Very Short Answer Questions NCERT Business Studies Solutions Class 12 Chapter 9

Q1. What is meant by capital structure?

Capital structure is the combination of debt and equity, which is used by a company to finance its requirements for funds. Debt can be obtained in the form of loans, while equity is generated through retained earnings or common stock.

Q2. Discuss the two objectives of Financial Planning.

Financial planning is the process of framing financial policies, procedures, programs and budgets that are necessary for the financial activities of the enterprise.

Objectives of financial planning are:

1. To ensure proper utilisation of funds available for the organisational activities.

2. To determine the capital structure, which is the composition of debt and equity that is necessary for a business.

Q3. Name the concept of financial management, which increases the return to equity shareholders due to the presence of fixed financial charges.

Trading on equity concept increases returns to equity shareholders due to the presence of fixed financial charges.

Q4. Amrit is running a 'transport service' and earning good returns by providing this service to industries. Giving reason, state whether the working capital requirement of the firm will be 'less' or 'more'.

The type of business conducted by Amrit is transport service which will be operating on a large scale. Hence, there is a need for more amount of working capital.

Q5. Ramnath is into the business of assembling and selling televisions. Recently he has adopted a new policy of purchasing the components on three months' credit and selling the complete product in cash. Will it affect the requirement for working capital? Give reasons in support of your answer

As Ramnath has adopted the policy of purchasing components on credit for 3 months and selling the product in cash, the working capital requirement is reduced.

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Q1. What is financial risk? Why does it arise?

Financial risk is said to be the situation when a company is unable to meet its set of fixed expenses such as interest payment, loan repayment and preference dividend pay-out. It is a situation where a company is unable to meet its financial obligations. Financial risk arises due to the high level of debt in the capital structure. A high level of debt leads to a high amount of interest which increases the chances of defaulting on payment.

Q2. Define a 'current asset'. Give four examples of such assets.

The current assets of a firm are those assets that have the potential to be converted into cash or cash equivalents within the current accounting period. Current assets provide liquidity to the company. Examples of current assets are cash, short-term investment, marketable securities and debtors.

Q3. What are the main objectives of financial management? Briefly explain.

The main objective of financial management is the maximisation of shareholders' wealth. Therefore, financial management is all about making those decisions that will bring gains for the shareholders. Gains can be said to be achieved when the market value of shares rises. Once the primary objective of wealth maximisation is achieved, the other objectives, such as maintaining liquidity and proper utilisation of funds, are fulfilled along with it.

Q4. Financial management is based on three broad financial decisions. What are these?

Financial management is the technique of proper allocation, acquisition and use of funds by the company. The three broad financial decisions on which financial management is based are investment decisions, financial decisions and dividend decisions.

Q5. Sunrises Ltd., dealing in readymade garments, is planning to expand its business operations in order to cater to the international market. For this purpose, the company needs an additional 80,00,000 to replace machines with modern machinery of higher production capacity. The company wishes to raise the required funds by issuing debentures. The debt can be issued at an estimated cost of 10%. The EBIT for the previous year of the company was 8,00,000, and the total capital investment was 1,00,00,000. Suggest whether the issue of debenture would be considered a rational decision by the company. Give reasons to justify your answer. (Ans. No, the Cost of Debt (10%) is more than ROI which is 8%).

A company is able to issue debentures for fundraising when the debt cost is less than the cost of capital.

In this question, the cost of capital of Sunrises Limited is 10% which is 8,00,000, as the total capital is 80,00,000.

Now, the return on investment is calculated as

ROI = Return / Investment

= 8,00,000/1,00,00,000

= 8 %

Assuming that the company will be operating with the same efficiency, the additional investment of 80,00,000 will have an ROI of 8%, which will amount to 6,40,000.

The cost of debt will be 8,00,000, which is more than the ROI of 6,40,000. Therefore, it is advisable for a company not to issue a debenture when the cost of debt is higher than the cost of capital.

Q6. How does working capital affect both the liquidity as well as the profitability of a business?

Working capital in a business is the surplus that is determined by subtracting current liabilities from the current assets of the organisation. By increasing the working capital, the liquidity of an organisation increases. But more current assets present in business results in a fall in profitability of the organisation, as current assets offer low returns, which cause a decline in the profit of a business.

