INDIAN SCHOOL AL WADI AL KABIR

Class: XII Business Studies	**Department: Commerce**
Worksheet No: 1	**Topic: Financial Management**

A. Fill in the blanks

1. Money required for carrying out business activities is called ______________ . (Business finance)

2. _________ is concerned with optimal procurement as well as usage of finance. (Financial Management)

3. Primary aim of financial management is to maximize shareholder's wealth, which is referred to as the _________________________ (wealth maximization concept).

4.___________________ decision can be long-term or short-term. (Investment)

5.____________ decision involves how much of the profit earned by company (after paying tax) is to be distributed to the shareholders and how much of it should be retained in the business for meeting the investment requirements. (dividend)

6.________________ aims at smooth operations by focusing on fund requirements and their availability in the light of financial decisions. (Financial planning)

7.______________ refers to the mix between owners and borrowed funds. (Capital structure)

8. The proportion of debt in the overall capital is also called _______________ (financial leverage)

9. Financial leverage is said to be ___________ when the return on investment becomes higher than cost of debt. (favourable)

10. More debt can be used if debt can be raised at a ___________rate. (lower)

True or False

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

12. working capital tries to link the present with the future and a link between investment and financing decisions on a continuous basis. **False** (Financial Planning)

13. Cost of debt is higher than cost of equity for a firm **False** (lower)

interest paid on debt is not a deductible expense for computation of tax liability False (debt is a deductible expense)

14. As the financial leverage increases, the cost of funds declines- **True**

15.The interest coverage ratio refers to the number of times earnings before interest and taxes of a company covers the interest obligation-**True**

Choose the correct answer

16. A public issue of equity may reduce the managements holding in the company and make it vulnerable to takeover. Identify the factors that affecting choice of capital structure

a) Flexibility
b) Control
c) Tax rate
d) Cost of equity

17. It aims at choosing the best investment and financing alternatives by focusing on their costs and benefits.

a) Financial Planning
b) Working capital
c) Financial management
d) Fixed capital

18. Short term investment decisions are concerned with the decisions about the levels of cash, inventories and debtors. It is also known as _______________.

a) Capital budgeting decisions
b) working capital decisions
c) capital structure
d) Financing decision

19. It refers to the increase in profit earned by the equity shareholders due to the presence of fixed financial charges like interest.

a) Trading on equity
b) Financial leverage
c) Earnings per share
d) Capital structure

20. This decision is about the quantum of finance to be raised from various long-term sources.

a) Financial decision
b) Capital budgeting decision
c) Dividend decision
d) Financing Decision

21. **Identify the type of decisions:**

1. Ranveer wants to open a restaurant and he is also taking into consideration, the amount of funds which will be required to set up the business-like like food making and storing machineries.
2. Bilal is running a glass manufacturing company. He thinks of expanding his business. He meets his uncle and asks him for a sum of Rs. 2 crores. His uncle asks for a high interest rate. He agrees to it and promises to pay the money back within 2 years.
3. A leading marketing company has decided to raise money through the stock market. It issued IPO in the market last year. The company knows there are going to be sizeable floatation costs involved in it.
4. A company which has 10 branches in the city has decided to open its 11th branch. The company has taken this branch on rent. In this way the company has saved money which it would otherwise have invested in purchasing it.
5. A company has decided to plough back the money in the form of retained earnings. This decision will save the company at least ‘50 crores. These funds can be used for the long-term growth of the business.
6. ‘Brandon Iron Works’ has been doing a great job in the area of manufacturing iron. Within two years the company has reached among the top 3 performers of the industry. The company has made a lot of profit and decided to distribute its profits to the shareholders who stood with it during the hard times.

7. Bharat Steel Ltd., an Indian company producing 50 million tonnes of steel annually and generating revenue of 38 billion US dollars has recently acquired the 5 second largest steel producing company, 'German Steels.' After this acquisition Bharat Steels Ltd. will become the World's largest steel producer. For this acquisition Bharat Steels Ltd. had to arrange about 50,000 crores of rupees through debt and equity.
8. A company has decided to issue debentures as it knows that it will not lead to any additional costs. These debentures will be carrying a very low rate of return for the debenture holders but will be a surety for them to get their money back. Investors who want financial safety would like to go for this option as there will be an assured definite return.
9. Ventec Steel Manufacturers is a well reputed company but due to some HR related issues it came into limelight for bad reasons. The issue was related with non-payment of salaries of the employees but now the company wants to sort this issue out. The company has decided to pay the salary of all the employees for the last six months. The company has done so to avoid any image spoiling to take place.
10. A soft drink company has decided to run an advertisement campaign. It will hire many famous Bollywood celebrities for this purpose. The advertisement campaign could involve more than '150 crores. Every major newspaper is mentioning about it.
11. Bhaskar and Sons has decided to open a new branch in the middle of the city in order to increase its business.

