



Collegedunia NCERT Notes

The Ultimate NCERT Revision Guide for Class 12 Business Studies

Chapter 9: Financial Management

What this chapter covers: business finance and financial management; the role, objectives (wealth maximisation) and three financial decisions (investment, financing, dividend); financial planning; capital structure and the factors that determine it; trading on equity; fixed and working capital and their determinants in Indian businesses. Session 2026-27.

Contents

1. Business Finance and Financial Management

Core Definition

Business finance is the money required for carrying out business activities. Almost every business activity needs finance – to establish, run, modernise, expand or diversify.

Financial Management is concerned with the *optimal procurement* (sourcing funds) as well as the *usage* (deploying funds) of finance.

Procurement requires comparing different sources of finance in terms of *cost* and *risk*; usage requires deploying funds in projects that earn more than the cost of those funds.

2. Role and Objectives of Financial Management

2.1 Primary Objective – Wealth Maximisation

Why Wealth, Not Profit

The primary aim of financial management is to maximise *shareholders' wealth*, measured by the *market price of the equity share*. This is preferred over profit maximisation because profit (i) is short-term, (ii) ignores risk, (iii) ignores time value of money, and (iv) can be manipulated by accounting choices.

A financial decision creates wealth only if its *net present value* is positive at the firm's cost of capital.

2.2 Three Financial Decisions

The Three Decisions

**Investment
(Capital Budgeting)**

**Financing
(Capital Structure)**

**Dividend
(Payout vs Retain)**

(i) Investment Decision – where to put the money. Capital budgeting decides long-term investment in fixed assets (plant, R&D, acquisition). Working-capital management decides investment in current assets.

(ii) Financing Decision – where to get the money. Mix of equity and debt (the capital structure).

(iii) Dividend Decision – how much to pay out. Balance shareholder dividend with retained earnings for growth.

3. Financial Planning

Definition

Financial Planning is the preparation of a *financial blueprint* of the organisation's future operations – estimating the funds required, the timing and the sources from which the funds will come.

3.1 Two Twin Objectives

1. **To ensure availability of funds whenever required** – right quantum, right timing, right source.
2. **To see that the firm does not raise resources unnecessarily** – no idle surplus, no unnecessary financial cost.

3.2 Importance

- Tackles uncertainty about future operations.
- Links investment and financing decisions.
- Helps in coordinating various business functions.
- Reduces wastage and surprises.
- Provides a base for evaluating actual vs planned performance.

Memory Aid - A-N

Availability of funds + **N**o unnecessary fund-raising – the two NCERT objectives of financial planning.

4. Capital Structure

Definition

Capital structure is the mix of *owners' funds* (equity + retained earnings) and *borrowed funds* (debt + debentures) in the long-term capital of the firm. The *optimum capital structure* minimises the weighted average cost of capital (WACC) and maximises the market price of the share.

4.1 Trading on Equity

The Core Rule

Trading on equity is beneficial only if

$$\text{ROI} > \text{Cost of Debt}$$

When ROI exceeds the cost of debt, the spread accrues to equity shareholders – their EPS rises. When ROI is less than cost of debt, debt destroys value.

4.2 Factors Affecting Capital Structure

1. **Cash flow position** – stable cash flow supports more debt.
2. **Interest Coverage Ratio (ICR)** – $\frac{\text{EBIT}}{\text{Interest}}$; higher is safer; supports more debt.
3. **Debt Service Coverage Ratio (DSCR)** – $\frac{\text{Profit after tax} + \text{Depreciation} + \text{Interest}}{\text{Interest} + \text{Principal repayment}}$; higher is better.
4. **Return on Investment (ROI)** – if $\text{ROI} > \text{cost of debt}$, more debt is good.
5. **Cost of debt** – lower cost \Rightarrow more attractive debt.
6. **Tax rate** – higher tax \Rightarrow greater tax shield on interest.
7. **Cost of equity** – equity is generally costlier than debt.

8. **Floatation costs** – public issues are expensive; debt is cheaper to float.
9. **Risk consideration** – high business risk \Rightarrow lower financial risk \Rightarrow less debt.
10. **Flexibility** – keep some debt capacity in reserve.
11. **Control** – equity dilutes promoter control; debt does not.
12. **Regulatory framework** – SEBI / Companies Act rules.
13. **Stock market conditions** – bullish market favours equity; bearish favours debt.
14. **Capital structure of peers** – industry norms guide the mix.

5. Fixed Capital

Meaning

Fixed capital refers to investment in *long-term assets* – assets that remain in the business for more than one year (plant, machinery, building, vehicles). The decision is called a *capital budgeting decision*.