Q7. Aval Ltd. is engaged in the business of export of canvas goods and bags. In the past, the performance of the company had been up to expectations. In line with the latest demand in the market, the company decided to venture into leather goods, for which it required specialised machinery. For this, the Finance Manager Prabhu prepared a financial blueprint of the organisation's future operations to estimate the number of funds required and the timings with the objective of ensuring that enough funds are available at the right time. He also collected relevant data about the profit estimates for the coming years. By doing this, he wanted to be sure about the availability of funds from the internal sources of the business. For the remaining funds, he is trying to find out alternative sources from outside.

a. Identify the financial concept discussed in the above paragraph. Also, state the objectives to be achieved by the use of the financial concept so identified. (Financial Planning)

b. 'There is no restriction on payment of dividends by a company.' Comment. (Legal & Contractual Constraints)

a. The financial concept discussed here is capital budgeting; it is the decision regarding capital investment which will have an impact on the profitability of the company in the long term.

The company wants to invest in new machinery, which needs investment, this will have a direct impact on the operations, which will result in affecting the profitability of the organisation.

The following objectives can be achieved:

1. Cash flow: Investment will bring new machinery, which will increase organisations' profitability.

2. When a company wants to raise funds from both inside and outside the organisation, it will be helpful to analyse that return generated from such investment will be more than the cost of capital.

3. Investment used: The company is planning to raise funds from both inside and outside. It is important to know that funds from internal and external sources will have different rates of interest.

b. Companies pay dividends to shareholders, which are part of the company earnings. Paying of dividends is based on the following factors:

1. Legal Constraint: Legal constraints are such constraints that are mentioned in the company laws which impact paying out dividends on certain occasions. It should be followed properly.

2. Contractual Constraints: Paying out of dividends reduces cash in the company. Money that is raised as a loan will put certain restrictions on the company for paying dividends, such constraints are called contractual constraints.

Long Answer Questions NCERT Business Studies Solutions Class 12 Chapter 9

Q1. What is working capital? How is it calculated? Discuss five important determinants of working capital requirement.

Working capital in a business is the surplus that is determined by subtracting current liabilities from the current assets of the organisation. Current assets are those assets that can be converted into cash or cash equivalent within the current accounting period. Two broad categories of working capital can be classified:

1. Gross Working Capital

2. Net Working Capital

Gross Working Capital is referred to as the current assets that are present in the balance sheet of a company.

Net Working Capital is the difference between current assets and current liabilities present in the balance sheet of an organisation. Net working capital is considered to be more relevant for capital financing and management.

Working capital is calculated as

Working Capital = Current Assets – Current Liabilities

The following are the determinants of the working capital requirement:

1. Business Type: The nature of the business of a firm determines its working capital requirement. The size and type of operations of an organisation will affect the extent of working capital required. For example, firms that offer services will have low working capital requirements, whereas a manufacturing plant will have a large working capital requirement. The operating cycle of such a firm is more.

2. Scale of operations: The extent of the scale of operations is a determining factor for working capital. A firm having a large scale of operation will see an increase in working capital requirement as firms have a high requirement of maintaining inventory. Similarly, a firm having a small scale of operations will have a low working capital requirement.

3. Fluctuations of Business Cycle: The working capital will also vary with the different phases in which a business is running. During high demand in the market, there will be a high requirement for production; so, working capital will be more, whereas in terms of low demand.

4. Production Cycle: Every industry will have a different production cycle depending on the type of industry. A firm having a longer production cycle will have a higher requirement of working capital, and firms having a short production cycle will have a low working capital requirement.

5. Growth Prospects: Companies that have higher growth prospects and are looking for expansion have a higher working capital requirement.

Q2. "Capital structure decision is essentially optimisation of risk-return relationship." Comment.

Capital structure is the combination of debt and equity, which is used by a company to finance its requirements for funds. Debt can be obtained in the form of loans, while equity is generated through retained earnings or common stock. Borrowed funds can be in the form of loans, debentures, bank loans, etc. While in the case of an owner's fund, it can be in the form of preference share capital, reserves, retained earnings, equity share capital, etc.

