growth Prospects** If the growth potential of an enterprise is higher, then it will require more amount of working capital so that it is able to meet higher production and sales target whenever required.

(d) **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 purchase, the working capital requirement is reduced.

7. Discuss the need and importance of working capital.

Or

Why is an adequate amount of working capital required in an enterprise?

Ans. Adequate working capital is essential for smooth and efficient working of every business enterprise. Adequate working capital provides the following advantages to a business enterprise

(i) A firm with adequate working capital can meet its liabilities promptly. Prompt payment helps to raise the credit-standing or reputation of the enterprise.

(ii) Adequacy of working capital enables the firm to take advantage of any favourable business opportunity, e.g. to purchase raw materials at a discount or to execute a special order.

(iii) Financial soundness of business boosts the morale of employees.

(iv) Lack of adequate working capital may result in interruptions in operations and underutilisation of plant capacity.

(v) Adequate working capital permits timely and regular payment of cash dividends. This helps to maintain cordial relations with shareholders.

Chapter Test

Multiple Choice Questions

1. Which one of the following is related to planning, organising, directing and controlling of financial activities?

(a) Financial decision (b) Capital structure
(c) Investment decision (d) Financial management

2. 'Temptations' is a food joint in Imperial Mall in Bengaluru. It is becoming popular among students and working people due to healthy, on-the-go dishes on its menu like 'Tancer Wrap', 'Chickpeas Salad', 'Grilled Sandwiches', etc.

It has now decided to open two new branches in other parts of Bengaluru.

Which financial decision has been discussed in the above case?

(a) Long-term investment decision
(b) Short-term investment decision
(c) Dividend decision
(d) Financing decision

3. 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 equity, lower risk and lower profits
(d) lower equity, lower risk and higher profits

4. Tata International Ltd. earned a net profit of ₹ 50 crores. Ankit the finance manager of Tata International Ltd. wants to decide how to appropriate these profits. Which financial decision is to be taken the in above case?

(a) Investment decision (b) Dividend decision
(c) Financing decision (d) None of the above

5. The process of estimating the financial requirements of an organisation specifying the sources of funds and ensuring that enough funds are available at the right time is called

(a) Financial management (b) Financial planning
(c) Financial decision (d) Business finance

Short Answer (SA) Type Questions

1. Somnath Ltd. is engaged in the business of export of garments. In the past, the performance of the company had been upto 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 financing 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 availablity of funds from the internal sources of the business. For the temaining funds he is trying to find out alternative sources from outside.

Justify the financial concept discussed in the above paragraph. Also state the objectives to be achieved by the use of financial concept, so identified.

2. Your are a financial expert and your company starts a business of manufacturing baby toys. Suggest the working capital requirement and phases of operating cycle.

3. Though Angel Pharma is making huge profits every year on a regular basis, it is not able to provide sufficient dividend to its shareholders.
As a result, EPS remains low. Identify and explain the concept that can help to resolve the problem.

4. "The overall financial health of a business is determined by the quality of its financial management." In the light of the above statement, discuss some of the aspects which affect the financial health of a business.

5. How is shareholders, wealth maximisation linked with the market price of the shares of the company?

Long Answer (LA) Type Questions

1. Sudha is an enterprising business woman who has been running a poultry farm for the past ten years. She has saved ₹ 4 lakh from here business.
She shared with her family her desire to utilise this money to expand her business.

Her family members gave her different suggestions like buying new machinery to replace the existing one, acquiring altogether new equipments with latest technology, opening a new branch of the poultry farm in another city and so on.
Since, these decisions are crucial for her business, involve huge amount of money and are irreversible except at a huge cost, Sudha wants to analyse all aspects of the decisions, before taking any final decision.

(i) Indentify and explain the financial decisions to be taken by Sudha.

(ii) Also, explain briefly the factors that will effect this decision.

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

Answers

Multiple Choice Questions

***1.** (d)* ***2.** (a)* ***3.** (a)* ***4.** (b)* ***5.** (b)*