

MADE BY
SMIT SIR
Commerce Tutor

CBSE CLASS 12
BUSINESS STUDIES
PREMIUM NOTES

CHAPTER 9
Financial Management

NCERT BASED | EXAM FOCUSED | EASY LANGUAGE

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Chapter Snapshot

#	Question	Answer
1	What is this chapter about?	How businesses manage money — where to invest, how to raise funds, and whether to pay dividends or reinvest profits.
2	Why is it important?	Every business decision ultimately involves money. Financial management is the backbone of all business operations.
3	Real-life use	A startup deciding between a bank loan and investor funding; a company deciding whether to pay dividends or reinvest; deciding how much inventory to hold.
4	Why do students struggle?	Many sub-topics (fixed vs working capital, factors affecting capital structure) have long lists that look similar. Also, Trading on Equity confuses many.
5	How to study it	Understand the 3 financial decisions first. Then do capital structure, fixed capital, and working capital — each with one business example per factor.
6	Exam weight	Very high — Part B chapters carry significant weightage. Capital structure factors and working capital factors are the most-tested topics.
7	Most important areas	3 Financial Decisions (I-F-D), Financial Planning, Capital Structure factors, Fixed Capital factors, Working Capital factors.
8	Difficulty level	Medium-High — conceptually rich. Factors lists are long and need proper examples to distinguish.
9	Revision time	First read — 2 hours. Second revision — 1 hour. Final revision — 30 minutes.
10	One-line summary	Financial management is about taking the right decisions on where to invest, how to raise money, and how to use profits — to maximise the wealth of shareholders.

Section 1 Big Picture of the Chapter

Imagine you are opening 'Smit Sir's Commerce Academy'.

You have a great idea. Students want to enroll. But before you open the doors, three BIG financial questions hit you:

Question 1 — Where to invest? (Investment Decision)

Do you buy your own building (₹50 lakh), or rent one (₹1 lakh/month)? Do you buy 20 computers or 40? Do you invest in a studio for online classes or a physical classroom?

This is the **Investment Decision** — deciding how to use your long-term money.

Question 2 — Where to get the money from? (Financing Decision)

Do you take a bank loan (debt) at 10% interest? Do you bring in a partner who invests but wants a profit share (equity)? Or a mix of both? Taking too much loan = risky. Taking only equity = you share control.

This is the **Financing Decision** — deciding the best mix of debt and equity to fund the business.

Question 3 — What to do with the profits? (Dividend Decision)

After one year, you make ₹5 lakh profit. Do you pay it all out to yourself (dividend)? Keep it all in the business to grow (retained earnings)? Or split it 50-50?

This is the **Dividend Decision** — deciding how to distribute profits.

These three decisions together = Financial Management.

TEACHER TIP — SMIT SIR

Classroom hook: Ask students — 'Imagine you have ₹10 lakh. You want to start a business. What are the first 3 questions you need to answer?' Their answers will map directly to Investment Decision, Financing Decision, and Dividend Decision. Connect emotion to theory in 2 minutes.

Section 2 Learning Objectives

After studying this chapter, you will be able to:

1. Define financial management in CBSE language.
2. Explain the objective of financial management — wealth maximisation vs profit maximisation.
3. Distinguish between Investment Decision, Financing Decision, and Dividend Decision.
4. Explain the concept of Financial Leverage (Trading on Equity) with an example.
5. Define Financial Planning and explain its importance.
6. Explain Capital Structure and the factors affecting it.
7. Define Fixed Capital and explain the factors affecting its requirement.
8. Define Working Capital and its types.
9. Explain the factors affecting Working Capital requirements with examples.
10. Write structured 4-mark and 6-mark exam answers from this chapter.

EXAM TIP

Exam priority: Factors affecting capital structure (10 factors), factors affecting fixed capital (7 factors), and factors affecting working capital (10+ factors) are the three highest-frequency question areas. Master all three factor lists — they appear almost every board exam.

Section 3 Chapter Map

Topic No.	Topic Name	What You'll Learn
1	Meaning & Objectives	Definition + Wealth vs Profit maximisation
2	Financial Decisions	Investment, Financing, Dividend — meaning, factors, and examples
3	Financial Leverage / Trading on Equity	How debt magnifies returns (and losses)
4	Financial Planning	Meaning + Objectives + Importance
5	Capital Structure	Meaning + Optimal capital structure + 10 factors
6	Fixed Capital	Meaning + 7 factors affecting requirement
7	Working Capital	Meaning + Types + 10 factors affecting requirement

MEMORY TRICK

Anchor: Meaning → 3 Decisions → Leverage → Planning → Capital Structure → Fixed Capital → Working Capital.