Answer:

1. Investment decision
2. Financing decision
3. Financing decision
4. Investment decision (short-term investment decision/working capital)
5. Dividend decision (As out of the EPS one portion will be dividend and the other retained earnings. This is decided by dividend decision).
6. Dividend decision
7. Financing decision
8. Financing decision
9. Investment decision (Working capital or short-term investment decision)
10. Investment decision (Long-term investment decision. Remember running an ad campaign is not a short-term investment decision. It is a long-term investment decision)
11. Investment decision (Long-term investment decision)

22.Ramit is using ICR (Interest Coverage Ratio) as the indicator of the interest paying capacity of his company. However, one of his old school days' friends Shobhit tells him to use DSCR (Debt Service Coverage Ratio) as the indicator to judge it.
Do you agree with his friend?
Give reason for your answer.
Answer:
Yes, I agree with him.
As it is a better indicator of company's ability to pay fixed financial charges like interest because it completes the shortcoming in ICR. ICR is unable to show the situation of cash balance whereas in DSCR cash profits generated by the operations are compared with the total cash required for the service of the debt.
ICR is the simple ratio of EBIT/Interest.

23.**Identify in the following cases factor affecting the choice of capital structure**

1. Rajan has an option of taking loan from his relatives. These people have assured him to give loan at a low interest rate. So, he decides to use debt as a source of financing his project. Now he goes to different relatives and friends to see if he can get a cheaper source of debt with even lower rate of interest.
2. Prerak Iron Ltd. is thinking of raising finance to further its projects overseas. For this the company is observing the other companies' raising of finance. Their debt-equity ratios are being thoroughly studied by the financial experts of the company.
3. A company is trying to raise funds after consulting the experts. The owner of the company has decided to find out the banks which can grant loan under norms. He will assure that all norms are followed by the company. He has also decided to gain knowledge about the SEBI guidelines related to public issues of shares and debentures.
4. The management of a company is very much concerned about the latest happenings in the stock market. They always want to know whether the conditions in the stock market are bullish or bearish so that they may know the feasible time to grow money by issue of shares.
5. A firm has decided not to issue equity this year. The reason they have given is the involvement of costs like printing charges, brokerage, advertising costs and underwriter's commission. The company says all these costs will add on to become substantial.
6. A company already has high fixed operation costs. If it takes loan its fixed financial costs will increase leading to an overall increase in payments. Had the situation been opposite it would have considered taking loan but now the only option is to go for equity.
7. A company is thinking of taking debt to meet its finance requirements. It is thinking so because interest is a tax-deductible expense. Due to the new budget by the government raising debt has become comparatively cheaper and equity is losing its attractiveness.
8. Mr. Madan Sharma has a company having 10 branches throughout the country. He is thinking of opening a new branch. For this he requires a good amount of investment. He talks to his friends, banks and other sources to raise debt as a source of finance. However, he prevents himself from using all possible sources of finance so that he can maintain his borrowing power.
9. A leading company decides to raise fund. It decides to go for debt as the source of finance. The reason behind this choice is the possibility of losing management's holding in the company if equity is issued. The company already has been using equity as a source of finance during last couple of years.
10. A company is no more interested in raising funds in the form of debt. The amount of EBIT that the company has is decreasing in relation to the amount of interest it has to pay on the debt it has borrowed. If it borrows more of debt than this ratio EBIT/ Interest will further go down.
11. Neelam has decided to consider debt as the source of raising finance. Her decision has come after considering the strong buffer of funds she already has. She has enough amount of funds to cover fixed cash payments. Her business unit has no problem in running normal business operation and it has low business risk. Further the financial risk is also low.
12. A company has decided to go for trading on equity as an option. This is being done to increase the Earning per Share (EPS). Definitely the ability of the company to use debt is greater.

Answer:

1. Cost of debt
2. Capital structure of other companies
3. Regulatory framework
4. Stock market conditions
5. Floatation costs

6. Risk consideration
7. Tax rate (As with the new budget the tax rate has increased)
8. Flexibility
9. Control
10. Interest Coverage Ratio (ICR)
11. Cash flow position
12. Return on Investment (RoI)

24.Future Business' is in whole sale business. The manager in charge is taking care of all the operations. The branch in Delhi is earning a lot of revenue these days. It requires fixed capital investment for which it has to borrow money.
What do you think is going to be the size of the investment required?
Answer:
The size of investment required will be low as the 'Future Business' is in trading business. The fixed capital requirement generally is low in trading business.

25.Atul is thinking of opening a scissors manufacturing plant. He requires capital investment. He discusses the project with his father. His father after listening to his project tries to find out the fixed capital requirement for his plant.
What do you think will be the fixed capital requirement for the scissors manufacturing plant of Atul?
Answer:
The fixed capital requirement for the plant of AtuI will be high as it is a manufacturing plant. For a manufacturing plant the fixed capital requirement is high since the purchase of plant and machinery, equipment's, etc. is involved.

