

Chapter 1: Introduction to Corporate Finance

EXERCISE Q.1 [PAGES 10 - 12]

Exercise 1 | Q 1.01 | Page 10

Select the correct answer from the options given below and rewrite the statement.

_____ is related to money and money management.

1. Production
2. Marketing
3. **Finance**

SOLUTION

Finance is related to money and money management.

Exercise 1 | Q 1.02 | Page 10

Select the correct answer from the options given below and rewrite the statement.

Finance is the management of _____ affairs of the company

1. **monetary**
2. marketing
3. production

SOLUTION

Finance is the management of **monetary** affairs of the company

Exercise 1 | Q 1.03 | Page 10

Select the correct answer from the options given below and rewrite the statement.

Corporation finance deals with the acquisition and use of _____ by business corporation.

1. **goods**
2. capital
3. land

SOLUTION

Corporation finance deals with the acquisition and use of **capital** by business corporation.

Exercise 1 | Q 1.04 | Page 10

Select the correct answer from the options given below and rewrite the statement.

Company has to pay _____ to government.

1. **taxes**
2. dividend
3. interest

SOLUTION

Company has to pay **taxes** to government.

Exercise 1 | Q 1.05 | Page 10

Select the correct answer from the options given below and rewrite the statement.

_____ refers to any kind of fixed assets.

1. Authorised capital
2. Issued capital
3. **Fixed capital**

SOLUTION

Fixed capital refers to any kind of fixed assets.

Exercise 1 | Q 1.06 | Page 10

Select the correct answer from the options given below and rewrite the statement.

_____ refers to the excess of current assets over current liabilities.

1. **Working capital**
2. Paid-up capital
3. Subscribed capital

SOLUTION

Working capital refers to the excess of current assets over current liabilities.

Exercise 1 | Q 1.07 | Page 10

Select the correct answer from the options given below and rewrite the statement.

Manufacturing industries have to invest _____ amount of funds to acquire fixed assets.

1. **huge**
2. less
3. minimal

SOLUTION

Manufacturing industries have to invest **huge** amount of funds to acquire fixed assets.

Exercise 1 | Q 1.08 | Page 10

Select the correct answer from the options given below and rewrite the statement.

When the population is increasing at high rate, certain manufacturers find this as an opportunity to _____ business.

1. close
2. **expand**
3. contract

SOLUTION

When the population is increasing at high rate, certain manufacturers find this as an opportunity to **expand** business.

Exercise 1 | Q 1.09 | Page 10

Select the correct answer from the options given below and rewrite the statement.

The sum of all _____ is gross working capital.

1. expenses
2. **current assets**
3. current liabilities

SOLUTION

The sum of all **current assets** is gross working capital.

Exercise 1 | Q 1.10 | Page 10

Select the correct answer from the options given below and rewrite the statement.

_____ means mix up of various sources of funds in desired proportion.

1. Capital budgeting
2. **Capital structure**
3. Capital goods

SOLUTION

Capital structure means mix up of various sources of funds in desired proportion.

Exercise 1 | Q 2 | Page 11

Match the pairs.

Group 'A'	Group 'B'
a) Capital budgeting	1) Sum of current assets
b) Fixed capital	2) Deals with acquisition and use of capital
c) Working capital	3) Fixed liabilities
d) Capital structure	4) Sum of current liabilities
e) Corporate finance	5) Fixed assets
	6) Investment decision
	7) Financing decision
	8) Deals with acquisition and use of assets
	9) Mix up of various sources of funds
	10) Product mix

SOLUTION

Group 'A'	Group 'B'
a) Capital budgeting	1) Investment decision
b) Fixed capital	2) Fixed assets
c) Working capital	3) Sum of current assets
d) Capital structure	4) Mix up of various sources use of assets
e) Corporate finance	5) Deals with acquisition and use of capital

Exercise 1 | Q 3.01 | Page 11

Write a word or a term or a phrase which can substitute the following statement.
A key determinant of success of any business function.

SOLUTION

A key determinant of success of any business function. - **Finance**

Exercise 1 | Q 3.02 | Page 11

Write a word or a term or a phrase which can substitute the following statement.
The decision of finance manager which ensures that firm is well capitalised.

