VIDYA BHAWAN BALIKA VIDYA PITH

शक्ति उत्थान आश्रम लखीसराय बिहार

Class 12 commerce Sub. BST. Date 03.07.2021

Teacher name – Ajay Kumar Sharma

Financial Management

Question 6:

What are the main objectives of financial management? Briefly explain

ANSWER:

The paramount objective of the financial management is maximising the shareholders' wealth. That is, the basic objective of financial management for a company is to opt for those financial decisions that prove gainful from the point of view of the shareholders. The share holders are said to gain when the market value of their shares rise. The market value of shares increase when the benefits from a financial decision exceed the cost involved in taking them. In other words, a financial decision raises the market value of share if it results in some value addition. Thus, financial decisions should be taken such that some value addition takes place and ultimately the price of the equity share increases. When a financial decision is able to fulfil the primary objective of wealth maximisation, other objectives such as proper utilisation of funds, maintenance of liquidity etc. are automatically fulfilled.

Question 7:

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

ANSWER:

Working capital of a business refers to the excess of current assets (such as cash in hand, debtors, stock, etc.) over current liabilities. Working capital affects both the liquidity as well as profitability of a business. As the amount of working capital increases, the liquidity of the business increases. However, since current assets offer low return, with the increase in working capital the profitability of the business falls. For example, an increase in the inventory of the business increases its liquidity but since the stock is kept idle, the profitability falls. On the other hand, low working capital, hinders the day to day operations of the business. Thus, the working capital should be such that a balance is maintained between the profitability and liquidity.

Question 8

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

ANSWER:

Every business needs to take the decision regarding the investment in current assets i.e. the working capital. Current assets refer to the assets that are converted into cash or cash equivalents in a short period of time (less than or equal to one year). There are two broad concepts of working capital namely, Gross working capital and Net working capital.

Gross working capital (or, simply working capital) refers to the investment done in the current assets. Net working capital, on the other hand, refers to the amount of current assets that is in excess of current liabilities. Herein, current liabilities are those obligatory payments which are due for payment such as bills payable, outstanding expenses, creditors, etc. Net Working Capital is calculated as the difference of current assets over current liabilities. i.e.

NWC = Current Assets − Current Liabilities

The following are five determinants of working capital requirement.

i) ***Type of Business***: Working capital requirement of a firm depends on its nature of business. An organisation that deals in services or trading will not require much of working capital. This is because such organisations involve small operating cycle and there is no processing done. Herein, the raw materials are the same as the outputs and the sales transaction takes place immediately. In contrast to this, a manufacturing firm involves large operating cycle and the raw materials need to be converted into finished goods before the final sale transaction takes place. Thereby, such firms require large working capital.

ii) ***Scale of Operations***: Another factor determining the working capital requirement is the scale of operations in which the firm deals. If a firm operates on a big scale, the requirement of the working capital increases. This is because such firms would need to maintain high stock of inventory and debtors. In contrast to this, if the scale of operation is small, the requirement of the working capital will be less.

iii) ***Fluctuations in Business Cycle***: Different phases of business cycle alter the working capital requirements by a firm. During boom period, the market flourishes and thereby, there is higher sale, higher production, higher stock and debtors. Thus, during this period the need for working capital increases. As against this, in a period of depression there is low demand, lesser production and sale, etc. Thus, the working capital requirement reduces.

iv) ***Production Cycle***: The time period between the conversion of raw materials into finished goods is referred as production cycle. The span of production cycle is different for different firms depending on which the requirement of working capital is determined. If a firm has a longer span of production cycle, i.e. if there is a long time gap between the receipt of raw materials and their conversion into final finished goods, then there will be a high requirement of working capital due to inventories and related expenses. On the other hand, if the production cycle is short then requirement of working capital will be low.

v) ***Growth Prospects***: Higher growth and expansion is related to higher production, more sales, more inputs, etc. Thus, companies with higher growth prospects require higher amount of working capital and vice versa.

Question 9

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

ANSWER:

Capital Structure refers to the combination of different financial sources used by a company for raising funds. The sources of raising funds can be classified on the basis of ownership into two categories as borrowed funds and owners' fund. Borrowed funds are in the form of loans, debentures, borrowings from banks, public deposits, etc. On the other hand, owners' funds are in the form of reserves, preference share capital, equity share capital, retained earnings, etc. Thus, capital structure refers to the combination of borrowed funds and owners' fund. For simplicity, all borrowed funds are referred as debt and all owners' funds are referred as equity. Thus, capital structure refers to the combination of debt and equity to be used by the company. The capital structure used by the company depends on the risks and returns of the various alternative sources.

Both debt and equity involve their respective risk and profitability considerations. While on one hand, debt is a cheaper source of finance but involves greater risk, on the other hand, although equity is comparatively expensive, they are relatively safe.

The cost of debt is less because it involves low risk for lenders as they earn an assured amount of return. Thereby, they require a low rate of return which lowers the costs to the firm. In addition to this, the interest on debt is deductible from the taxable income (i.e. interest that is to be paid to the debt security holders is deducted from the total income before paying the tax). Thus, higher return can be achieved through debt at a lower cost. In contrast, raising funds through equity is expensive as it involves certain floatation cost as well. Also, the dividends are paid to the share holders out of after tax profits.

Though debt is cheaper, higher debt raises the financial risk. This is due to the fact that debt involves obligatory payments to the lenders. Any default in payment of the interest can lead to the liquidation of the firm. As against this, there is no such compulsion in case of dividend payment to shareholders. Thus, high debt is related to high risk.

Another factor that affects the choice of capital structure is the return offered by various sources. The return offered by each source determines the value of earning per share. A high use of debt increases the earning per share of a company (this situation is called Trading on Equity). This is because as debt increases the difference between Return on Investment and the cost of debt increases and so does the EPS. Thus, there is a high return on debt. However, even though higher debt leads to higher returns but it also increases the risk to the company.

Therefore, the decision regarding the capital structure should be taken very carefully, taking into consideration the return and risk involved.

Question 10

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

ANSWER:

Yes, capital budgeting decision is a very essential decision which needs to be taken carefully. It has the capability of changing the financial fortunes of a business. Capital budgeting decision refers to the decisions regarding the allocation of fixed capital to different projects. Such decisions involve investment decisions regarding attainment of new assets, expansion, modernisation and replacement. Such long term investments include purchasing plant and machinery, furniture, land, building, etc. and also expenditure as on launch of a new product, modernisation and advertising, etc. They have long term implications on the business and are irrevocable except at a huge cost. They affect a business' long term growth, profitability and risk.

The following are the factors that highlight the importance of capital budgeting decisions.

i) ***Long Term Implications***: Investment on capital assets (long term assets) yield return in the future. Thereby, they affect the future prospects of a company. A company's long term growth prospects depend on the capital budgeting decisions taken by it.

ii) ***Huge Amount of Funds***: Investing in fixed capital involves a large amount of funds. This makes the capital budgeting decisions all the more important as huge amount of funds remain blocked for a longer period of time. These decisions once made are difficult to change. Thus, capital budgeting decisions need to be taken carefully after a detailed study of the total requirement of funds and the sources from which they are to be raised.

iii) ***High Risk***: Fixed assets involve huge amount of money and thereby, involve huge risk as well. Such decisions are risky as they have an impact on the long term existence of the company. For example, decision about the purchase of new machinery involves a risk in terms of whether the return from the machinery would be greater than the cost incurred on it.

iv) ***Irreversible Decisions***: These decisions once made are irrevocable. Reversing a capital budgeting decision involves huge cost. This is because once huge investment is made on a project, withdrawing it would mean huge losses.