Unit 9

Part A

1. What is Business Finance?

Money required for carrying out business activities is called business finance.

2. State the primary objective/aim of financial management.

Financial Management aims at reducing the cost of funds procured, keeping the risk under control and achieving effective deployment of such funds.

3. What do you understand by 'Capital Structure'?

One of the important decisions under financial management relates to the financing pattern or the proportion of the use of different sources in raising funds.

4. Write the meaning of 'Financial Risk'.

Financial risk is the chance that a firm would fail to meet its payment obligations.

5. Give an example for fixed asset.

Building

6. Give an example for current asset.

Cash

7. How do you calculate Net Working Capital?

NWC = CA – CL i.e. Current Assets - Current Liabilities.

8. The cheapest source of finance is (a) Debenture (b) Equity share capital (c) Preference share **(d) Retained earnings**
9. The decision of acquiring a new machine or opening a new branch is an example for (a) Financing decision (b) Working capital decision **(c) Investment decision** (d) None of the above
10. The decision of how much to be raised from which source is an example for **(a) Financing decision** (b) Working capital decision (c) Investment decision (d) None of the above
11. Companies with higher growth pattern are likely (a) to pay lower dividends **(b) to pay higher dividends** (c) that dividends are not affected by growth issues (d) none of the above
12. Current assets are those assets which get converted into cash (a) within six months **(b) within one year** (c) between 1 and 3 years (d) between 3 and 5 years
13. A fixed asset should be financed through **(a) a long term liability** (b) a short term liability (c) a mix of ling and short term liabilities (d) None of the above

Part B

14. What do understand by Financial Management?

Financial Management is concerned with optimal procurement as well as usage of finance. For optimal procurement, different available sources of finance are identified and compared in terms of their costs and associated risks.

15. Give the meaning Investment Decision with an example.

A firm's resources are scarce in comparison to the uses to which they can be put. A firm, therefore, has to choose where to invest these resources, so that they are able to earn the highest possible return for their investors. The investment decision, therefore, relates to how the firm's funds are invested in different assets.

For example, making investment in a new machine to replace an existing one or acquiring a new fixed asset or opening a new branch etc.

16. What is Financing Decision? Give an example.

This decision is about the quantum of finance to be raised from various long-term sources (short-term sources are studied in working capital management).

Example: A firm may want to choose either raising money through debt or equity to finance a project.

17. Give the meaning of Dividend Decision.

The third important decision that every financial manager has to take relates to the distribution of dividend. Dividend is that portion of profit which is distributed to shareholders.

18. State the twin objectives of Financial Planning.

(a) To ensure availability of funds whenever these are required
(b) To see that the firm does not raise resources unnecessarily

19. What is Financial Leverage? Write the formula to calculate Financial Leverage.

The proportion of debt in the overall capital is also called financial leverage. Financial leverage is computed as D/E when D is the Debt and E is the Equity.

20. Give the meaning of 'Trading on Equity'.

Trading on Equity refers to the increase in profit earned by the equity shareholders due to the presence of fixed financial charges like interest.

21. Write the formula to calculate Debt Service Coverage Ratio.

Debt Service Coverage Ratio takes care of the deficiencies referred to in the Interest Coverage Ratio (ICR). It is calculated as follows: A higher DSCR indicates better ability to meet cash commitments and consequently, the company's potential to increase debt component in its capital structure.

Part C

22. Explain any four factors affecting financing decisions
    a) Cash Flow Position of the Company: A stronger cash flow position may make debt financing more viable than funding through equity.
    b) Fixed Operating Costs: If a business has high fixed operating costs (e.g., building rent, Insurance premium, Salaries, etc.), It must reduce fixed financing costs. Hence, lower debt financing is better. Similarly, if fixed operating cost is less, more of debt financing may be preferred.
    c) Control Considerations: Issues of more equity may lead to dilution of management's control over the business. Debt financing has no such implication. Companies afraid of a takeover bid would prefer debt to equity.
    d) State of Capital Market: Health of the capital market may also affect the choice of source of fund. During the period when stock market is rising, more people invest in equity. However, depressed capital market may make issue of equity shares difficult for any company

