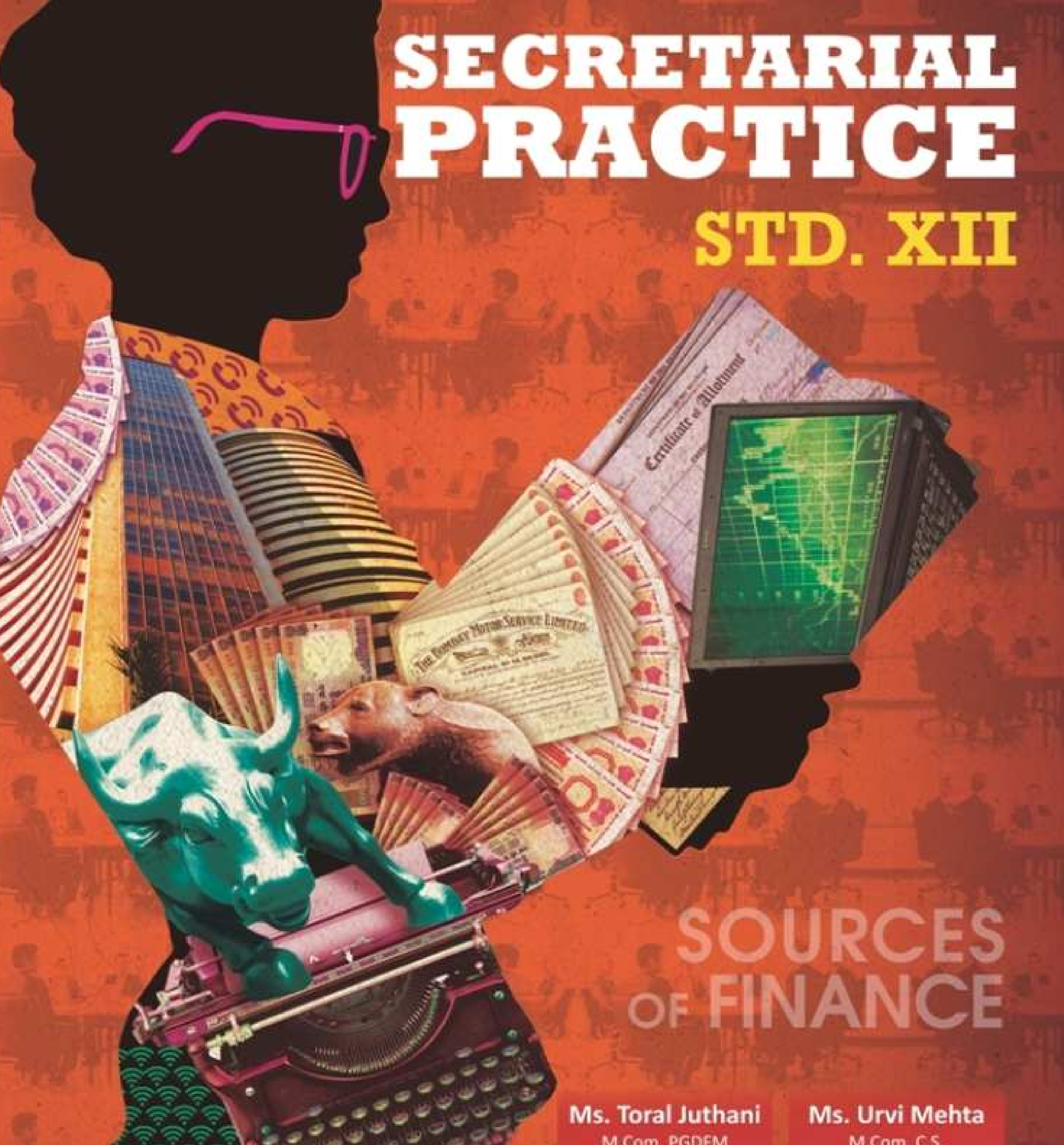

SECRETARIAL PRACTICE

STD. XII

SOURCES OF FINANCE

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Target Publications Pvt. Ltd.

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STD. XII Commerce
Secretarial Practice

Fourth Edition: March 2016

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- Exhaustive coverage of syllabus in Question Answer Format.
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PREFACE

Secretarial Practice is a subject that compiles the knowledge and skills a Company Secretary should posses. The competency of the company secretary lies in conducting valid correspondence between the Board of Directors and the public, thereby acting as a front face of the organization.

We present to you **"Std. XII Commerce: Secretarial Practice"** with a revolutionary fresh approach towards content thus laying a platform for an in-depth understanding of the subject.

This book has been written according to the revised syllabus and guidelines as per the State Board and covers answers not only to the textual questions but also for board question papers from March 2008 to March 2016.

In addition to this, we have included extra questions in each lesson that not only aim at covering the entire topic but also make students ready to face the competition. The sub-topic wise classified “Question and Answer” format of this book helps students in easy comprehension.

Furthermore, we have provided model answers to each question in the form of pointers which makes it easy for students to memorize and reproduce the answers in their examinations.

We have incorporated “Mnemonics” to facilitate easy answer recall. Every chapter ends with a Quick Recap to facilitate quick revision of the lesson learnt. The book also includes two model question papers as per the latest paper pattern. The model questions are provided with relevant marking schemes so as to highlight the importance of each question.

We are sure this study material will turn out to be a powerful resource for students and facilitate them in understanding the concepts of this subject in the most lucid way.

The journey to create a complete book is strewn with triumphs, failures and near misses. If you think we've nearly missed something or want to applaud us for our triumphs, we'd love to hear from you.

Please write to us on: *mail@targetpublications.org*

Best of luck to all the aspirants!

Yours faithfully,
Publisher

Gyan Guru (GG)

We present to you our mascot 'GG', who has been proudly introduced by us for the very first time. GG is a student-buddy who pops up throughout the book and draws your attention to important bits of knowledge also termed as 'Good to Know'. These 'Good to Know' sections help you understand a concept distinctly with a corresponding example from your immediate environment. This is our initiative in education that helps linking learning to life and we're hopeful that you are going to love it.

BOARD PAPER PATTERN

Time: 3 Hours **Total Marks: 80**

Q.1. Objective type questions: **[15]**

Includes three sub-questions of five marks each. All sub-questions are compulsory.