Debt and equity both have their risk and profitability. Debt is a relatively cheap source while the greater risk is there, and equity is comparatively expensive but is of lower risk for the firm. Fundraising through debt is cheaper, while same with equity is expensive. Debt, though cheaper, has more risks, as it has an obligation towards lenders. For equity, there is no such compulsion to pay dividends.

Also, the return offered by the sources leads to an increase in value per share. Debt gives higher returns per share but increases the risk comparatively many times.

Therefore, capital structure decisions should be taken into consideration with return and the amount of risk involved.

Q3. "A capital budgeting decision is capable of changing the financial fortunes of a business." Do you agree? Why or why not?

Capital budgeting decision needs to be taken very carefully, as the fortunes of a business can be changed with such a decision. The decision of capital budgeting is the allocation of fixed capital to different projects. Capital budgeting involves purchasing new assets, or it can be regarding the replacement or modernisation of the assets. All these decisions have a long-term impact on the business and can affect profitability and risk.

The following points highlight the importance of capital budgeting decisions:

1. Investment in long-term assets will yield returns in future and, by doing so, affect the future prospects of a business. Therefore, the kind of decision taken by a company will reflect on its long-term growth.

2. A large amount of funds is required to acquire assets. Therefore, the money that is invested will be blocked for a certain period, which makes it all the more important to plan capital budgeting decisions.

3. Acquiring assets is of high risk because it has a long-term impact on the business. If the return on the asset is less than the investment, the business will be impacted.

4. Decisions, once made, are irreversible as reversing leads to a great amount of loss.

Q4. Explain the factors affecting the dividend decision.

A dividend decision is a decision to share a portion of profit which is to be shared between shareholders and what should be kept as retained earnings. The following factors affect dividend decisions:

1. Businesses are able to pay dividends from current and past earnings. A company which is having higher earnings will be in a better position to pay dividends in comparison to a company having limited earnings.

2. Companies having stable earning are in a good position to provide dividends as compared to companies which are inconsistent in earnings.

3. Companies follow a stable dividend-sharing policy. It will only be changed when there is a rise in earning.

4. Companies that are looking for higher growth may keep a certain portion of earning as dividends while investing the majority in expansion. Therefore, such companies offer lesser dividends.

5. If the company does not have a good cash flow, it will impact the dividends paid out.

6. Company must also check the shareholder preferences while paying dividends, as shareholders may require a certain amount of dividend.

7. Taxation policies play a major role in deciding the dividends. A policy levying high tax on dividend distribution leads to companies offering lower dividends and vice versa.

8. Stock market prices will fluctuate depending on the dividend that is declared. It can rise with a high dividend payout while declining with a low dividend payout.

9. There can be contractual constraints at the time of offering loans that are imposed by the lender in the form of an agreement. Such agreements need to be checked before issuing dividend payouts.

10. Companies having greater access to capital markets can pay a higher dividend and vice versa.

11. Companies have to follow the rules, regulations and restrictions of the Companies Act while declaring dividend pay-out.

Q5. Explain the term ”Trading on Equity”. Why, when and how it can be used by a company?

Trading on equity is a process of using debt in order to produce a gain for the owners. In this process, new debt is taken in order to gain new assets with which they can earn a greater level of interest, which is more than the interest that is paid for the debt. This process is practised as the equity shareholders are only interested in the income that is generated from the business. It is only practised by a company when the rate of return on investment is greater than the rate of interest for the fund that is borrowed. This practice is a form of financial leverage that a company exercises. There is an increase in earnings per share when this process is adopted.

Trading on equity is profitable only when the return on investment is greater than the amount of funds borrowed. It is said that trading on equity shall be avoided if the return on investment is less than the rate of interest from the funds that are borrowed.

Q6. 'S' Limited manufactures steel at its plant in India. It is enjoying a buoyant demand for its products as economic growth is about 7%-8%, and the demand for steel is growing. It is planning to set up a new steel plant to cash on the increased demand. It is estimated that it will require about Rs 5000 crores to set up and about Rs 500 crores of working capital to start the new plant.