SOLUTION

The decision of finance manager which ensures that firm is well capitalised. - **Financing Decision**

Exercise 1 | Q 3.03 | Page 11

Write a word or a term or a phrase which can substitute the following statement.
The decision of finance manager to deploy the funds in systematic manner

SOLUTION

The decision of finance manager to deploy the funds in systematic manner
- **Investment decision**

Exercise 1 | Q 3.04 | Page 11

Write a word or a term or a phrase which can substitute the following statement.
Capital needed to acquire fixed assets which are used for longer period of time.

SOLUTION

Capital needed to acquire fixed assets which are used for longer period of time. - **Fixed Capital**

Exercise 1 | Q 3.05 | Page 11

Write a word or a term or a phrase which can substitute the following statement.
The sum of current assets

SOLUTION

The sum of current assets. - **Working Capital**

Exercise 1 | Q 3.06 | Page 11

Write a word or a term or a phrase which can substitute the following statement.
The excess of current assets over current liabilities.

SOLUTION

The excess of current assets over current liabilities. - **Gross working capital**

Exercise 1 | Q 3.07 | Page 11

Write a word or a term or a phrase which can substitute the following statement.
The process of converting raw material into finished goods.

SOLUTION

The process of converting raw material into finished goods. - **Product Cycle**

Exercise 1 | Q 3.08 | Page 11

Write a word or a term or a phrase which can substitute the following statement.
The boom and recession cycle in the economy

SOLUTION

The boom and recession cycle in the economy. - **Business cycle**

Exercise 1 | Q 3.09 | Page 11

Write a word or a term or a phrase which can substitute the following statement.
The ratio of different sources of funds in the total capital.

SOLUTION

The ratio of different sources of funds in the total capital. - **Capital structure**

Exercise 1 | Q 3.10 | Page 11

Write a word or a term or a phrase which can substitute the following statement.
The internal source of financing.

SOLUTION

The internal source of financing. - **Retained earnings**

Exercise 1 | Q 4.01 | Page 11

State whether the following statement is true or false.

Finance is related to money and money management.

1. **True**
2. False

SOLUTION

Finance is related to money and money management. - **True**

Exercise 1 | Q 4.02 | Page 11

State whether the following statement is true or false.

Business firm gives green signal to the project only when it is profitable.

1. **True**
2. False

SOLUTION

Business firm gives green signal to the project only when it is profitable. - **True**

Exercise 1 | Q 4.03 | Page 11

State whether the following statement is true or false.

Corporate finance brings co-ordination between various business activities.

1. **True**
2. False

SOLUTION

Corporate finance brings co-ordination between various business activities. - **True**

Exercise 1 | Q 4.04 | Page 11

State whether the following statement is true or false.

Fixed capital is also referred as circulating capital.

1. True
2. **False**

SOLUTION

Fixed capital is also referred as circulating capital. - **False**

Exercise 1 | Q 4.05 | Page 11

State whether the following statement is true or false.

Working capital stays in the business almost permanently.

1. **True**

2. False

SOLUTION

Working capital stays in the business almost permanently. - **False**

Exercise 1 | Q 4.06 | Page 11

State whether the following statement is true or false.

The business will require huge funds, if assets are acquired on lease basis.

1. True
- 2. False**

SOLUTION

The business will require huge funds, if assets are acquired on lease basis. - **False**

Exercise 1 | Q 4.07 | Page 11

State whether the following statement is true or false.

The business dealing in luxurious products will require huge amount of working capital.

- 1. True**
2. False

SOLUTION

The business dealing in luxurious products will require huge amount of working capital.
- **True**

Exercise 1 | Q 4.08 | Page 12

State whether the following statement is true or false.

A firm with large scale operations will require more working capital.

- 1. True**
2. False

SOLUTION

A firm with large scale operations will require more working capital. - **True**

Exercise 1 | Q 4.09 | Page 12

State whether the following statement is true or false.

Liberal credit policy creates a problem of bad debts.

- 1. True**
2. False

SOLUTION

Liberal credit policy creates a problem of bad debts. - **True**

Exercise 10 | Q 4.1 | Page 12

State whether the following statement is true or false.

Financial institutions and banks cater to the working capital requirement of business.

1. True
2. False

SOLUTION

Financial institutions and banks cater to the working capital requirement of business.

- True

Exercise 1 | Q 5.1 | Page 12

Find the odd one.

1. Land and Building
2. Plant and Machinery
3. Cash

SOLUTION

Cash

Exercise 1 | Q 5.2 | Page 12

Find the odd one.

