

Chapter 9 · Financial Management

CBSE Class 12 Business Studies (054) · Part B · Unit 9+10 = 15 marks · Ultimate Revision Sheet

60-SECOND RECALL

Definition	Planning, organising, directing and controlling the financial activities such as procurement and utilisation of funds.
Primary objective	WEALTH MAXIMISATION — maximising the market value of the equity share (not profit maximisation).
3 Financial decisions	Investment (where to invest) · Financing (where to raise from) · Dividend (how much to distribute)
Capital structure	Mix of Debt and Equity . More debt = more risk but possible higher EPS.
Trading on equity	Using debt to increase the EPS of equity shareholders — works only when ROI > cost of debt.
Fixed vs Working capital	Fixed = long-term assets Working = current assets for day-to-day operations

1. Meaning, Role & Objectives

WRITE THIS VERBATIM Financial management is concerned with optimal procurement as well as the usage of finance. It deals with planning, organising, directing and controlling the financial activities of an enterprise.

Role / Importance of Financial Management

Financial management affects almost every item in the financial statements: *the size and composition of fixed assets · the quantum of current assets · the amount of long-term and short-term finance · the break-up of long-term financing into debt and equity · all items in the profit and loss account.*

THE OBJECTIVE — know this exactly The primary objective is **wealth maximisation**, i.e. **maximising the market value of the equity shares** of the company. This is superior to **profit maximisation** because profit maximisation ignores **risk**, ignores the **timing of returns**, and is **vague** (short-term or long-term profit?).

2. The Three Financial Decisions

A. Investment Decision (Capital Budgeting)

Deciding **how the firm's funds are invested in different assets**. Long-term investment decisions are called **capital budgeting decisions**; they are **irreversible** and involve huge amounts, so they affect the earning capacity of the business.

Factors affecting: *Cash flows of the project · Rate of return · Investment criteria involved (the calculation techniques and the required rate of return).*

B. Financing Decision

Deciding **how much to raise from which source** — the mix of owners' funds (equity) and borrowed funds (debt).

Factors affecting: Cost (debt is cheaper) · Risk (debt is riskier — fixed obligation) · Floatation costs · Cash flow position · Fixed operating costs · Control considerations (equity dilutes control) · State of the capital market.

C. Dividend Decision

Deciding how much of the profit to distribute as dividend and how much to retain in the business.

Factors affecting: Amount of earnings · Stability of earnings · Stability of dividends · Growth opportunities (more opportunities → retain more) · Cash flow position · Shareholders' preference · Taxation policy · Stock market reaction · Access to capital market · Legal constraints · Contractual constraints.

3. Financial Planning

DEFINITION Financial planning is the process of estimating the fund requirements of a business and specifying the sources of those funds. Its twin objectives are: (1) to ensure availability of funds whenever required and (2) to see that the firm does not raise resources unnecessarily.

Importance (5)

1. It helps in forecasting what may happen in future under different business situations, so the firm can prepare alternatives in advance.
2. It helps in avoiding business shocks and surprises.
3. It helps in coordinating various business functions such as sales and production.
4. It provides a link between investment and financing decisions on a continuous basis.
5. It makes evaluation easier by spelling out detailed objectives for different departments.

4. Capital Structure

DEFINITION Capital structure is the mix of borrowed funds (debt) and owners' funds (equity) used to finance a business. It is computed as $\text{Debt} / \text{Equity}$ or $\text{Debt} / (\text{Debt} + \text{Equity})$.

TRADING ON EQUITY — the single most examined concept in this chapter.

Trading on equity means using debt in the capital structure to increase the Earnings Per Share (EPS) of equity shareholders. It works only when the Return on Investment (ROI) is HIGHER than the cost of debt, because debt is cheaper (interest is tax deductible) and its cost is fixed. If ROI falls below the cost of debt, EPS falls — this is the risk of trading on equity.