Story: What IS financial management → What DECISIONS it makes → HOW leverage works → HOW to plan → WHERE to get money (capital structure) → WHERE to invest long-term (fixed capital) → WHERE to invest short-term (working capital).

Section 4 Key Terms Before Starting

Term	Simple Meaning	One-line Example
Financial Management	Planning, organising, directing and controlling financial activities of a firm.	Deciding whether to take a loan or issue shares to fund a new factory.
Wealth Maximisation	Maximising the market value of shareholders' shares over the long term.	A company focuses on sustainable profits that raise its share price from ₹100 to ₹500.
Investment Decision	Decision on where to deploy long-term funds (in which assets).	Should we build our own factory or buy machinery?
Financing Decision	Decision on the right mix of debt and equity.	Should we take a bank loan or issue equity shares to fund expansion?
Dividend Decision	Decision on what portion of profit to distribute as dividend and what to retain.	Of ₹10 crore profit: pay ₹6 crore as dividend, retain ₹4 crore.
Capital Structure	The mix (ratio) of long-term debt and equity in a firm's financing.	Debt: Equity = 40:60 — a moderately leveraged capital structure.
Financial Leverage	Using debt (fixed-interest) funds to magnify returns on equity.	Borrowing at 8% and investing at 15% — difference goes to shareholders.
Trading on Equity	Using borrowed funds to earn more than the cost of debt — magnifying EPS.	Borrowing ₹10 lakh at 10% and earning 20% return → shareholders gain extra 10%.
Fixed Capital	Capital invested in long-term (fixed) assets like land, buildings, machinery.	A factory building, manufacturing plant, or commercial vehicle fleet.
Working Capital	Capital needed for day-to-day operations — to finance current assets.	Cash to pay salaries, money tied up in raw material stock, debtors.
Gross Working Capital	Total investment in all current assets.	Total current assets of ₹50 lakh = gross working capital.
Net Working Capital	Current assets minus current liabilities.	Current assets ₹50 lakh – current liabilities ₹20 lakh = NWC ₹30 lakh.
Financial Planning	Estimating the fund requirements of a business and deciding how to meet them.	Planning that the business will need ₹2 crore next year for expansion, and how to raise it.
EPS	Earnings Per Share — net profit available to equity shareholders divided by number of shares.	Profit ₹10 lakh, shares 1 lakh → EPS = ₹10 per share.

Section 5 Detailed Topic-wise Notes

Topic 1 Meaning and Objective of Financial Management

A. Simple Meaning

Financial management means planning, organising, directing and controlling financial activities — particularly the procurement (getting money) and utilisation (using money) of funds — to meet business goals.

B. CBSE / NCERT Definition

DEFINITION

Financial Management is concerned with the optimal procurement of funds and their effective utilisation with a view to maximising the owner's wealth.

Three key words:

Optimal procurement = getting money at the **lowest cost** from the **right sources**.

Effective utilisation = investing money in the **right assets** to generate **maximum returns**.

Maximise owner's wealth = the ultimate goal — increase the **market value of shares** over time.

C. Objective — Wealth Maximisation, NOT just Profit Maximisation

Basis	Profit Maximisation	Wealth Maximisation
Meaning	Maximise short-term profit in absolute terms.	Maximise the long-term market value of shareholders' wealth (share price).
Time frame	Short-term focus.	Long-term, sustainable focus.
Risk consideration	Ignores risk — focuses on any profit, even if risky.	Considers risk — sustainable returns matter more than high-risk profits.
Time value of money	Ignores time value — ₹1 today = ₹1 next year.	Considers time value — ₹1 today is worth more than ₹1 next year.
Quality of earnings	Ignores quality — any source of profit is acceptable.	Considers quality — sustainable, transparent earnings only.
Dividend policy	May pay high dividends to show profit.	Decides dividends based on long-term growth and shareholder value.
CBSE preference	Considered INADEQUATE as the	Considered the CORRECT objective of

Basis	Profit Maximisation	Wealth Maximisation
	sole objective.	financial management.
Example	Cutting R&D to boost this year's profit.	Investing in R&D to build products that grow share price over 5 years.

COMMON MISTAKE

Do NOT write: 'The objective of financial management is to maximise profit.' That is WRONG in CBSE context.

WRITE: 'The objective of financial management is wealth maximisation — maximising the market value of equity shares — which is superior to profit maximisation because it considers time value of money, risk, and quality of earnings.'

KEYWORDS FOR EXAM

Must-use: wealth maximisation, market value of shares, time value of money, risk, quality of earnings, optimal procurement, effective utilisation.

Topic 2 Three Financial Decisions

Every financial manager makes **three major decisions**. Together they determine the financial health of any business.