1. Debenture Capital
2. Equity Share Capital
3. Preference Share Capital

SOLUTION

Debenture Capital

Exercise 1 | Q 5.3 | Page 12

Find the odd one.

1. Fixed Capital
2. Capital Structure
3. Working Capital

SOLUTION

Capital Structure

Exercise 1 | Q 6.1 | Page 12

Complete the sentence.

Initial planning of capital requirement is made by _____

SOLUTION

Initial planning of capital requirement is made by finance Manager.

Exercise 1 | Q 6.2 | Page 12

Complete the sentence.

When there is boom in economy, sales will _____

SOLUTION

When there is boom in economy, sales will **Increase**

Exercise 1 | Q 6.3 | Page 12

Complete the sentence.

The process of converting raw material into finished goods is called _____

SOLUTION

The process of converting raw material into finished goods is called **Production cycle.**

Exercise 1 | Q 6.4 | Page 12

Complete the sentence.

During recession period sales will _____

SOLUTION

During recession period sales will **Decrease.**

Exercise 1 | Q 7 | Page 12

Select the correct option from the bracket.

Group 'A'	Group 'B'
a) Financing decision	1) _____
b) _____	2) Longer period of time.
c) Investment decision	3) _____
d) _____	4) Circulating capital
e) Combination of various sources of funds	5) _____

(To have right amount of capital, Deploy funds in systematic manner, Fixed capital, Working capital, Capital structure)

SOLUTION

Group 'A'	Group 'B'
a) Financing decision	1) <u>To have a right amount of capital</u>
b) <u>Fixed capital</u>	2) Longer period of time.
c) Investment decision	3) <u>Deploy funds in systematic manner.</u>
d) <u>Working Capital</u>	4) Circulating capital

e) Combination of various sources of funds	5) <u>Capital structure</u>
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Exercise 1 | Q 8.1 | Page 12

Answer in one sentence.

Define corporate finance.

SOLUTION

According to Henry Hoagland, "Corporate finance deals primarily with the acquisition and use of capital by a business corporation."

Exercise 1 | Q 8.2 | Page 12

Answer in one sentence.

What is fixed capital?

SOLUTION

Fixed capital is that portion of capital which is invested in fixed assets such as land, building, furniture, etc.

Exercise 1 | Q 8.3 | Page 12

Answer in one sentence.

Define working capital.

SOLUTION

Gerstenbergh defines it as "The excess of current assets over current liabilities."

Exercise 1 | Q 8.4 | Page 12

Answer in one sentence.

What is production cycle?

SOLUTION

The process of converting raw material into finished goods is called production cycle.

Exercise 1 | Q 8.5 | Page 12

Answer in one sentence.

Define capital structure.

SOLUTION

According to R. H. Wessel, "The long term sources of funds employed in a business enterprise."

Exercise 1 | Q 9.1 | Page 12

Correct the underlined word and rewrite the following sentence.

Finance is needed to pay dividend to debenture holders.

SOLUTION

Finance is needed to pay interest to debenture holders.

Exercise 1 | Q 9.2 | Page 12

Correct the underlined word and rewrite the following sentence.

When there is recession in economy sales will increase.

SOLUTION

When there is boom in economy sales will increase

Exercise 1 | Q 9.3 | Page 12

Correct the underlined word and rewrite the following sentence.

Share is an acknowledgment of loan raised by company.

SOLUTION

Debenture is an acknowledgment of loan raised by company.

Exercise 1 | Q 9.4 | Page 12

Correct the underlined word and rewrite the following sentence.

Equity shares carry dividend at fixed rate.

SOLUTION

Preference shares carry dividend at fixed rate.

EXERCISE 2 [PAGE 13]

Exercise 2 | Q 1 | Page 13

Explain the following term/concept.

Financing decision

SOLUTION

(a) The business firm has access to the capital market to fulfill its financial needs. The firm has multiple choices of sources of financing.

(b) Different types of securities like shares, debentures, etc. can be issued to raise funds. Funds may also be borrowed from financial institutions and lenders. The finance manager must ensure that the firm is well capitalised.

Exercise 2 | Q 2 | Page 13

Explain the following term/concept.

Investment decision

SOLUTION

(a) Investment decisions refer to the decisions regarding utilization of funds raised by the firm. It relates to the selection of assets in which funds are to be invested.