(A) Select the correct answer from the possible choices given below and rewrite the statements:

Five sub-questions. Each sub question carries three options. *[one mark each]*

(B) Match the pairs:

It contains 5 points in Group 'A' and 10 options in Group 'B'. *[one mark each]*

(C) Write a word or phrase or a term which can substitute each of the following statements:

Five sub-questions will be given. *[one mark each]*

Q.2. Distinguish between the following: **[15]**

(Any three out of five) *[5 marks each]*

Q.3. Write short notes on: **[15]**

(Any three out of five) *[5 marks each]*

Q.4. State with reasons, whether the following statements are True or False: **[15]**

(Any three out of five) *[5 marks each]*

[**1 mark**→ For stating True or False; **4 marks** → Reasons (Minimum four reasons are expected)]

Q.5. Answer in brief: **[10]**

(Any two out of four) *[5 marks each]*

[Out of the four questions, three will be asked on business correspondence with debenture holders and depositors]

Q.6. Answer the following: **[10]**

(Any one out of two)

[Out of the two questions, one will be asked on business correspondence with members]

Total: 80

Scheme of Evaluation		
		Marks
(A)	Written Examination	80
(B)	Project (with Viva)	20
	Total:	**100**

(A) Unitwise Weightage

Sr.No.	Units	Marks	Marks With Option
1.	Business Finance	07	12
2.	Sources of Business Finance	18	28
3.	Role of a Secretary in Capital Formation	12	22
4.	A. Issue of Debentures	12	17
	B. Deposits		
	C. Depository and Dematerialisation		

5.	Declaration and Payment of Dividend	07	12
6.	A. Correspondence with Members	17	27
	B. Correspondence with Debenture holders		
	C. Correspondence with Depositors		
7.	A. Financial Markets	07	12
	B. Stock Exchange		
	Total:	**80**	**130**

(B) Weightage to Objectives

Sr. No.	Objectives	Marks	Marks with Option	Percentage
1.	Knowledge	15	15	18.75
2.	Understanding	20	40	25.00
3.	Application	25	40	31.25
4.	Skill	20	35	25.00
	Total:	**80**	**130**	**100.00**

(C) Weightage to Type of Questions

Sr. No.	Type of Questions	Marks	Marks with Option	Percentage
1.	Objective Type	15	15	18.75
2.	Short Answers	55	95	68.75
3.	Long Answers	10	20	12.50
	Total:	**80**	**130**	**100.00**

Contents

Note: All Textual questions are represented by * mark.

01. Business Finance

Introduction

Mr. Arun is a musician and intends to start something of his own. His wife is a school teacher. She asked him to go ahead with his plan of opening a music class.

Now for executing this plan, Arun requires various musical instruments like Keyboards, Guitar etc. He is an expert in playing Guitar and Mandolin himself. However, he requires skilled musicians to teach vocals and keyboard. He also requires a place for conducting the music class. His wife is well aware of his financial worries and hence offers him ₹ 30,000 out of her own savings. He himself has savings to the tune of ₹ 50,000 which he is ready to invest in his new venture. He wants to check whether their combined savings would be enough to fund his venture. So he makes a list of his expenditures as shown below:

Musical Instruments = ₹ 1,00,000; Rent = ₹ 15,000 p.m.; Fees to music teachers = ₹ 20,000.

He is short of funds to the tune of ₹ 55,000 and hence approaches some of his friends and acquaintances for help. They contribute ₹ 20,000.

As a last resort, Arun goes to a bank for a loan to fund the remaining amount of ₹ 35,000. He gets the loan easily on the security of jewellery. He then makes a list of the available sources of funds to see if the amount tallies with the planned expenditure.

Retained earnings (own + wife's savings) = ₹ 80,000

Borrowed Funds (from friends) = ₹ 20,000

Borrowed Funds (through bank loan) = ₹ 35,000

Total Funds Employed = ₹ 1,35,000

In this chapter, we will learn the importance and objectives of financial planning, meaning of capital structure & its components and the factors affecting requirement of capital.

Business Finance

Meaning of Business Finance:

- The term ‘business finance’ can be broadly explained by considering the factors ‘business’ and ‘finance’.
- The term ‘business’ deals with production and distribution of goods and services.
- The term ‘finance’ is required for consumption as well as investment in any business.
- In simple words, business finance applies to all financial activities of agriculture, industry, banking, transport, insurance etc.
- Thus, the scope of business finance includes commercial finance, industrial finance, property finance, corporate finance and even agriculture finance.
- It mainly deals with raising, administering and disbursing of funds by a business firm or an organization.
- In actual practice, business finance refers to ‘corporation finance’.
- In this era of MNCs, the business finance is almost identified with ‘corporation finance’ as such finance deals with financial matters of corporate enterprise.
- In the academic world, the term ‘corporation finance’ is now known as ‘financial management’.

Meaning of Financial Management

*Q.1. **What is Financial Management? State its role in the organization.** **[5]**

Ans:
- Being a specialized function of general management, financial management is mainly concerned with raising of finance and its optimum and effective utilization for achievement of goals of the organization.
- It deals with planning, organizing, directing, co-ordinating and controlling financial activities.
- It is also called as **‘Resource Management’**.

Definitions of Financial Management:
- In the words of **Ezra Soloman,** "Financial Management is concerned with effective use of an important economic resource, namely capital funds".
- In the words of **Kuchal S. C.,** "Financial Management deals with procurement of funds and their effective utilization in business".

Role of Financial Management:
The role of financial management can be explained with reference to the functions performed by it. They are 'routine functions' and 'executive functions'.

Routine Functions: [Mnemonic: KFC CD]

i. **Record Keeping and Reporting:**
- The finance manager has to keep records of all financial transactions and send the reports to different departmental heads.

ii. **Preparing various Financial Statements:**
- The finance manager prepares various financial statements to analyze the position and performance of an organization.

iii. **Cash Planning:**
- Cash planning is properly done by the finance manager as it allows the company to plan its working capital.

iv. **Credit Management:**
- The financial manager has to manage the credit properly.
- This means managing the funds which are due (with the creditors) and accordingly deciding the credit period that is to be offered to the debtors.

v. **Reporting to Directors:**
- Providing accurate information to Board of Directors on current financial position for making decisions of purchases, marketing, pricing etc.

