# Part - B
# Business Finance and Marketing

## Unit - 9 : FINANCIAL MANAGEMENT

### Summary of the Chapter

**Business Finance-** It refers to funds required for carrying out business activities.

**Financial Management**- It includes decisions relating to procurement of funds, investment of funds in long term and short term assets and distribution of earning to the owner.

**Objective of Financial Management:-**Maximize wealth of equity shareholders which means maximizing the market price of equity shares.

**Financial Decisions-**

A) **Investment decision**-It is concerned with investment of firms fund in different assets (Fixed assets and current assets)

**Long Term or Capital Budgeting Decisio**n- Related to decisions taken to invest in the fixed assets.

**Factors Affecting –**

1. Cash flow positions  2. Return on investment  3. Investment criteria.

B) **Financing decision**- It deals with determination of sources of finance, amount to be raised from each source.

Factors Affecting**-**

1. Cost
2. Risk
3. Tax Rate
4. Cash flow position

C) **Dividend decisions**- It refers decisions related to amount of profit to be distributed among shareholders and amount of profit to be retained in the business for financing.

**Factors Affecting-**

1. Amount of earning
2. Stability of earning
3. cash flow position
4. Taxation policy

**Financial planning**- is the process of estimating the funds requirement, specifying the sources of fund and utilizing them in an optimum manner.

**Objective of financial Planning-**

1. To ensure availability of funds whenever required
2. To ensure unnecessarily finance is not raised.

**Capital Structure** – Refers to proportion of debt and equity used for financing the operations of business.

**Factors Affecting–**

1. Cash flow positions
2. Return on investment
3. Tax rate
4. Cost of Debts
5. Control
6. Risk
7. Stock market condition.

**Fixed Capital** – it refers to money invested in the fixed assets, which is to be used over a long period of time.

**Factors Affecting** –

1. Nature of business
2. Scale of operations
3. Choice of technique
4. Growth prospectus

**Working Capital** – it refers to money invested in the current assets, which is to be used over a short period of time.

**Factors Affecting** – 1-Nature of business 2- Scale of operations 3-Production cycle 4-Seasonal factors.

## Very Shport Questions Anwers - (1 Mark)

**Q. 1.** Management has to decide whether a new and modern plant should be replaced with the old one. Which type the financial decision is it.

**Ans.** Investment Decision.

**Q.2.** A company wants to establish a new unit in which a machinery of worth Rs.10 lakhs is involved. Identify the type of decision involved in financial management?

**Ans.** Capital Budgeting decision or investment decision.

**Q.3.** A decision is taken to raise money for long-term capital needs of the business from certain sources. What is this decision called?

**Ans.** Financing decision.

**Q.4.** What is meant by 'Financial Risk'?

**Ans.** Financial risk refers to inability to meet fixed financial charges like interest payment, preference dividend and repayment obligations.

**Q.5.** What kind of decisions involves distributions of profit to shareholders?

**Ans.** Dividend Decisions.

**Q.6** Which type of dividend policy should be followed by a company having growth opportunities?

**Ans.** Conservative dividend policy, i.e. such company should pay less dividend.

**Q.7.** Identify, why the requirement of Fixed Capital for a trading concern are different from that of a manufacturing organization.

**Ans.** Trading concern requires less fixed capital as compared to manufacturing organization because trading concern requires relatively much less investment in fixed assets.

**Q.8.** Ankit adopted a new policy in his business: Purchase computer on credit and sell them for cash. Will it affects the requirement of working capital?

**Ans.** Yes, it will reduce the need of working capital as there are no debtors due to cash sales and there is less investment in inventory due to credit availed.

**Q.9.** For optimal procurement of funds, a finance manager identifies different available sources and compares those in term of cost and associated risks. Identify and define the concept highlighted in the above lines.

**Ans.** The concept is financial management and is concerned with management of flow of funds and involves decisions relating to procurement and investment of funds, in long term and short term assets and distribution of earning to the owner.

**Q.10.** How do 'Growing Opportunities' as a factor affect dividend decision? State.

**Ans.** Companies having growing opportunities in near future declare lesser dividend as compared to companies, which do not have any growth plans.

**Q.11.** State how 'Growth Prospects' affect the working capital requirements of a company?

**Ans.** The firms which have sufficient possibilities of growth prospects in future require more working capital. However, for companies with lesser prospects, less working capital is needed.

## Short Answer Type Questions (3/4 marks Each)

**Q 1.** What are the objectives of financial management for an organization? Give any three reasons in support of your answer.

**Ans.**
1. Financial management helps in determination of total funds required.
2. Helps in allocation of fund for fixed assets and current assets.
3. Helps in determination of sources to raise fund for the organization.
4. Wealth maximization

**Q 2** What do you mean by Financial planning? Explain its two importances.

Ans. **Financial planning** is the process of estimating the funds requirement, specifying the sources of fund and utilizing them in an optimum manner.

**Importance of financial Planning-**

1. **To ensure availability of funds whenever required**–financial needs are anticipated and then the sources of availability of finance are allocated.
2. **It helps the company to prepare for the future-**It forecasts what may happen in future under different business situations and decide what must be done in each situations.

**Q 3**. Financial decision is concerned with selection of fixed assets in which funds will be invested by the business? Identify the decision and explain any three factors affecting the decision.

Ans. **Long term Investment decision/ Capital Budgeting Decision**-It is concerned with investment of firm's fund in different fixed assets like buying of machinery.