(b) The funds can be invested in two types of assets, namely:

- Long term assets or fixed assets
- Short term assets or current assets

Exercise 2 | Q 3 | Page 13

Explain the following term/concept.

Fixed capital

SOLUTION

(a) Fixed capital refers to capital invested in fixed assets. Fixed Capital is invested in long term assets such as land, building, equipment, etc.

(b) Investor invests money in fixed capital to make a future profit. Fixed capital is usually required at the time of the establishment of the company.

Exercise 2 | Q 4 | Page 13

Explain the following term/concept.

Working capital

SOLUTION

(a) Working capital is the capital that is used to carry out the day to day business activities. The business firm has to arrange capital for making an investment in short term assets such as cash, account receivable, inventory, etc.

(b) The capital invested in these assets is referred to as Working Capital. Investor invests money in working capital for getting an immediate return.

EXERCISE 3 [PAGE 13]

Exercise 3 | Q 1 | Page 13

Study the following case/situation and express your opinion.

The management of 'Maharashtra State Road Transport Corporation', wants to determine the size of working capital.

- a. Being a public utility service provider, will it need less working capital or more?
- b. Being a public utility service provider, will it need more Fixed Capital?
- c. Give one example of public utility service that you come across on day-to-day basis.

SOLUTION

- a. Being a public utility service provider, it will need less working capital.

- b. Yes. Being a public utility service provider, it will need more fixed capital.
- c. BEST Brihanmumbai Electric Supply and Transport undertaking is an example of public utility service.

Exercise 3 | Q 2 | Page 13

Study the following case/situation and express your opinion.

A company is planning to enhance its production capacity and is evaluating the possibility of purchasing new machinery whose cost is 2 crore or has alternative of machinery available on lease basis.

- a. What type of asset is machinery?
- b. Capital used for purchase of machinery is fixed capital or working capital?
- c. Does the size of a business determine the fixed capital requirement?

SOLUTION

- a. Machinery is a fixed asset. This is because it stays with a company for a long period of time.
- b. Capital used for the purchase of machinery is fixed capital. It is the capital that stays in the company almost permanently.
- c. Yes, the size of a business determines the fixed capital requirement. Large size business has high fixed capital requirements and vice versa.

EXERCISE 4 [PAGE 13]

Exercise 4 | Q 1 | Page 13

Distinguish between the following.

Fixed Capital and Working Capital.

SOLUTION

Fixed Capital:	Working Capital
(1) Meaning: Fixed capital refers to any kind of physical capital i.e. fixed assets.	Working capital refers to current assets minus current liabilities.

(2) Nature: It stays in business almost permanently i.e. for more than one accounting year.	It stays in business for a short period of time. Thus, working capital is circulating capital.
(3) Purpose: Fixed Capital is invested in long term assets such as land, building equipment, etc.	Working capital is invested in short term assets such as cash, account receivable, inventory, etc.
(4) Sources: Fixed Capital funding can come from issuing shares, debentures, long term loans, etc.	Working Capital funding can come from short term loans, deposits, trade credit, etc.
(5) Objective of investor: Investor invests money in fixed capital to make a future profit.	Investor invests money in working capital for getting an immediate return.
(6) Risk Involved: Risk involved in fixed capital is high	The risk involved in working capital is less as compared to fixed capital.

EXERCISE Q.5 [PAGE 13]

Exercise 5 | Q 1 | Page 13

Answer in brief.

Define capital structure and state it's components.

SOLUTION

Definition:

“A firm's capital structure is the relation between the debt and equity securities that makes up the firm's financing of it's assets”.

Components of Capital Structure:

There are four basic components of capital structure. They are as follows :

1. **Equity share capital:** It is the basic source of financing activities of the business. Equity shares are shares which get dividend and repayment of capital after it is paid to preference shares. They own the company. They bear the ultimate risk associated with ownership. They carry dividends at a fluctuating rate depending upon the profits.
2. **Preference share capital:** Preference shares carry preferential right as to payment of dividends and have priority over equity shares for return of capital when the company is liquidated. These shares carry dividends at a fixed rate.
3. **Retained earnings:** It is an internal source of financing. It is nothing but a ploughing back of profit.
4. **Borrowed capital:** It comprises the following:
 - a. **Debenture:**
It is an acknowledgement of loans raised by the company. Company has to pay interest at an agreed rate.
 - b. **Term loan:**
Term loans are provided by the bank and other financial institutions. They carry a fixed rate of interest.