1

INVESTMENT DECISION — Where to invest long-term funds?



2

FINANCING DECISION — What is the best mix of debt and equity?



3

DIVIDEND DECISION — How much profit to distribute vs retain?

2.1 Investment Decision (Capital Budgeting Decision)

DEFINITION

Investment Decision is the decision about where to invest the long-term funds of the business — in which fixed assets (long-term) or current assets (short-term).

Two types:

- (1) **Long-term investment decision (Capital Budgeting):** investing in fixed assets — land, building, machinery, plant.
- (2) **Short-term investment decision (Working Capital Management):** investing in current assets — cash, inventory, debtors.

Factors considered in Investment Decision (Capital Budgeting):

Factor	Explanation	Example
1. Cash flows of the project	The stream of cash inflows and outflows expected from the investment. Higher and more certain cash flows = better investment.	A new machine costing ₹50 lakh generates ₹10 lakh/year net cash flow for 8 years — good investment.
2. Rate of return (IRR)	Expected profitability of the investment. Higher return = better. Compare with cost of capital.	If the investment generates 18% return but capital costs 12% — invest.
3. Risk involved	Greater uncertainty in cash flows = greater risk. Risk-adjusted returns must be evaluated.	Investing in a new international market carries more risk than expanding an existing domestic line.
4. Investment criteria used	Different evaluation methods: NPV (Net Present Value), IRR (Internal Rate of	NPV of Project A = ₹5 lakh positive — accept. NPV negative

Factor	Explanation	Example
	Return), Payback Period — each gives different answers.	— reject.

EXAM TIP

Board exam tip: When a question asks 'What is capital budgeting?' — answer: capital budgeting = long-term investment decisions — deciding whether to invest in fixed assets like land, building, machinery. Always add: 'The goal is to select the project with maximum return at acceptable risk.'

2.2 Financing Decision

DEFINITION

Financing Decision is the decision about the best capital mix — the right proportion of debt (borrowed funds) and equity (owner's funds) — to finance the business.

Simple: How much should we borrow? How much should we raise from shareholders? What is the safest and cheapest combination?

Key concept — Financial Leverage / Trading on Equity:

CONCEPT — TRADING ON EQUITY / FINANCIAL LEVERAGE

Trading on equity means using borrowed funds (debt) at a fixed interest cost to earn a higher return — and passing the surplus to equity shareholders, thereby increasing their EPS (Earnings Per Share).

Simple: Borrow at 10% interest. Invest and earn 20% return. The extra 10% goes to shareholders. Shareholders gain MORE by using debt — that's the 'trade'.

Numerical Example:

Firm A: Capital ₹10 lakh, all equity. Earnings ₹2 lakh. $EPS = ₹2 \text{ lakh} / 10,000 \text{ shares} = ₹20$.

Firm B: Capital ₹10 lakh = ₹5 lakh equity + ₹5 lakh debt at 10%. Earnings ₹2 lakh, Interest = ₹50,000. Net for equity = ₹1.5 lakh / 5,000 shares = ₹30.

Firm B's EPS is ₹30 vs Firm A's ₹20 — by using debt (leverage), equity shareholders gain more.

Caution: Leverage magnifies gains when return > interest rate. But it also magnifies losses when return < interest rate. High debt = high risk.

10 Factors Affecting Financing Decision (Capital Structure):

These **10 factors** are **one of the most asked 5/6-mark questions** in CBSE boards. Know ALL 10 with example.

1. Cash Flow Position

Explanation: A business with strong, consistent cash flows can comfortably service debt (pay interest on time). Weak cash flows make debt risky.

EXAMPLE

A mature FMCG company like HUL has predictable cash flows — can take on more debt safely.

Keywords: cash flow, debt servicing, interest payment

2. Interest Coverage Ratio

Explanation: $ICR = EBIT / \text{Interest}$. Higher ICR = company earns much more than interest due = can safely take more debt.

EXAMPLE

EBIT = ₹10 lakh, Interest = ₹2 lakh → $ICR = 5$. Comfortable to add more debt. ICR of 1.5 = risky.

Keywords: ICR, EBIT, interest, coverage

3. Debt Service Coverage Ratio (DSCR)

Explanation: $DSCR = \text{Earnings available for debt service} / \text{Debt service amount}$. Measures ability to repay both principal and interest.

EXAMPLE

A firm with DSCR of 3 can repay debt 3x over — lenders are happy to give more loans.

Keywords: DSCR, principal repayment, lenders, debt capacity

4. Return on Investment (ROI)

Explanation: If $ROI > \text{interest rate on debt}$ → taking debt is profitable (trading on equity works). If $ROI < \text{interest rate}$ → avoid debt.