Executive functions: [Mnemonic: CAR DIP]

i. **Checking and Analysis of Financial Performance:**
- An organization prepares and analyzes various financial statements which helps in improving techniques of financial control.

ii. **Advising Board of Directors:**
- A finance manager brings to the notice of the Board of Directors problems related to finance and also suggests possible solutions for the same.
- He also gives advice on important matters such as pricing, expansion, acquisition, dividend policy etc.

iii. **Forecasting Financial Requirements:**
- Forecasting of finance means projection of financial needs of business for future.
- In simple words, forecasting means budgeting financial needs of the expected programmes.
- An organization requires capital i.e. fixed capital (long term) and working capital (short term) for running its business.
- Forecasting not only considers the amount of funds required but also considers:
  when the funds are required,
  duration for which funds are required, and
  kind of funds (i.e. owned or borrowed).

iv. **Deciding Sources of Funds:**
- After determining the amount of finance required, various sources (such as shares, debentures, financial institutions, money lenders etc.) of raising such funds are to be considered.
- Utmost care is to be taken while selecting the source as there needs to be a proper balance between owned funds and owed funds.
- Further, there has to be a proper balance between long term funds and short term funds.

v. Investment Decisions:
- After raising the funds, these funds must be wisely utilized.
- Investment decision ensures effective utilization of funds raised by the organization in:
  - long term assets or fixed assets such as land, building, machinery, furniture etc.
  - short term assets or current assets such as inventory, account receivables, etc.
- The decision regarding fixed assets is popularly known as 'capital budgeting'.
- Whereas, the decision regarding current assets is known as 'working capital management'.
- It becomes the responsibility of the finance manager to ensure efficient utilization of every current asset to maintain control on cash inflow and cash outflow.

vi. Dividend Policy:
- A finance manager has to decide the proportion of profit that it is to be retained in the business for future expansion and the proportion that is to be distributed as dividend among shareholders.
- It is the prime duty of the finance manager to balance the investor's expectations and use of retained earnings for future expansion or acquisition of additional assets.

Good to Know:
- *In ancient times, there was no concept of 'financial management' as we understand it today. However, monarchs and states were able to influence the amount of their revenues through the ownership and control of property, labour and taxes, and by means of further conquest. The introduction of coinage in the late seventh century BC, and the subsequent monopoly of the monarch or state on coining and issuing rights, provided an important means of adding to those revenues through the manipulation of a currency's weight and precious metal content.*

***Q.2. What are the objectives of financial management?** **[5]**

Ans: According to **Kuchal S. C.,** "Financial Management deals with procurement of funds and their effective utilization in business".

The basic objectives of financial management are stated as follows:

Profit Maximization:
- It is considered as the basic principle of any business activity.
- According to this principle, all functions of business aim at profit.
- The concept of profit maximization is traditional in nature and is based on the assumption that profit is a tool of measuring the success of any business firm.
- Profit maximization is considered to be the most important business objective since,
  - it is difficult for any business firm to survive without profit;
  - success can be measured with the profit earning capacity of an organization;
  - high profit results in better returns (i.e. dividend) to shareholders;
  - increase in profitability of an organization allows the use of surplus funds for the future expansion of the firm; and
  - it has to be achieved for socio-economic welfare.

Wealth Maximization:
- According to **Prof. Soloman Ezra,** the ultimate goal of financial management should be maximization of owners' wealth.
- Wealth maximization is also known as 'value maximization' i.e. maximizing net present value of a firm.
- The focus of financial management must be on wealth maximization of the owners' i.e., equity shareholders.

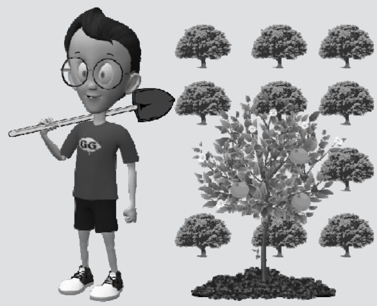
- The wealth of shareholders can be reflected in market value of shares.
- It can be said that, the wealth of equity shareholders is maximized only when market value of equity shares is maximized.

Social Satisfaction:

- Business firms now-a-days not only think about investors, but also consider welfare of people in general.
- As the business firms operate in society, they are responsible towards the society.
- They do so by protecting the interests of suppliers, customers, creditors, employees of the company and government.
- The shareholders expect high rate of dividend, customers want products of good quality at reasonable prices, society requires effective and efficient use of scarce resources of production and government insists on compliance of rules and regulations and regular payment of taxes. A business firm has to fulfill all such social responsibilities.
- Thus, along with profit maximization and wealth maximization, social satisfaction is an equally important objective of any business firm.

Good to Know:

- *As a part of its corporate social responsibility initiative, Aamby Valley City planted 1,25,2576 trees in a span of 6 hours 35 minutes with the active help and support of 1,400 volunteers.*
- *For this noble initiative it was featured in the Guinness Book of World Records on 5th June 1998.*



Financial Planning

Meaning of Financial Planning:

The term ‘financial planning’ refers to assessment of financial requirements and arranging the sources of capital.

It is required not only to increase profit but also for survival of the firm.

It can be implemented with an effective ‘financial plan’.

The financial plan includes information about the economic environment in which the business operates.

It establishes targets of sales and profits and promotes co-ordination of resources and efforts to reach these targets.

To sum up, financial planning is ‘an advance programming of all plans of financial management’.

Definition of Financial Planning:

According to **J.H. Boneville,** “The financial plan has two fold aspects, it refers not only to capital structure of the corporation but also to the financial policies which corporation has adopted or intends to adopt”.

***Q.3. What is Financial Planning? State the importance of Financial Planning. [5]**

Ans: The term ‘financial planning’ refers to assessment of financial requirements and arranging the sources of capital.

The finance manager gets entire information about his firm’s activities and on that basis, he prepares a financial plan.

The financial plan so prepared becomes crucial with respect to decision making.

The importance of financial planning is as below:

i. Elimination of Waste:

- Through financial planning, several factors such as change in government policy (on taxes), fluctuating interest rates etc. can be anticipated and duly tackled.

- If there is lack of proper financial planning, the organization may suffer huge irreversible and uncompensable losses due to wasteful expenditure.

ii. **Co-ordination:**
- Proper financial planning is the key for smooth functioning of the organizational activities such as production, distribution, marketing and personnel.
- These activities will hamper if not supported by proper financial planning.
- Finance manager brings about co-ordination among all departmental heads of the organization.

iii. **Dynamism:**
- A dynamic finance manager would take initiative and face various changing financial situations/challenges as and when they arise.
- Proper and effective financial planning helps the finance manager to forecast the future trends.
- Such forecasting helps the organization to undertake only profitable projects and avoid the unprofitable ones.

iv. **Communication:**
- Proper financial planning helps the finance manager to communicate the various aspects of financial plan to the executives of other departments.
  This further helps to eliminate the wastage of time, goodwill and financial resources of the company.

v. **Decision Making:**
- Financial planning helps a firm to take appropriate and timely decisions to achieve its objectives.
- Thus, to implement any scheme, there must be a budgetary provision in the financial planning.

vi. **Integration:**
- A proper financial plan provides a fairly good idea to the firm about its available resources.
- Financial planning is to be completed in full consultation and co-operation of other departments, which in turn, promotes team spirit among all the executives of the company.
  Thus, financial planning assists in integration of firm's activities.

vii. **Futuristic:**
- Financial planning takes into account not only the present but also the future developments.
- This futuristic element of financial planning helps for advance programming.