Exercise 5 | Q 2 | Page 13

Answer in brief.

State any four factors affecting fixed capital requirement.

SOLUTION

Factors affecting fixed capital requirement:

1. **Nature of business:** Manufacturing industries and public utilities have to invest a huge amount of funds to acquire fixed assets. While the Trading business may not need huge investments in fixed assets.
2. **Size of business:** Where a business firm is set up to carry on large scale operations, its fixed capital requirements are likely to be high. It is because most of their production processes are based on automatic machines and equipment.
3. **Scope of business:** There are business firms which are formed to carry on production or distribution on a large scale. Such businesses would require more amount of fixed capital.
4. **Extent of lease or rent:** If an entrepreneur decides to acquire assets on a lease or on a rental basis, less amount of funds for fixed assets will be needed for the business.

Exercise 5 | Q 3 | Page 13

Answer in brief.

What is corporate finance and state two decisions which are the basis of corporate finance?

SOLUTION

Definition:

“corporate finance deals primarily with the acquisition and use of capital by business corporation.”

Meaning:

The term corporate finance also includes financial planning, study of the capital market, money market and share market. It also covers capital formation and

Two decisions that are the basis of corporate finance.

1. **Financing Decision:** The business firm has access to the capital market to fulfill its financial needs. The firm has multiple choices of sources of financing. The firm can choose whether it wants to raise equity capital or debt capital. Firms can even opt for a bank loan, public deposits, debentures, etc. to raise funds. The finance manager ensures that the firm is well capitalised i.e. they have the right amount of capital and that the firm has the right combination of debt and equity.
2. **Investment Decision:** Once the business firm has gained access to capital, the finance manager has to take a decision regarding the use of the funds in a systematic manner so that it will bring a maximum return for its owners. For this, the firm has to take into consideration the cost of capital. Once they know the cost of capital, the firm can deploy or use the funds in such a way that returns are more than the cost of capital.

EXERCISE 6 [PAGE 13]

Exercise 6 | Q 1 | Page 13

Justify the following statement.

The firm has multiple choices of sources of financing

SOLUTION

Justification:

(a) Finance is the life-blood of the organisation.

The business firm has access to the capital market to fulfill its financial needs.

(b) The firm has multiple choices of sources of financing. Different types of securities like shares, debentures, etc. can be issued to raise funds.

(c) Funds may also be borrowed from financial institutions and lenders. The finance

manager must ensure that the firm is well capitalised.

(d) Thus, it is rightly justified that, the firm has multiple choice of sources of financing.

Exercise 6 | Q 2 | Page 13

Justify the following statement.

There are various factors affecting the requirement of fixed capital.

SOLUTION

Justification:

There are various factors affecting the requirement of fixed capital. Some of them are as follows:

(a) Nature of Business: The nature of business plays a vital role in determining fixed capital requirements.

For instance, a manufacturing company needs more fixed capital as compared to a trading company. This is because, the trading company does not need a plant, machinery, etc.

(b) Size of business: The companies which are operating at large scale require more fixed capital as they need more machinery and other assets.

Whereas, small scale business need less amount of fixed capital. Hence, the size of the firm, either in terms of its assets or sales, affects the need for fixed capital.

(c) Scope of business: The scope of business is the maximum extent up to within which a business can act or perform its business activities.

If the scope of business is vast, it needs higher fixed capital. For instance, a company involved in multiple activities like manufacturing processing, and assembling usually needs a substantial amount of fixed capital. Similarly, if the scope of business is limited, then it requires less fixed capital.

For instance, if a company does only assembling activities, it needs a fewer amount of fixed capital.

(d) The extent of lease or rent: If companies can arrange financial and leasing facilities easily then they require less fixed capital as they can acquire assets on easy instalments instead of paying a huge amount at one time.

On the other hand, if the easy loans and leasing facilities are not available then more fixed capital is needed as companies will have to buy plants and machinery by paying huge amounts together.

(e) Choice of Technique: Those manufacturing enterprises which make use of modern and automatic machines need a large amount of fixed capital.

On the other hand, those enterprises in which production is carried out mainly through labour, need less fixed capital.

Exercise 6 | Q 3 | Page 13

Justify the following statement.

Fixed capital stays in the business almost permanently.