26.Ravi has started a pizza base manufacturing business. The early morning schedule is very busy as the product is dispatched as soon as it is made to keep it fresh and is sent to the various pizza making restaurants or hotels. Daily fresh pizza base has to be delivered on the basis of estimated orders as there is no sure shot consumption pattern in the city.
What do you think is going to be the working capital requirement of this business? Why?
Answer:
The working capital requirement of this business will be low.
The reason for this low requirement is that the production cycle for Pizza base is short and as the production is made on estimated order no inventory is required which will further prevent inventory costs.

27.Radhika and Vani who are young fashion designers left their job with a famous fashion designer chain to set-up a company 'Fashionate Pvt. Ltd.' They decided to run a boutique during the day and coaching classes for entrance examination of National Institute of Fashion Designing in the evening. For the coaching centre they hired the first floor of a nearby building. Their major expense was money spent on photocopying of notes for their students. They thought of buying a photocopier knowing fully that their scale of operations was not sufficient to make full use of the photocopier.
In the basement of the building of 'Fashionate Pvt. Ltd.' Praveen and Ramesh were carrying on a printing and stationery business in the name of 'Neo Prints Pvt. Ltd.' Radhika approached Praveen with the proposal to buy a photocopier jointly which could be used by both of them without making separate investment, Praveen agreed to this.
Identify the factor affecting fixed capital requirements of 'Fashionate Pvt. Ltd.'
Answer:

Level of Collaboration.

28.Rizul Bhattacharya after leaving his job wanted to start a Private Limited Company with his son. His son was keen that the company may start manufacturing of mobile-phones with some unique features. Rizul Bhattacharya 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 Bhattacharya to choose furniture business over mobile phones
Answer:
Technology Upgradation.

29.Ramesh is running a real estate construction company. He has to meet clients on a regular basis in order to make deals. For every decision he makes he has to be really cautious as he knows once he has made a decision he can't go back which will mean abandoning of the project. So he evaluates every decision before he makes it. That is why he pays a lot of attention to what his clients are saying and figures out which portion of the deal is in his capacity and favour. Recently his company pumped an amount of Rs.50 crores in a project and he knows this project can affect the returns of the firms in the long run both positively as well as negatively. All this is a part of the business in which he has established himself. He knows that the funds invested are only likely to give returns in the future and impact the future prospects of his business. The chances of success in any business are more when one does a lot of research. He has to involve a considerable portion of his funds and block them in long term projects. A thorough research is required in order to grow funds at the lowest cost possible. He is a very stable minded entrepreneur.

1. Which concept of management has been highlighted in the above case?
2. Identify its types highlighted in the above case.

Answer:

1. The concept of management highlighted in the above case is 'Importance of fixed capital investment'.
2. The reasons for the importance of fixed capital decisions highlighted in the above case are:
    - Irreversible decisions. For every decision he makes he has to be really cautious as he knows once he has made a decision he can't go back which will mean abandoning of the project.
    - Risk involved. Recently his company pumped an amount of Rs.50 crores in a project and he knows this project can affect the returns of the firms in the long run both positively as well as negatively.
    - Long-term growth. He knows that the funds invested are only likely to give returns in the future and impact the future prospects of his business.
    - Large amount of funds involved. He has to involve a considerable portion of his funds and block them in long term projects.

30.Bharat Steel Ltd., an Indian company producing 50 million tonnes of steel annually and generating revenue of 38 billion US dollars has recently acquired the 5 second largest steel producing company, 'German Steels.' After this acquisition Bharat Steels Ltd. will become the World's largest steel producer. For this acquisition Bharat Steels Ltd. had to arrange about 50,000

crores of rupees through debt and equity. State the function performed by the company for arranging the funds through debt and equity.
Answer:
Financing function or Financing decision. It refers to the decision about quantum of finance to be raised from various long-term sources.

31.Arun is a successful businessman in the paper industry. During his recent visit to his friend's place in Mysore, he was fascinated by the exclusive variety of incense sticks available there. His friend tells him that Mysore region is known as a pioneer in the activity of Agarbathi manufacturing because it has a natural reserve of forest products especially Sandalwood to provide for the base material used in production. Moreover, the suppliers of other types of raw material needed for production follow a liberal credit policy and the time required to manufacture incense sticks is relatively less. Considering the various factors, Arun decides to venture into this line of business by setting up a manufacturing unit in Mysore.
In context of the above case:

1. Identify and explain the type of financial decision taken by Arun.
2. Identify the three factors mentioned in the paragraph which are likely to affect the working capital requirements of his business.