***Q.4. Write a short note on: Objectives of Financial Planning. [5]**

Ans: The term 'financial planning' refers to assessment of financial requirements and arranging the sources of capital.

Objectives of financial planning include:

i. **Proper Utilization of Funds:**
- Maximum usage of the available financial resources is the basic aim of financial planning.
- It is important to ensure that adequate funds are raised at no extra cost.

ii. **Adequate Supply of Funds:**
- Financial planning includes forecasting the firm's financial needs.
- It is important to have sufficient supply of funds to ensure smooth functioning of the organization.
- There must be enough funds so that the firm does not face any financial distress.

iii. **Efficient Use of Funds:**
- It is important to manage funds wisely.
- Financial planning aims at supervising the usage of funds because the funds so generated are not only for earning profit but also for the survival of the firm.

iv. Elimination of Wasteful Expenditure:
- Financial planning ensures that no excess fund is raised by the firm.
- It is important that the firm generate or procure only that much amount which is needed.
- Any extra cost must not be incurred while raising the funds and the funds so raised should be properly utilized as per the requirement of the firm.
- Any surplus so generated needs to be monitored, so as to avoid its misuse.

Capital Structure

***Q.5. Write a short note on: Capital Structure and its components. [Mar 16, Oct 15] [5]**

Ans: Meaning of Capital Structure:
- Capital Structure constitutes two words i.e. Capital and Structure.
- The word 'Capital' refers to the investment of funds in business while 'Structure' means arrangement of different components in proper proportion.
- A company can raise its capital from different sources i.e. owned capital, borrowed capital or both.
- To decide capital structure means to decide upon the ratio of owned capital (i.e. equity share capital, preference share capital, reserves & surplus) to borrowed capital (i.e. debentures, loans, etc).
- According to **John H. Hampton,** "A firm's capital structure is the relation between the debt and equity securities that makes up the firm's financing of its assets."
- According to **R. H. Wessel,** capital structure is "the long term sources of funds employed in a business enterprise".
- According to **Weston and Bringham,** "capital structure is the permanent financing of firm represented by long term debt, preferred stock and net worth".
- The term capital structure means 'financing mix'. It refers to the proportion of different securities raised by a firm for long term finance.

Components of Capital Structure:

The components of Capital Structure are as follows:

i. Equity Share Capital:
- Equity share capital is provided by equity shareholders and it is the basic source of financing activities of business.
- The holders of such shares bear ultimate risk associated with the ownership.
- Equity shares carry dividend at a fluctuating rate, depending upon the profits earned by the company.

ii. Preference Share Capital:
- Preference shares carry dividend at a fixed rate and enjoy preferential right over equity shares for return of capital in case of winding up of the company.
- Unlike equity shareholders, preference shareholders have limited voting rights.

iii. Retained Earnings:
- The part of the profit retained by the company for meeting future financial needs and for expansion of the firm is known as retained earnings.
- In simple words, it is ploughing back of profits.

Good to Know:
- *The retained earnings of a few corporate entities for the financial year ended March, 2015 are as given below:*

(Amount in Crores)
Hindustan Unilever Ltd. = ₹1,812.99
Infosys Ltd. = ₹37,403.00
Godfrey Philips India Ltd. = ₹1,031.08

iv. **Borrowed Capital:**

It consists of the following:

- **Debentures:**
  A debenture is a certificate of loan evidencing the fact that the company is liable to pay a specified amount with interest at an agreed rate.
- **Term Loans:**
  Term loans are provided by banks and other financial institutions at a fixed rate of interest.

For e.g.

Balance sheet of Sunrise Company Limited as on 31st March 2012

Liabilities	Amount ₹	Assets	Amount ₹
Share Capital		**Fixed Assets**	
5000 Equity Shares		Building	2,00,000
of ₹ 10 each fully paid	50,000	Plant & Machinery	80,000
1000, 10% Preference			
Shares of 100 each		**Current Assets**	
fully paid	1,00,000	Cash in hand	14,000
Reserves & Surplus		Cash at bank	24,000
General & Surplus	20,000	Sundry Debtors	12,000
Liabilities		Inventories	10,000
1000, 12% Debentures of			
₹ 100 each fully paid	1,00,000		
Sundry Creditors	40,000		
Bank Overdraft	20,000		
Bills payable	10,000		
	3,40,000		**3,40,000**

Capital Structure = Equity shares + Preference share + Reserves + Debentures
= 50,000 + 1,00,000 + 20,000 + 1,00,000
= 2,70,000

***Q.6. What is Capital Structure? What are the internal and external factors influencing Capital Structure? [10]**

Ans: Capital Structure constitutes two words i.e. Capital and Structure. The word 'capital' refers to the investment of funds in business while 'structure' means arrangement of different components in proper proportion. Capital structure means 'financing mix'. It refers to the proportion of different securities raised by a firm for long term finance.

Factors influencing Capital Structure:

The factors which play a vital role in determining the capital structure are divided into two categories viz. Internal Factors and External Factors.

A. **Internal Factors: [Mnemonic: SCRAP^2 TAG]**

i. **Size and Nature of Business:**

- The size of business has great impact on its capital structure.
- Trading concerns raise capital by issue of equity as well as preference shares as they require more working capital.
- Small companies have limited capacity to raise funds from external sources.
- Large companies possess huge investments; hence they can issue debentures by offering securities of fixed assets such as land, building, machinery etc.
  Such companies prefer to raise funds by issuing equity shares along with debentures.

ii. Capital Gearing:

- The ratio between debt capital (fixed interest) and equity capital (variable dividend) is called **capital gearing.**
- It is high gearing when the proportion of debt capital is high than the equity share capital while it is low gearing when the proportion of debt capital is low than the equity share capital.
- In order to protect the interest of equity shareholders, the company usually uses proper mix of various types of securities in its capital structure.

iii. Requirement of Capital:

- In the initial stages of business, a company cannot issue varieties of securities as there is considerable risk involved and hence, it is preferable to raise capital through equity shares.
- Later on for expansion or modernization, the company may issue other types of securities such as debentures, public deposits etc.

iv. Adequate Earnings and Cash Position:

- Developed companies with stable earnings (stable cash flow) utilize large amount of debt capital in their capital structure as they can pay a fixed rate of interest.
- Companies with unstable earnings (unpredictable cash flow) should not opt for debt in their capital structure as they may face difficulty in paying the fixed amount of interest.

v. Future Plans and Development:

- Capital structure is designed by the management keeping in mind the future development and expansion plans.
- Equity shares can be issued in the initial stages whereas debentures and preference shares may be issued in future to finance developmental plans.

vi. Period of Finance:

- While framing capital structure, the 'period for which finance is needed' must also be considered.
- If funds are required on regular basis, the company should raise it through issue of equity shares.
- For a shorter period, funds can be raised through issue of debentures or preference shares.

vii. Trading on Equity:

- The use of borrowed capital for financing a firm is known as **Trading on Equity.**
- If the rate of interest on debt is lower than the rate of earnings of the company, the equity shareholders get additional dividend.
- This increases the creditworthiness of the company and the company is able to raise further loan at a lower rate of interest.
- On the other hand, if the company's earnings are not sufficient, it may lead to financial crisis as the interest on debt has to be paid even in case of loss. The entire earnings may exhaust in payment of interest. In this case, no dividend can be declared by the company.
- If no dividend is paid on equity shares, it adversely affects the creditworthiness of the company.
- Thus, trading on equity is double edged sword. It may increase the income of the shareholder if things head in a proper direction. On the other hand, it increases the risk of loss under unfavourable conditions.

viii. Attitude of Management:

- Capital structure is influenced by the attitude of the persons in the management.
- If the management wishes to have exclusive control, they raise capital through preference shares and debt capital.
- Since the holder of such shares do not enjoy any voting rights, thereby cannot interfere in the management of the company.

ix. Growth of Business Firm:
- Capital requirement of a firm depends upon the stage of development.
- At the initial stage, the source of finance is mostly equity shares and short term loans.
- As the stage progresses, the requirement increases and funds are procured by issuing debentures and preference shares.

B. External Factors: [Mnemonic: MAGIC CAT]

i. Market Conditions:
- Various methods of financing should be considered depending upon the prevailing market conditions.
- If the share market is in a declining situation, the company should raise funds by issuing debts.
- On the other hand, during the period of boom in the share market, the company should raise funds by issuing equity shares.

ii. Attitude of Investors:
- Attitude of investors also plays an important role in determination of capital structure.
- If the investors prefer to take risk and expect higher returns, they invest in equity shares.
- If the investors prefer to earn safe and assured income and are not ready to take risk, they invest in preference shares and/or debentures.

iii. Government Rules and Regulations:
- According to SEBI, the normal debt equity ratio is 2 : 1.
- However, in case of large capital intensive projects, the permitted ratio is 3 : 1.
- Government provides aid and concessions to small industrial projects to raise more debt capital.

iv. Rate of Interest:
- Capital structure depends upon the rate of interest prevailing in the market.
- If the rate of interest is higher, firms delay debt financing.
- Conversely, if the rate of interest is lower, firms will opt for debt financing.

v. Competition:
- The company which faces cut-throat competition should raise funds by issuing equity shares as their earnings are not certain and adequate.
- However, the company which has a monopoly position in the market may issue debt capital because of certainty of earnings.

vi. Cost of Capital:
- Cost of capital is the minimum return expected by its supplier/investor.
- The expected return depends upon the degree of risk.
- In case of debt holder, rate of interest is fixed and the loan is repaid within the prescribed period.
- A high degree of risk is assumed by equity shareholders than the debt holders.
- In case of shareholders, rate of dividend is not fixed and their capital is repaid only when the company is liquidated. Thus, debt is a cheaper source of capital than equity.
- The preference share capital is also cheaper but not cheap as debt.
- However, the company cannot minimize cost of capital by employing only debt.
- As debt becomes more expensive beyond a particular point due to the increased risk of excessive debt.

vii. Attitude of Financial Institutions:
- Attitude of financial institutions is to be considered while determining capital structure.
- If financial institutions prescribe high terms of lending, then the company should move to other source of financing.
- However, if financial institutions prescribe easy terms of lending, the company should obtain funds from such institutions.

viii. **Taxation:**
- Interest paid against debt is tax deductable expenditure whereas dividend is not considered as tax deductable expenditure for the company.
- Hence, issue of debt capital is more preferable than issue of share capital.
- The companies with higher taxes employ debt capital as it is a tax deductable expense.

Q.7. Write a short note on: Sound Capital Structure. **[5]**

Ans:
- Capital structure refers to the composition of capital and ratio of different securities in total capital.
- It comprises of net worth (equity + reserves) and long term liabilities.
- A company can raise its capital from different sources i.e. owned capital or borrowed capital or combination of both.
- Different proportions of various sources are used in capital structure as per business requirement.
- The organization is said to have a sound capital structure when the ratio of securities i.e. debt to equity, is favourable. The ideal ratio prescribed by SEBI is 2 : 1.
- Balanced capital structure is an optimal mixture of debt and equity.
- There is no ideal pattern of capital structure. However, there should be an appropriate mix of securities in the capital structure so that EPS i.e. earnings per share is maximized.
- **For e.g.** Sunrise Company Ltd. has share capital of ₹ 2,00,000 divided in 20,000 equity shares. This company has an expansion programme requiring an investment of another ₹ 1,00,000. The management is considering alternatives as follows:
  Issue of 10,000 equity shares of ₹ 10/- each
  Issue of 10,000 12% preference shares of ₹ 10/- each.
  Issue of 1000 10% debentures of ₹ 100/- each.

  Let us calculate EPS assuming the earning of company is ₹ 50,000 before interest and tax (i.e. EBIT) and tax rate at 50%.

Present and Projected Earning per share

Particulars	Present capital structure	Proposed capital structure		
	All Equity	All Equity	Equity + Preference	Equity + Debt.
Earning before interest and tax	50,000	50,000	50,000	50,000
Less Interest	-	-	-	10,000
Less Tax @ 50%	50,000 25,000	50,000 25,000	50,000 25,000	40,000 20,000
Less Pref. Dividend	-	-	12,000	-
Profit	25,000	25,000	13,000	20,000
No. of Equity share	20,000	30,000	20,000	20,000
EPS	1.25	0.83	0.65	1.00

The above table indicates the equity & debt model is the most suitable capital structure.

Fixed Capital and Working Capital

***Q.8. What is Fixed Capital? State factors affecting requirement of Fixed Capital.** **[5]**

Ans: Meaning of Fixed Capital:
- Fixed capital is that portion of total capital which is invested in fixed assets such as, land, building, equipments, machinery etc.
- It may be held in business for 5, 10 or 20 years or more. Thereafter it may be sold or reused.