**Factors Affecting –**

1. **Cash flow positions of the company**-Before considering an investment option, business must carefully analyse the net cash flow expected from the investment during the life of the investment. Investment should be made if net cash flow is more.
2. **Return on investment**-Investment should be done in the projects which earn the higher rate of return. It should be calculated on the basis of expected return of the projects.
3. **Investment criteria**-Before taking decision, each investment opportunity must be compared by using the various capital budgeting techniques. These techniques involve calculation of rate of return, cash flow during the life of investment, cost of capital etc.

**Q.4**. 'Sarah Ltd.' is a company manufacturing cotton yarn. 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 organization and believes in quality, equal employment opportunities and good remuneration practices.

It has many shareholders who prefer to receive a regular income from their investments. It has taken a loan of Rs.40 lakhs from IDBI and is bound by certain restrictions on the payment of dividend according to the terms of loan in 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 identity and explain any four such factor.

**Ans.** **Dividend Decision**- It refers decisions related to the amount of profit to be distributed among shareholders and amount of profit to be retained in the business for further growth of the business..

Factors affecting dividend decision:

*(i)* **Stability of Earnings**: It affects dividend decision as a company having stable earnings is in a position to declare higher dividends.

*(ii)* **Cash Flow Position:** A good cash flow position is necessary for declaration of dividend. 'There is availability of enough cash in the company'.

*(iii)* **Growth prospects:** If a company has good growth opportunities, it pays out fewer dividends. 'Good prospects for the growth in the future'.

*(iv)* **Shareholders' Preferences:** Shareholders' preference is kept in mind by the management before declaring dividends. 'It may have shareholders who prefer to receive regular income from their investments'.

## Long Answer Type Questions (5/6 marks)

**Q1**. What is the Capital structure? Explain any five factors affecting the choice of capital structure?

Ans. Capital structure refers to mix sources of long term finance. Sources of finance include Share capital Borrowed fund and Retained earnings. The appropriate proportion of funds is made in such a manner that it can give more benefit or return to the shareholders.

**Factors affecting the choice of capital structure**

1. **Cash Flow Position:** Size of projected cash flows must be considered before issuing debt, to ensure that it has sufficient cash buffer after meeting its fixed cash obligations.
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.
3. **Debt Service Coverage Ratio (DSCR):** Debt Service Coverage Ratio takes care of the deficiencies referred to in the Interest Coverage Ratio (ICR).
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.

**Q2**. What do you mean by **Working capital**? Explain any four factors affecting the requirement of working capital.

Ans. **Working capital** refers to the amount which is invested in current assets. This fund also needed for payment of daily expenses, payment of current liabilities etc. this investment facilitate smooth business operation.

**Factors affecting the requirement of working capital .**

1. **Nature of business:-**the requirement of working capital depends on the nature of business. Manufacturing business requires more amount of working capital because it takes lot of time in converting raw materials into finished goods while trading business requires less amount of working capital.
2. **Scale of operation**: - Business operating on larger scale require more funds to maintain the high quantum of inventory, debtors or meet day to day expenses as compared to small scale business.
3. **Business Cycle**: - Different phases of business cycle affect the requirement of working capital by a firm. In case of boom, there is increase in production and scales leading to the increased requirement for working capital whereas the requirements for working capital reduce during depression.
4. **Seasonal factors**: - many businesses may have high level of activity during specific period of time which may be referred as season time. Therefore, during peak season the level of activity is high leading to increased need of working capital as compared to the capital during lean period.

Q3. Which decision is concerned with rising of finance using shareholders' funds or borrowed funds? Identify and describe the financial decision involve in this decision. Explain any four factors affecting that decision.

Ans. **Financing decision**:- This decision concerned with raising of finance using shareholders fund or borrowed fund. It involves identification of various sources of finance and the quantum of finance to be raised from long term and short term sources.

**Factors affecting the financing decision**.

1. **Cost: -** cost of raising fund influences the financing decisions. A prudent financial manager selects the cheapest source of finance.
2. **Risk**: - Debt capital is most risky and from the point of view of risk it should not be used.
3. **Floatation cost**: - From the point of view of floating costs, retained profit is the most appropriate source. Therefore, it should be made.
4. **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 advantage of cheap finance, debt can be given priority.

**Q 4**. What do you mean by Fixed capital? Explain any four factors affecting the requirement of fixed capital.

Ans. Fixed capital refers to the amount which is invested in fixed assets of the business enterprise.

This capital is used to acquire Land & Building, Plant and Machinery, Furniture etc. This capital is raised from the long term sources of finance.

**Factors affecting the requirement of fixed capital** .

1. **Nature of business:-**The requirement of fixed capital depends on the nature of business. Manufacturing business requires heavy amount of fixed capital to invest in the fixed assets like- Land & Building, Plant and Machinery, Furniture etc, whereas trading concern business require less capital.
2. **Scale of operation**:- Business operating on larger scale requires larger amount of fixed capital as they need heavy and bigger machinery and equipments. However, firms operating at small scale need relatively lesser fixed capital.
3. **Choice of Technique**- Production technique adopted by business also influences the requirement of fixed capital. Companies using capital-intensive technique require more fixed capital as larger investment is needed in the plant and machinery as it relies less on manual labour.
4. **Growth prospects**-Companies with growth plans in future need more fixed capital as more investment in the plant and machinery is needed to increase the production capacity. In other situation requires less fixed capital.