23. Explain any four factors affecting dividend decisions.
    a. Amount of Earnings: Dividends are paid out of current and past earning. Therefore, earnings are a major determinant of the decision about dividend.
    b. Stability Earnings: Other things remaining the same, a company having stable earning is in a better position to declare higher dividends. As against this, a company having unstable earnings is likely to pay smaller dividend.
    c. Stability of Dividends: Companies generally follow a policy of stabilising dividend per share. The increase in dividends is generally made when there is confidence that their earning potential has gone up and not just the earnings of the current year. In other words, dividend per share is not altered if the change in earnings is small or seen to be temporary in nature.
    d. Growth Opportunities: Companies having good growth opportunities retain more money out of their earnings to finance the required investment. The dividend in growth companies is, therefore, smaller, than that in the non– growth companies.

24. What is Capital Budgeting decision? Explain briefly the factors affecting capital budgeting decisions.

A long-term investment decision is also called a Capital Budgeting decision. It involves committing the finance on a long-term basis. For example, making investment in a new machine to replace an existing one or acquiring a new fixed asset or opening a new branch, etc

a) Cash flows of the project: When a company takes an investment, decision involving huge amount it expects to generate some cash flows over a period. These cash flows are in the form of a series of cash receipts and payments over the life of an investment. The amount of these cash flows should be carefully analysed before considering a capital budgeting decision.

b) The rate of return: The most important criterion is the rate of return of the project. These calculations are based on the expected returns from each proposal and the assessment of the risk involved. Suppose, there are two projects, A and B (with the same risk involved), with a rate of return of 10 per cent and 12 per cent, respectively, then under normal circumstance, project B should be selected.

c) The investment criteria involved: The decision to invest in a project involves several calculations regarding the amount of investment, interest rate, cash flows and rate of return. There are different techniques to evaluate investment proposals which are known as capital budgeting techniques. These techniques are applied to each proposal before selecting a project.

25. Explain with any four points the importance of financial planning.

   a. It helps in forecasting 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. For example, a growth of 20% in sales is predicted. However, it may happen that the growth rate eventually turns out to be 10% or 30%.
   b. It helps in avoiding business shocks and surprises and helps the company in preparing for the future
   c. If helps in co-ordinating various business functions, e.g., sales and production functions, by providing clear policies and procedures.
   d. Detailed plans of action prepared under financial planning reduce waste, duplication of efforts, and gaps in planning.

26. Explain any four factors affecting the fixed capital requirement of an organisation.

   a. Nature of Business: The type of business has a bearing upon the fixed capital requirements. For example, a trading concern needs lower investment in fixed assets compared with a manufacturing organisation; since it does not require to purchase plant and machinery, etc.
   b. Scale of Operations: A larger organisation operating at a higher scale needs bigger plant, more space etc. and therefore, requires higher investment in fixed assets when compared with the small organisation.
   c. Choice of Technique: Some organisations are capital intensive whereas others are labour intensive. A capital-intensive organisation requires higher investment in plant and machinery as it relies less on manual labour. The requirement of fixed capital for such organisations would be higher. Labour intensive organisations on the other hand require less investment in fixed assets.
   d. Technology Upgradation: In certain industries, assets become obsolete sooner. Consequently, their replacements become due faster. Higher investment in fixed assets may, therefore, be required in such cases.

For example, computers become obsolete faster and are replaced much sooner than say, furniture.

27. Explain any four factors affecting the working capital requirement of an organisation.
    a. Nature of Business: The basic nature of a business influences the amount of working capital required. A trading organisation usually needs a smaller amount of working capital compared to a manufacturing organisation. This is because there is usually no processing. Therefore, there is no distinction between raw materials and finished goods.
    b. Scale of Operations: For organisations which operate on a higher scale of operation, the 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.
    c. 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 depression as the sales as well as production will be small.
    d. Seasonal Factors: Most business have some seasonality in their operations. In peak season, because of higher level of activity, larger amount of working capital is required. As against this, the level of activity as well as the requirement for working capital will be lower during the lean season.