- Investors invest their money in fixed capital hoping to make future profit.
- The concept of "Fixed Capital" was first theoretically analyzed by economist **David Recardo**.
- In **National Accounts**, fixed asset is defined as "the stock of tangible, durable fixed assets owned or used by resident enterprises for more than one year. This includes building, plant, machinery, vehicle, equipment, etc."
- According to **Karl Mark,** "Fixed capital also circulates, except that the circulation time is much longer". *[It means that the fixed capital remains in business for a longer period of time. Whereas, investment in assets such as raw materials can be readily converted in cash]*
- The European system of National and Regional Accounts includes intangible assets such as computer software, copyright, etc. within the definition of fixed assets.

Factors affecting Fixed Capital Requirement:

The factors affecting fixed capital requirement are as follows:

i. Nature of Business:

- The nature of business plays a vital role in determining fixed capital requirement.
- **For e.g.** Rail, roads and other public utility services have large fixed investment. Their working capital requirements are nominal as they supply services and not products.
  They mainly deal in cash sales only.
- On the other hand, trading organizations like retailers require less of fixed capital as they do not need large funds for land, building, plants and machineries.

ii. Size of Business:

- Bigger the business, higher is the need of fixed capital.
- Hence, the size of a firm, either in terms of its assets or sales affects the need of fixed capital.

iii. Growth and Expansion:

- In order to manage growing production and turnover, a growing firm may need to invest more in fixed assets.

iv. Stage of Development of Business:

- The requirement of fixed capital for a newly established organization is more than that of an established organization.

v. Business Cycle:

- When there is a boom period in an economy, the organization invests more in fixed assets so as to increase its production capacity.
- However, during recession, the organization avoids undertaking huge projects, and hence, it may not require more of fixed capital.

***Q.9. What is Working Capital? State factors affecting requirement of working capital.** **[10]**

Ans: Meaning of Working Capital:

- Working capital means current assets or circulating capital.
- Experts define working capital in both, narrow as well as broad sense.
- In the narrow sense, it is defined as "the difference between current assets and current liabilities".
  According to **Gerstenbergh**, "working capital is the excess of current assets over current liabilities". However, Gerstenbergh prefers to call working capital as circulating capital.
- In a broader sense, working capital has been defined as follows:
  According to **Western and Brigham**, "working capital refers to a firm's investment in short term assets such as cash, short term securities, account receivable and inventories".
  As per **Mead, Baker and Mallot**, "working capital means current assets".
  As per **J. S. Mill,** "the sum of current assets is working capital of a business".
- It takes into account all current resources of the company. It refers to 'gross working capital'.

Factors affecting Working Capital Requirement: [Mnemonic: Bablu **RESPECTS VAN]**

The factors affecting working capital requirement are as follows:

i. **Business Cycle:**
- When there is boom in the economy, sales will increase, which will lead to an increase in investment in stock.
  Hence, additional working capital would be required.
- During recession period, sales would decline and the need of working capital would also decrease.

ii. **Requirement of Cash:**
- The requirement of working capital depends upon the cash required by the organization for various purposes.
- If the requirement of cash is more, then company requires more working capital and vice-versa.

iii. **Growth and Expansion Activities:**
- The working capital requirement increases with the growth of firm.
- It needs funds continuously to support large scale operation.

iv. **Seasonal Fluctuations:**
- The requirement of working capital depends upon the seasonal fluctuations.
- It states that, if the demand for the product is seasonal, the working capital required in that season will be more.
- **For e.g.** The demand for sweaters is more in winter. Sweater manufacturing companies need more working capital before winters to make the goods available in the market before the season starts.

v. **Production Cycle:**
- The process of converting raw material into finished goods is called 'production cycle'.
- A firm requires more working capital when the production cycle is longer and vice-versa.

vi. **External Factors:**
- If the financial institutions and banks provide funds to the firm as and when required, the need of working capital will be reduced.

vii. **Credit Control:**
- Volume and terms of credit sales, collection policy etc. are the important factors of credit control.
- Sound credit policy improves cash flow and hence the firms making cash sales require less working capital.
- Liberal credit policy increases the risk of bad debts and hence the firms selling on easy credit terms may require more working capital.

viii. **Terms of Purchase and Sales:**
- If the credit terms of purchases are favourable and terms of sales are less liberal then the requirement of working capital will reduce as the requirement of cash will be less.
- On the other hand, if the firm does not get proper credit for purchase and adopts liberal credit policy for sales, it will require more working capital.

ix. **Size of Business:**
- The size of business has a great impact on the requirement of working capital.
- Large scale firms require large amount of working capital.

x. **Volume of Sale:**
- The volume of sale is directly proportional to the size of working capital.
- If the volume of sale increases, there is an increase in amount of working capital and vice-versa.

xi. **Management Ability:**

- The requirement of working capital will reduce if there is proper co-ordination between production and distribution of goods.
- Lack of co-ordination between different departments may result in heavy stocking of finished and semi-finished goods, which ultimately leads to an increase in the requirement of working capital.

xii. **Nature of Business:**

- The nature of business highly influences the requirement of working capital.
- Industrial and manufacturing enterprises, trading firms, big retail stores etc. need a large amount of working capital as they have to satisfy varied and continuous demands of consumers.

Multiple Choice Questions

I. **Select the correct answer from the possible choices given below and rewrite the statements:** **[1 mark each]**

*1. Business finance deals with _______ activities of business.
(A) manufacturing (B) selling **(C) financial**

2. _______ refers to management of business funds.
(A) Financial management (B) Strategic management
(C) Inventory management

3. _______ is called as 'Resource Management'.
(A) Inventory management (B) Data management
(C) Financial management

4. Financial management has become an important aspect in the business environment of _______ countries.
(A) developed **(B) developing** (C) under-developed

*5. A business firm is basically _______ organization.
(A) profit-oriented (B) service-oriented (C) Non-profit

*6. Normally _______ gives advice to Board of Directors in respect of financial matters. **[Mar 16, Oct 14]**
(A) Auditor (B) Secretary **(C) Finance Manager**

7. Wealth maximization is also known as _______ maximization.
(A) value (B) source (C) man-power

*8. Wealth maximization of owner means maximization of _______ of shares.
(A) face value **(B) market value** (C) issue value

9. The financial plan must include information about _______ environment in which business operates.
(A) economic (B) social (C) cultural

*10. Due to _______ planning it is possible to eliminate wasteful expenditure.
(A) Financial (B) Sales (C) Production

*11. The _______ means mix-up of various sources of funds in desired proportions.
(A) Capital structure (B) Term loan (C) Retained profit

12. Capital structure is the _______ financing of firm represented by long term debt, preferred stock and net worth.
(A) temporary **(B) permanent** (C) balanced

13. The ideal structure for new company is to raise capital through _______.
(A) Debentures (B) Preference shares **(C) Equity shares**