Why capital budgeting decisions are special:

- Long-term growth: shape future earning power.
- Large amount of funds involved.
- Risk involved: returns stretch into an uncertain future.
- Irreversible: cannot be undone without heavy loss.

5.1 Factors Affecting Fixed Capital Requirement

1. **Nature of business** – manufacturing needs more, trading less.
2. **Scale of operations** – larger scale, larger fixed capital.
3. **Choice of technique** – capital-intensive needs more, labour-intensive less.
4. **Technology upgradation** – frequent upgrades push up fixed capital.
5. **Growth prospects** – higher anticipated growth \Rightarrow more capacity.
6. **Diversification** – new lines need additional fixed capital.
7. **Financing alternatives** – availability of leasing can reduce fixed capital requirement.
8. **Level of collaboration** – shared facilities reduce per-firm fixed capital.

6. Working Capital

Meaning

Working capital is the capital required to finance the day-to-day operations of the business – raw materials, wages, inventory, debtors – until cash returns from sales.

Net Working Capital

$$\text{NWC} = \text{Current Assets} - \text{Current Liabilities}$$

Current assets (in order of liquidity): cash, marketable securities, bills receivable, debtors, finished goods inventory, work-in-progress, raw materials, prepaid expenses.

Current liabilities: bills payable, creditors, outstanding expenses, advances from customers.

6.1 Liquidity-Profitability Trade-off

- More WC \Rightarrow higher liquidity, lower profitability (funds blocked in low-return current assets).
- Less WC \Rightarrow higher profitability, but liquidity risk.
- Optimum WC \Rightarrow adequate liquidity at the highest possible profitability.

6.2 Factors Affecting Working Capital Requirement

1. **Nature of business** – manufacturing $>$ service.
2. **Scale of operations** – larger scale needs more WC.
3. **Business cycle** – boom \Rightarrow more WC; depression \Rightarrow less.
4. **Seasonal factors** – peak season raises WC.
5. **Production cycle** – longer cycle \Rightarrow more WC.
6. **Credit allowed** (to customers) – more credit \Rightarrow more debtors \Rightarrow more WC.
7. **Credit availed** (from suppliers) – more credit \Rightarrow less WC.
8. **Operating efficiency** – better inventory and debtor turnover \Rightarrow less WC.
9. **Availability of raw material** – erratic supply \Rightarrow higher stock \Rightarrow more WC.
10. **Growth prospects** – more growth \Rightarrow more WC.
11. **Level of competition** – tougher competition \Rightarrow more finished goods stocks and liberal credit \Rightarrow more WC.
12. **Inflation** – rising prices push up WC need.

Why Hindustan Unilever Has Low Working Capital

HUL is a fast-moving consumer goods firm: short production cycle, large supplier credit, quick cash collection through distributor networks, and tight inventory control. Net effect – HUL often operates with *negative* working capital, using supplier money to fund operations.

7. Dividend Decision

7.1 Factors Affecting Dividend Decision

1. Earnings level.
2. Stability of earnings.
3. Stability of dividend (signalling effect).
4. Growth opportunities (retain for positive-NPV projects).
5. Cash flow position.
6. Shareholder preference.
7. Taxation policy.
8. Stock market reaction.
9. Access to capital markets (large firms can payout more).
10. Legal constraints (Companies Act – dividend only from profits, reserves transfer, AGM declaration).
11. Contractual constraints (loan covenants).

8. Quick Recap – Exam-Ready Summary

10-Point Cheat Sheet

1. Business finance = money needed to run a business.
2. Financial management = optimal procurement + usage of funds.
3. Primary objective = wealth maximisation (max market price of share).
4. Three financial decisions: Investment + Financing + Dividend.
5. Financial planning = blueprint; objectives = availability + no surplus.
6. Capital structure = debt-equity mix; optimum = minimum WACC.
7. Trading on equity benefits only if $ROI > \text{cost of debt}$.
8. Fixed capital decisions (capital budgeting) are large, long-term, risky and irreversible.
9. $NWC = CA - CL$; WC trade-off is between liquidity and profitability.
10. Dividend decision: 11 factors, ending in legal + contractual constraints.

CBSE Spotter Words

"Concept that increases return to equity holders due to fixed financial charges" ⇒ **Trading on Equity**. *"Financial blueprint of future operations"* ⇒ **Financial Planning**. *"Buying on credit and selling for cash"* ⇒ **Less working capital**. *"No restriction on dividend"* ⇒ **Wrong - legal + contractual constraints**.

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