SOLUTION

Justification:

- a. Fixed capital refers to capital invested in fixed assets. Fixed Capital is invested in long term assets such as land, building, equipment, etc.
- b. Investor invests money in fixed capital to make a future profit. It is permanent capital.
- c. Fixed capital is usually required at the time of the establishment of the company.
- d. However, existing companies may also need such capital for their: Expansion and development, Replacement of equipment, etc.
Thus, it is rightly justified that, fixed capital stays in the business almost permanently as it is invested in fixed assets.

Exercise 6 | Q 4 | Page 13

Justify the following statement.

Capital structure is composed of owned funds and borrowed funds.

SOLUTION

Justification:

- a. Capital structure constitutes two words i.e. capital and structure. 'Capital' refers to the investment of funds in the business while 'structure' means the arrangement of different components in proper proportion.
- b. Thus, capital structure means 'mix-up of various sources of funds in desired proportion'. A company can raise its capital from different sources i.e. owned capital or borrowed capital or both.
- c. The owned capital consists of equity share capital, preference share capital, reserves, and surplus. On the other hand, borrowed capital are debentures, loans, etc. The proportion of different sources are used in the capital structure.
- d. Thus, it is rightly justified that, capital structure is composed of owned funds and borrowed funds.

Exercise 6 | Q 5 | Page 13

Justify the following statement.

There are various factors affecting the requirement of working capital.

SOLUTION

Justification:

There are various factors affecting the requirement of working capital. Some of them are as follows:

(a) Nature of business: The requirement of working capital depends on the nature of business. The nature of business is usually of two types:

- Manufacturing Business and
- Trading Business.

- In the case of a manufacturing business, it takes a lot of time in converting raw material into finished goods. Therefore, more working capital is required.

- On the contrary, in the case of trading business, the goods are sold immediately after purchasing, or sometimes the sale is affected even before the purchase itself.

Therefore, less working capital is required.

(b) Size of Business: There is a direct link between working capital and the size of the business.

In other words, more working capital is required in the case of a big organisation.

Whereas, less working capital is required in the case of a small organisation.

(c) Business cycle: The need for working capital is affected by various stages of the business.

For instance:

- During the boom period, the demand for a product increases, and sales also increase. Thus, more working capital is required.
- During the depression period, the demand declines and it affects both the production and sales of goods.

Thus, less working capital is required.

(d) Production cycle: Production cycle means the time involved in converting raw material into a finished product. When the period of the production cycle is more, more working capital will be needed.

On the contrary, when the period of the production cycle is less, less working capital will be needed.

(e) Volume of Cycle: This is the most important factor affecting the size of working capital. The volume of sale and the size of working capital are directly related to each other. For instance, if the volume of sales is more, there is an increase in the amount of working capital. But if the volume of sales is less, there is a decrease in the amount of working capital.

EXERCISE 7 [PAGE 13]

Exercise 7 | Q 1 | Page 13

Answer the following question.

Discuss the importance of corporate finance

Importance of Corporate Finance:

In the functional management of a business enterprise, importance is given to production, finance, marketing, and personnel activities. Among all these activities, the utmost importance is given to financial activities. The importance of corporate finance may be discussed as follows

1. Helps in decision making: Most of the important decisions of business enterprises are determined on the basis of the availability of funds. It is difficult to perform any function of a business enterprise independently without finance. Every decision in the business is needed to be taken keeping in view of its impact on profitability. There may be a number of alternatives but the management is required to select the best one which will enhance profitability. A business organisation can give a green signal to the project only when it is financially viable. Thus corporate finance plays a significant role in the decision making process.

2. Helps in Raising Capital for a project: Whenever a business firm wants to start a new venture, it needs to raise capital. A business firm can raise funds by issuing shares, debentures, bonds, or even by taking loans from the banks.

3. Helps in Research and Development: Research and Development must be undertaken for the growth and expansion of the business. Detailed technical work is essential for the execution of projects. Research and Development is a lengthy process and therefore funds have to be made available throughout the research work. This would require continuous financial support.

4. Helps in smooth running of business firm: A smooth flow of corporate finance is needed so that salaries of employees are paid on time, loans are cleared on time, the raw material is purchased whenever required, sales promotion of existing products is carried out smoothly and new products can be launched effectively.