Factors Affecting Capital Structure

Factor	Effect on the use of DEBT
Cash flow position	Stronger cash flow → more debt can be serviced
Interest Coverage Ratio (ICR)	Higher ICR → more debt (lower risk of default)
Debt Service Coverage Ratio (DSCR)	Higher DSCR → more debt . Better than ICR because it includes repayment of principal
Return on Investment (ROI)	If $\text{ROI} > \text{cost of debt}$ → more debt (trading on equity works)
Cost of debt	Lower cost of debt → more debt

Tax rate	Higher tax rate → more debt (interest is tax deductible, so debt becomes cheaper)
Cost of equity	Too much debt raises risk to equity holders, who then demand a higher return → limits debt
Flootation costs	Cost of raising the funds affects the choice
Risk consideration	Higher business risk → less debt
Flexibility	The firm should keep borrowing capacity in reserve → limits debt
Control	Owners wanting to retain control prefer debt (equity dilutes control)
Regulatory framework	Norms of SEBI / RBI must be followed
Stock market conditions	Bullish market → equity is easier to raise; bearish → debt
Capital structure of other companies	Industry norms act as a guide

5. Fixed Capital

DEFINITION Fixed capital refers to investment in long-term assets — land, building, plant, machinery. These decisions are called **capital budgeting** decisions: they involve huge amounts, are **irreversible** and affect the long-term growth of the business.

Factors affecting the requirement of fixed capital:

1. **Nature of business** — a manufacturing concern needs far more fixed capital than a trading concern.
2. **Scale of operations** — larger scale → more machinery → more fixed capital.
3. **Choice of technique** — a **capital-intensive** firm needs more; a **labour-intensive** firm needs less.
4. **Technology upgradation** — industries where assets become obsolete fast need more fixed capital.
5. **Growth prospects** — higher growth expectation → more fixed capital to build capacity in advance.
6. **Diversification** — a firm entering new product lines needs more fixed capital.
7. **Financing alternatives** — if leasing is available, the requirement of fixed capital is **reduced**.
8. **Level of collaboration** — sharing facilities with other firms reduces the requirement.

6. Working Capital

DEFINITION Working capital refers to the capital required for day-to-day operations — investment in **current assets** such as inventory, debtors and cash. **Net working capital = Current Assets - Current Liabilities.**

Factors affecting the requirement of working capital:

1. **Nature of business** — a trading concern needs **less** (short operating cycle); a manufacturing concern needs **more**.
2. **Scale of operations** — larger scale → more inventory and debtors → more working capital.
3. **Business cycle** — a **boom** needs more working capital; a **depression** needs less.
4. **Seasonal factors** — peak season needs more working capital.
5. **Production cycle** — a longer production cycle blocks funds for longer → more working capital.

6. **Credit allowed** to customers — a liberal credit policy → **more** working capital.
7. **Credit availed** from suppliers — more credit received → **less** working capital.
8. **Operating efficiency** — efficient firms have a faster cycle → **less** working capital.
9. **Availability of raw material** — ready availability → smaller inventory → **less** working capital.
10. **Growth prospects** — higher planned growth → more working capital.
11. **Level of competition** — more competition forces liberal credit and larger stock → **more**.
12. **Inflation** — rising prices → **more** working capital needed for the same quantity.

TRAP Credit **ALLOWED** vs Credit **AVAILED** move in **opposite** directions. Credit **allowed** to customers **increases** working capital needs; credit **availed** from suppliers **decreases** them. Students routinely mix these up.

7. Case-Study Keyword Triggers 40% of the paper is competency-based

If the case says...	The answer is...
"decided to buy a new machine for ₹50 lakh"	Investment decision (capital budgeting)
"decided to raise funds by issuing debentures"	Financing decision
"decided to pay 20% dividend and retain the rest"	Dividend decision
"used more debt because ROI was higher than interest"	Trading on equity
"interest is tax deductible so debt is cheaper"	Tax rate factor (capital structure)
"promoters did not want to lose control"	Control consideration → prefer debt
"company has many growth projects ahead"	Growth opportunities → pay lower dividend
"manufacturing unit vs a trading shop"	Nature of business (fixed / working capital)
"offered customers 90 days credit"	Credit allowed → more working capital
"suppliers gave 60 days credit"	Credit availed → less working capital
"took the machine on lease instead of buying"	Financing alternatives → less fixed capital
"firm is labour-intensive"	Choice of technique → less fixed capital
"woollen garments sell only in winter"	Seasonal factors (working capital)

MOST-ASKED BOARD QUESTIONS

1. [6M] Explain the factors affecting the choice of capital structure.
2. [6M] Explain the factors affecting the requirement of fixed / working capital.
3. [4-6M] Explain the three financial decisions and the factors affecting them.
4. [4M] What is meant by trading on equity? When is it beneficial?
5. [3-4M] Explain the importance / objectives of financial planning.
6. [1M] What is the primary objective of financial management? → **Wealth maximisation**

THE HABIT THAT SCORES — For every capital-structure or working-capital factor, write the **direction** of the effect ("higher tax rate → more debt", "longer production cycle → more working capital"). Naming the factor without the direction is a half-mark answer.