*14. Large manufacturing companies have _______ investments in fixed assets.
(A) huge (B) small (C) moderate

*15. The _______ concerns can acquire funds from various sources.
(A) well established (B) newly established (C) small trading

16. If funds are required on regular basis, the company should raise funds through issue of _______.
(A) Equity shares (B) Preference shares (C) Debentures

*17. Trading on equity means use of _______ capital for financing a firm. **[Mar 14]**
(A) equity (B) preference **(C) borrowed**

*18. During the period of boom in share market, _______ are issued to raise capital.
(A) bonds (B) debentures **(C) equity shares**

*19. The investors who are ready to take risk prefer _______ shares for investment.
(A) preference **(B) equity** (C) bonus

*20. If share market is depressed a company should issue _______ capital.
(A) debt (B) owned (C) mix

*21. The SEBI has prescribed debt-equity ratio norm of _______.
(A) 1 : 1 **(B) 2 : 1** (C) 2 : 2

*22. The _______ is considered as tax deductable expenditure.
(A) dividend (B) bonus **(C) interest**

*23. The _______ capital stay in business almost permanently.
(A) fixed (B) working (C) debt

*24. The difference between current assets and current liabilities is _______ capital.
(A) debt (B) fixed **(C) working**

*25. Big retail stores require large amount of _______ capital. **[Mar 15, Oct 15]**
(A) fixed **(B) working** (C) loan

*26. If the volume of sales increases, there is _______ in amount of working capital.
(A) an increase (B) a decrease (C) no change

27. If credit policy is _______, it is possible for the company to improve its cash flow.
(A) sound (B) liberal (C) just

*28. A firm selling on credit terms requires _______ working capital.
(A) more (B) medium (C) less

*29. A firm making cash sales requires _______ working capital.
(A) less (B) more (C) no

Match the Pairs

II. **Match the correct pairs:** **[1 mark each pair]**

***1.**

	Group "A"		Group "B"
i.	Financial management **[Mar 15]**	a.	Minimise market value of equity shares
ii.	Wealth maximization	b.	Investment in fixed assets
iii.	Financial plan **[Mar 16]**	c.	Ratio of buying and selling
iv.	Capital structure	d.	Management of business funds
v.	Fixed capital **[Mar 14]**	e.	Ad hoc programming of finance
		f.	Investment in current assets
		g.	Management of business activities
		h.	Maximise market value of equity shares
		i.	Ratio of different securities in capital
		j.	Advance programming of financial management

Ans: **(i – d), (ii – h), (iii – j), (iv – i), (v – b).**

2.

	Group "A"		Group "B"
i.	Finance Manager	a.	Use of equity capital for financing business.
ii.	Debt - equity ratio	b.	Tax deductable expenditure
iii.	Trading on equity	c.	Ratio between income and expenditure.
iv.	Interest	d.	Non – tax deductable expenditure
v.	Capital gearing	e.	Provides advice to secretary on financial matters.
		f.	2 : 1
		g.	Double edged sword
		h.	1 : 2
		i.	Provides advice to Board of Directors on financial matters.
		j.	Ratio between debt capital and equity capital.

Ans: **(i – i), (ii – f), (iii – g), (iv – b), (v – j).**

One Word

III. **Write a word or a term or a phrase which can substitute each of the following statements:** **[1 mark each]**

*1. A function concerned with raising of finance and its effective utilization in business.
*2. The basic principle of business activities that aims at profit. **[Oct 14]**
*3. The principle which means maximization of market price of equity shares.
*4. An advance programming of all plans of financial management.
*5. A mix-up of various sources of funds in desired proportion.
6. Capital or funds provided by equity shareholders.
7. Loans provided by bank and other financial institutions.
*8. The use of borrowed capital for financing business firm. **[Oct 15]**
*9. The ratio between debt capital (fixed interest) and equity capital (variable dividend).
*10. The portion of total capital which is invested in fixed assets.
*11. The sum of current assets of the business.
*12. The difference between current assets and current liabilities.

Ans:

1.	Financial management	2.	Profit maximization
3.	Wealth maximization	4.	Financial planning
5.	Capital structure	6.	Equity share capital
7.	Term loans	8.	Trading on equity
9.	Capital gearing	10.	Fixed capital
11.	Working capital	12.	Net working capital

Distinguish Between

***IV.** **Distinguish between: Fixed Capital and Working Capital.** **[Mar 15, Oct 14] [5]**

Ans:

Sr.No.	Fixed Capital	Working Capital
	Meaning	
1.	Fixed capital is that portion of total capital which is invested in fixed assets such as land, building, equipments, machinery etc.	Working capital refers to a firm's investment in short term assets such as cash, short term securities, account receivable and inventories.
	Nature	
2.	It may be held in business for 5, 10, 20 years or more.	It remains in the business for a short period of time and circulates into the business.
	Purpose	
3.	Fixed capital is invested in long term assets for the growth and expansion of a firm.	It is invested in short term assets to fulfil working capital needs.
	Sources	
4.	It is generated by issuing shares, debentures, borrowing of loans etc.	It is accumulated through trade credits, short term loans, public deposits etc.
	Objective	
5.	Investors invest their money in fixed capital for better future returns.	Investors invest in working capital for immediate returns.
	Risks Involved	
6.	Risk involved in the investment of fixed capital is high.	Risk involved in the investment of working capital is low as compared to fixed capital.
	Authority	
7.	Generally, Top level management decides on matters related to fixed capital investment.	Middle level or lower level managers can decide on matters related to working capital needs.
	Factors Affecting	
8.	Need of fixed capital depends upon various factors such as: size of business, nature of machinery required, expansion etc.	Need of working capital depends upon various factors such as: seasonal fluctuation, production cycle, requirement of cash etc.

True or False

V. **State with reasons, whether the following statements are True or False: [5 marks each]**

***1.** **Financial management is essential for all types of organizations. [Mar 14, 15]**

Ans: This statement is **TRUE.**

Reasons:

- All types of organizations, whether profit making or non-profit making, need financial management as it plays a crucial role in making effective and optimum use of financial resources.
- These organizations require funds for their development and expansion.
- Financial management refers to management of funds and is mainly concerned with raising of finance and its effective utilization.
- It also deals with planning, organizing, directing, co-ordinating and controlling financial activities.
- Financial management helps in maximizing profit of the company which results in maximization of the owners' wealth.

Hence, financial management is essential for all types of organizations.