5. Brings coordination between various activities: Corporate finance plays a significant role in the control and co-ordination of all activities in an organisation. For e.g. Production will suffer if the finance department does not provide adequate finance for the purchase of raw materials and meeting other day-to-day financial requirements for a smooth running of production unit. Due to this, sales will also suffer and consequently, the income of concern, as well as rate of profit, will be affected. Thus the efficiency of every department depends upon effective financial management.

6. Promotes expansion and diversification: Modern machines and modern techniques are required for expansion and diversification. Corporate finance provides money to purchase modern machines and technologies. Therefore finance becomes mandatory for the expansion and diversification of a company.

7. Managing Risk: Company has to manage several risks, such as sudden fall in sales, loss due to natural calamity, loss due to strikes, etc. The company needs financial aid to manage such risks

8. Replace old assets: Assets such as plant and machinery become old and outdated over the years. They have to be replaced by new assets. Finance is required to purchase new assets.

9. Payment of dividend and interest: Finance is needed to pay a dividend to shareholders, interest to creditors, banks, etc.

10. Payment of taxes/fees: Company has to pay taxes to the Government such as Income Tax, Goods and Service Tax (GST), and fees to the Registrar of Companies on various occasions. Finance is needed for paying taxes and fees.

Exercise 7 | Q 2 | Page 13

Answer the following question.

Discuss the factors determining working capital requirement.

SOLUTION

Meaning

Working capital is the capital that is used to carry out the day to day business activities. The business firm has to arrange capital for making an investment in short term assets such as cash, account receivable, inventory, etc.

The capital invested in these assets is referred to as 'Working Capital'. An investor invests money in working capital for getting an immediate return.

Definition:

According to Gerstenbergh, "Working capital is the excess of current assets over liability". This approach is called Net Working Capital.

Factors affecting working capital requirement:

There are no precise standards to measure working capital adequacy. Management has to determine the size of working capital in the light of certain aspects of the business firm and the economic environment within which the firm operates.

1. Nature of business: Firms engaged in manufacturing essential products of daily consumption would need relatively less working capital as there would be constant and sufficient cash inflow in the firm to take care of liabilities. Likewise, public utility concerns have to maintain small working capital because of continuous flow of cash from their customers.

2. Public utility concern: These concerns provide services such as transport, gas, electricity, etc.

On the contrary, if the business is dealing with luxurious products, it requires a huge amount of working capital, as sale of luxurious items are not frequent.

Trading/merchandising firms that are concerned with the distribution of goods have to carry big inventories of goods to meet customer's demand and have to extend credit facilities to attract customers. Hence they need a large amount of working capital.

Merchandising firms are those which are concerned with buying and selling of goods, either as wholesaler or retailer, without altering the physical form of goods.

3. Size of business: The size of the business also affects the requirement of working capital. A firm with large scale operations will require more working capital.

4. The volume of sales: This is the most important factor affecting the size of working capital. The volume of sales and the size of working capital are directly related to each other. If the volume of sales increases, there is an increase in the amount of working capital and vice versa.

5. Production cycle: The process of converting raw material into finished goods is called production cycle.

If the period of the production cycle is longer, then the firm needs more amount of working capital. If the manufacturing cycle is short, it requires less working capital.

6. Business cycle: When there is a boom in the economy, sales will increase. This will lead to an increase in investment in stocks. This requires additional working capital. During a recession, sales will decline and hence the need for working capital will also decline.

7. Terms of purchases and sales: If the firm does not get credit facility for purchases but adopts a liberal credit policy for its sales, then it requires more working capital. On the other hand, if credit terms of purchases are favourable and terms of credits sales are less liberal, then the requirement of cash will be less. Thus working capital requirements will be reduced.

8. Credit control: Credit control includes factors such as the volume of credit sales, the terms of credit sales, the collection policy, etc. If a credit control policy is sound, it is possible for the company to improve its cash flow. If credit policy is liberal, it creates a problem of the collection of funds. It can increase the possibility of bad debts. Therefore a firm requires more working capital. The firm making cash sales requires less working capital.

9. Growth and Expansion :

The working capital requirement of a firm will increase with the growth of a firm. A growing company needs funds continuously to support large scale operations.

10. Management ability :

The requirement of working capital is reduced if there is proper co-ordination between the production and distribution of goods. A firm stocking on heavy inventory calls for a higher-level for working capital.

11. External factors :

If financial institutions and banks provide funds to the firm as and when required, the need for working capital is reduced.