Answer:

1. Investment decision has been taken by Arun. Investment decision seeks to determine as to how the firm's funds are invested in different assets. It helps to evaluate new investment proposals and select the best option on the basis of associated risk and return. Investment decision can be long term or short-term. A long-term investment decision is also called a Capital Budgeting decision
2. The three factors mentioned in the paragraph which are likely to reduce the working capital requirements of his business are as follows: .
   - **Availability of raw material:** As there is easy availability of Sandalwood which is used as the base material for production, the working capital requirements of his business will be less as there is no need to stock the raw materials.
   - **Production cycle:** The production cycle is shorter and less time is required to manufacture incense sticks. Thus, the working capital requirements of his business will be low.
   - **Credit availed:** Due to the fact that the suppliers of other types of raw material needed for production follow a liberal credit policy, the business can be operated on minimum working capital.

32.Bhuvan inherited a very large area of agricultural land in Haryana after the death of his grandfather. He plans to sell this piece of land and use the money to set up a small-scale paper factory to manufacture all kinds of stationary items from recycled paper. Being an amateur in business, he decides to consult his friend Subhash who works in a financial consultancy firm. Subhash helps him to prepare a blue print of his future business operations on the basis of sales forecast in next five years. Based on these estimates, he helps Bhuvan to assess the fixed and working capital requirements of business.
In context of the above case:

1. Identify the type of financial service that Subhash has offered to Bhuvan.

2. Briefly state any four points highlighting the importance of the type of financial service identified in part (1).

Answer:

1. Financial planning is the type of financial service that Subhash has offered to Bhuvan.
2. The four points highlighting the importance of financial planning are as follows:
    - It ensures smooth running of a business enterprise by ensuring availability of funds at the right time.
    - It helps in anticipating future requirements of a funds and evading business shocks and surprises.
    - It facilitates co-ordination among various departments of an enterprise like marketing and production functions, through well-defined policies and procedures.
    - It increases the efficiency of operations by curbing wastage of funds, duplication of efforts, and gaps in planning.

33.Visions Ltd. is a renowned multiplex operator in India. Presently, it owns 234 screens in 45 properties at 20 locations in the country. Considering the fact that the there is a growing trend among the people to spend more of their disposable income on entertainment, two years back the company had decided to add more screens to its existing set up and increase facilities to enhance leisure, food chains etc. It had then floated an initial public offer of equity shares in order to raise the desired capital. The issue was fully subscribed and paid. Over the years, the sales and profits of the company have increased tremendously and it has been declaring higher dividend and the market price of its shares has increased manifolds.
In context of the above case:

1. Name the different kinds of financial decisions taken by the company by quoting lines from the paragraph.
2. Do you think the financial management team of the company has been able to achieve its prime objective? Why or why not? Give a reason in support of your answer.

Answer:

1. The different kinds of financial decisions taken by the company are as follows:
    - **Investment decision:** “Two years back the company had decided to add more screens to its existing set up and increase facilities to enhance leisure, food chains etc.”
    - **Financing decision:** “It had then floated an initial public offer of equity shares in order to raise the desired capital.”
    - **Dividend decision:** “Over the years, the sales and profits of the company have increased tremendously and it has been declaring higher dividend.”
2. Yes, the financial management team of the company has been able to achieve its prime objective i.e. wealth maximisation of the shareholders by maximising the market price of the shares of the company.

34. Booms Ltd. is a company engaged in production of organic foods. Presently, it sells its products through indirect channels of distribution. But, considering the sudden surge in the demand for organic products, the company is now inclined to start its online portal for direct marketing. The financial managers of the company are planning to use debt in order to take advantage of trading on equity. In order to finance its expansion plans, it is planning to ‘ raise a debt capital of Rs. 40

lakhs through a loan @ 10% from an industrial bank. The present capital base of the company comprises of Rs. 9 lakh equity shares of Rs. 10 each. The rate of tax is 30%.

In the context of the above case:

1. What are the two conditions necessary for taking advantage of trading on equity?

2. Assuming the expected rate of return on investment to be same as it was for the current year i.e. 15% , do you think the financial managers will be able to meet their goal. Show your workings clearly.

Sources	**Situation 1 Amount (in Rs.)**	**Situation 2 Amount (in Rs.)**
Equity shares	90,00,000	90,00,000
10 % Debentures	NIL	40,00,000
Total Capital	90,00,000	1,30,00,000
EBIT	13,50,000	19,50,000
Less: Interest	—	– (4,00,000)
EBT	13,50,000	15,50,000
Less: Tax @ 30%	– (4,05,000)	– (4,65,000)
EAT	9,45,000	10,85,000
No. of shares of Rs. 10 each	9,00,000	9,00,000
EPS	9,45,000/9,00,000 = 1.05	10,85,000/9,00,000 = 1.21

Yes, the financial managers will be able to meet their goal as the projected EPS, with the issue of debt, is higher than the present EPS.