2. **Financial management has become subject of considerable importance in developed countries.**

Ans: This statement is **FALSE.** *[Financial management is a matter of great concern in developing countries]*

Reasons:

- Financial management refers to management of funds and is mainly concerned with raising of finance and its effective utilization.
- Financial management is a subject of considerable importance in developing countries like India.
- In such countries, the existence of business entity depends upon the savings of the people which are meager in general.
- These scarce savings should be utilized to the maximum efficiency through well-managed financial activities.
- Routine and executive functions of financial management help a finance manager to make optimum use of financial resources.

Thus, financial management is a matter of great concern in developing countries.

***3.** **The proper aim of financial management is wealth maximization.**

Ans: This statement is **TRUE.**

Reasons:

- Financial management refers to management of funds and is mainly concerned with raising of finance and its effective utilization.
- The shareholders invest their funds in a company or an organization with a motive to increase the investment.
- The wealth of such shareholders is reflected in market value of shares.
- If the market value of equity shares increases, wealth of shareholders also increases.
- The share price of a company, quoted in share market index, is a reflection of its earning capacity, dividend and retention policy.

Thus, the proper aim of financial management is maximizing market value of equity shares of the company.

***4. Maximization of profit is real and complete motive.**

Ans: This statement is **FALSE.** *[Maximization of profit is not the real and complete motive]*

Reasons:

- Profit is a tool of measuring the success of any business firm i.e. high level profitability results in better return (dividend) to the shareholders which in turn increases their earnings per share (EPS).
- In simple terms, the business firm should undertake only such activities that increase profit and those activities which decrease profit should be avoided.
- Maximization of profit is important in regard to various factors such as: to generate funds for future expansion, better dividend to the shareholders, increase in the creditworthiness of the firm etc.
- However, it is not the only factor important for financial management.
- The proper aim of financial management is wealth maximization of its equity shareholders.
- Moreover, business firms now-a-days aim at social satisfaction and social welfare.
- Therefore, profit maximization along with wealth maximization and social satisfaction are the important objectives of financial management.

Thus, 'Maximization of profit is not the real and complete motive'.

***5. It is not possible to go ahead without financial plan. [Mar 16, Oct 15]**

Ans: This statement is **TRUE.**

Reasons:

- Financial Planning is an important function of financial management. It predicts the financial requirement and arranges for the sources of required funds. It is a continuous process in day to day administration of business.
- Financial planning is not only required for profit making but even for survival of a firm. The financial plan must include information about economic environment in which the business operates. Financial planning serves as a guide for overall activities of the organization.
- The information provided in the financial plan assists in decision making of a firm. It establishes targets of sales and profits and promotes co-ordination of resources and efforts to reach these targets. It is an advance programming of all plans of financial management.

Thus, it is not possible for finance manager to go ahead unless he prepares a sound financial plan.

***6. There is hard and fast rule for the proportion of owned funds and borrowed funds.**

Ans: This statement is **FALSE.** *[The proportion of owned funds and borrowed funds may differ from organization to organization depending upon certain factors viz. internal and external factors]*

Reasons:

- The pattern of capital structure of various firms varies widely. Hence to determine the best possible pattern of capital structure i.e. proportion of owned funds and borrowed funds, many factors are to be considered viz. internal and external factors.
- Many internal factors influence capital structure viz. requirement of capital, size and nature of business, growth of business, cash position, period of finance, trading on equity, development of the firm etc.
- On the other hand, external factors such as market conditions, cost of capital, attitude of investors and financial institutions, government policies and regulations etc. influence capital structure.
- Also, it is important to maintain a proper mix of various types of finance in capital structure, so that the interest of equity shareholders is protected.

Thus, the above statement is false.

Additional Questions for Revision

Q.1. Write short notes on: **[5 marks each]**

***i. Role of Financial Management.**

Ans: *Refer Q.1. "Role of Financial Management."*

***ii. Importance of Financial Planning.** **[Mar 14]**

Ans: *Refer Q.3.*

Q.2. State, with reasons, whether the following statement is True or False: **[5 marks each]**

i. Modern management lays a great emphasis on a detailed 'financial plan'.

Ans: This statement is **TRUE.**

Reasons:

Refer V. (5).

***ii. Trading on equity is a double edged sword.**

Ans: This statement is **TRUE.**

Reasons:

Refer Q.6. (A) (vii).

***iii. Requirement of working capital does not depend upon any factor.** **[Oct 14]**

Ans: This statement is **FALSE.** *[Requirement of working capital depends upon many factors]*

Reasons:

Refer Q.9. *[Any 5 points].*

QUICK RECAP

Financial Management

Functions

Routine

[Mnemonic: KFC CD]

i. Record **K**eeping and Reporting
ii. Preparation of Various **F**inancial Statements
iii. **C**ash planning
iv. **C**redit Management
v. Providing Information to Board of **D**irectors

Executive

[Mnemonic: CAR DIP]

i. **C**hecking and Analysis of Financial Performance
ii. **A**dvising Board of Directors
iii. Forecasting Financial **R**equirements
iv. **D**eciding Sources of Funds
v. **I**nvestment Decisions
vi. Dividend **P**olicy

Objectives

i. Profit Maximization
ii. Wealth Maximization
iii. Social Satisfaction

Capital Structure

Components

Owned / Shareholder's Funds

i. Equity share capital
ii. Preference share capital
iii. Retained earnings

Owed / Borrowed Funds

i. Debentures
ii. Term loans

Influencing Factors

Internal Factors

[Mnemonic: SCRAP² TAG]

i. **S**ize and Nature Business
ii. **C**apital Gearing
iii. **R**equirement of Capital
iv. **A**dequate earnings and Cash Position
v. Future **P**lans and Development
vi. **P**eriod of Finance
vii. **T**rading on Equity
viii. **A**ttitude of Management
ix. **G**rowth of Business Firm

External Factors

[Mnemonic: MAGIC CAT]

i. **M**arket Conditions
ii. **A**ttitude of Investors
iii. **G**overnment Rules and Regulations
iv. Rate of **I**nterest
v. **C**ompetition
vi. **C**ost of Capital
vii. **A**ttitude of Financial Institutions
viii. **T**axation

Types of Capital

Fixed Capital

Factors affecting Fixed Capital Requirement

i. Nature of business
ii. Size of business
iii. Growth and expansion of business
iv. Stage of development of business
v. Business cycle

Working Capital

Factors affecting Working Capital Requirement

[Mnemonic: Bablu RESPECTS VAN]

i. **B**usiness Cycle
ii. **R**equirement of Cash
iii. Growth and **E**xpansion Activities
iv. **S**easonal Fluctuations
v. **P**roduction Cycle
vi. **E**xternal Factors
vii. Credit **C**ontrol
viii. **T**erms of Purchase and Sales
ix. **S**ize of Business
x. **V**olume of Sale
xi. Management **A**bility
xii. **N**ature of Business