Questions

1. Describe the role and objectives of financial management for this company.

2. Explain the importance of having a financial plan for this company. Give an imaginary plan to support your answer.

3. What are the factors which will affect the capital structure of this company?

4. Keeping in mind that it is a highly capital-intensive sector, what factors will affect the fixed and working capital? Give reasons in support of your answer.

1. Role of financial management in this company is as follows:

1. Financial management will help in taking decisions to purchase fixed assets which will increase the composition of fixed assets.

2. The composition of funds that are used by a company refers to the mix of short and long-term funds that are used by the company. Fund composition is determined by the company's decision which is regarding profitability and liquidity. It can be said that if a company is looking to attain higher liquidity, it would be looking to opt for long-term financing and companies looking for short-term liquidity will opt for short-term financing.

3. The proportion of debt and equity that should be used in long-term financing or, in other words, the distribution of funds that are raised with a mix of debt and equity, which is taken by financial management.

4. The amount of current assets that a company holds is dependent on the financial decision of the company. A higher amount will lead to more working capital but a decrease in profits and vice versa.

In this case, the basic objective of financial management will be towards increasing or maximising shareholders' wealth. Decisions that will be beneficial for the shareholders, i.e., help in increasing their market value of shares. This can be achieved if financial management takes a decision that results in an increase in the value of shares where benefits obtained from making this decision exceed the cost of taking the financial decision.

2. These points highlight the importance of financial planning for the company:

i. It enables the company to forecast future requirements.

ii. Financial plan will be helpful in avoiding any kind of shortage that may occur or surplus that can also occur. It ensures that funds are used optimally.

iii. It helps in better coordination between the sales and production teams.

iv. It helps in avoiding any type of waste such as time, money and effort.

v. If the targets and policies are well defined, then financial planning helps in evaluating the performance in a good way.

Proposed Financial Plan

The company can use the 50% through the issue of shares, and the other 50% can be collected using funds that are borrowed from outside in the form of debts.

3. Following factors will affect the capital structure choice:

i. Company should be opting for debt capital in case of strong cash flow is present. Debt requires payment of principal as well as interest that is applicable to the principal.

ii. Debt service coverage ratio determines the obligations towards cash payment of a company as against the cash availability. Having a high DSCR can make the company opt for debt as a source of funds.

iii. Equity cost can be directly related to the financial risk that a company faces. A company having a higher financial risk will see the expectations of shareholders rise, which raises the cost of equity. The rising cost of equity makes it difficult to opt for equity.

iv. Good stock market conditions are very much conducive to for opting equity capital, whereas poor stock market conditions are difficult for opting for equity capital.

v. Higher interest coverage ratio, which is a measure of the times EBIT is able to meet interest rate obligations. A higher interest coverage ratio translates to lower risk for the company, which enables a company to opt for a high portion of debt in the composition of its capital structure.

vi. A high rate of floatation cost leads to a reduction of the component in capital structure. A high floatation cost of equity results in a low capital structure.

vii. Higher rate of interest applicable on debt leads to higher debt cost, which makes it difficult to choose debt as capital structure.

4. Factors affecting fixed capital requirements are as follows:

i. Fixed capital can be determined by the type of business. As the company mentioned here (S Limited) is a company which is into manufacturing, it will have a large operating cycle which therefore results in a need for a large amount of fixed capital.

ii. The scale of operations of a company also determines the need for investment in assets such as machinery, land, plants and buildings, which requires a large sum of fixed capital.

iii. A growing company or a company which is seeking expansion will need more amount of fixed capital which is the case with S Limited.

Factors affecting working capital requirements will be as follows:

i. The working capital requirements for a company will vary on the type of business it is conducting. As it is a manufacturing firm will, it will have a large operating cycle as goods need to be transformed from raw materials to finished goods. Therefore, the requirement for working capital will be more for this firm.

ii. As this company is conducting large-scale operations, there will be requirements for a large amount of working capital.

iii. The company is looking to expand its business which requires more working capital as it will lead to higher growth prospects.

iv. As the product that is being manufactured by this company is in high demand, the company would need to produce more to meet the requirements. Therefore, there will be a need for a large amount of working capital.