EXAMPLE

$ROI = 20\%$, Debt interest rate = 10% → debt is beneficial. $ROI = 8\%$, Debt rate = 10% → avoid debt.

Keywords: ROI, interest rate, leverage, profitable

5. Cost of Debt

Explanation: Lower the interest rate on debt, more attractive is debt as a source of finance. High interest rates make debt expensive and risky.

EXAMPLE

In 2020, interest rates were low — many companies raised cheap debt to expand. In 2023,

rates rose — same companies switched to equity.

Keywords: cost of debt, interest rate, cheap finance

6. Tax Rate

Explanation: Interest paid on debt is tax-deductible. So debt has a tax advantage — the higher the tax rate, the more valuable the tax shield.

EXAMPLE

Company pays 30% tax. Interest = ₹1 lakh. Tax saving = ₹30,000. Net cost of debt = ₹70,000 instead of ₹1 lakh.

Keywords: tax shield, tax deductible, interest, tax advantage

7. Flexibility

Explanation: Too much debt reduces flexibility — covenants restrict business decisions. Good capital structure maintains borrowing capacity for future needs.

EXAMPLE

A company that has used all its debt capacity cannot borrow more in an emergency. Keeping some 'borrowing headroom' = financial flexibility.

Keywords: flexibility, future borrowing, capacity, headroom

8. Control

Explanation: Issuing new equity shares dilutes the existing shareholders' control (ownership percentage falls). Debt does not dilute control. Companies wary of losing control prefer debt.

EXAMPLE

Promoters holding 70% do not want to issue more shares (would dilute to 50%). They prefer debt to maintain control.

Keywords: control, dilution, shareholding, promoter

9. Floatation Costs

Explanation: Floatation costs = costs of issuing shares (broker fees, legal fees, SEBI compliance, listing fees). These are high for equity. Debt has lower floatation costs.

EXAMPLE

Issuing a public IPO costs crores in fees. Taking a bank loan costs minimal processing fee. Low floatation cost = preference for debt.

Keywords: floatation cost, issue cost, IPO, equity

10. Regulatory Framework

Explanation: RBI guidelines, SEBI regulations, Companies Act — all regulate how much debt a company can take and how equity can be issued. Business must comply.

EXAMPLE

RBI limits bank lending to a single borrower at 15-20% of bank capital — this caps how much debt a company can get from one bank.

Keywords: RBI, SEBI, regulations, compliance, legal limit

MEMORY TRICK

Memory trick — "C-I-D-R-C-T-F-C-F-R" / "Can I Decide Rates? Consider Tax, Flexibility, Control, Floatation, Regulation.":

C — Cash flow position

I — Interest Coverage Ratio

D — Debt Service Coverage Ratio

R — Return on Investment

C — Cost of debt

T — Tax rate

F — Flexibility

C — Control

F — Floatation costs

R — Regulatory framework

2.3 Dividend Decision

DEFINITION

Dividend Decision is the decision on how much of the net profit should be distributed to shareholders as dividend and how much should be retained in the business as retained earnings.

Dividend payout ratio = $\text{Dividend} / \text{Net Profit} \times 100$

Retention ratio = $1 - \text{Dividend payout ratio}$

Simple: Out of ₹100 profit — how much to pay out (dividend), how much to keep (retained earnings for growth)?

Factors Affecting Dividend Decision:

Factor	Explanation
1. Earnings	Dividends can only be paid from profits. More stable and higher earnings = ability to pay more dividend.
2. Stability of Earnings	Companies with stable earnings can commit to regular dividends. Companies with volatile earnings pay variable or no dividends.
3. Growth Opportunities	If the business has high-return investment opportunities, it should retain profits rather than pay dividend. Shareholders benefit more from reinvestment than cash dividends.
4. Cash Flow Position	Dividend requires cash outflow. Even if profit is high, if cash is low (tied in debtors or inventory), dividend cannot be paid. Profits $\neq$ Cash.
5. Shareholder Preferences	Some shareholders (retired, income-seeking) prefer regular cash dividends. Others (growth investors) prefer retained earnings → capital appreciation.
6. Taxation Policy	If dividend income is taxed higher than capital gains, shareholders may prefer the company to retain earnings (capital gains route). Tax laws shape dividend preference.
7. Stock Market Reactions	A dividend cut often signals trouble — stock price drops. Consistent dividend payments signal financial health and stabilise share price.
8. Legal Constraints	Companies Act requires companies to transfer a portion of profits to reserves before declaring dividend. Dividend cannot be paid out of capital.
9. Access to Capital Market	If a company can easily raise funds from the market (strong credit rating, strong brand), it can afford to pay more dividends — it can always raise money for growth externally.
10. Contractual Constraints	Loan agreements may restrict dividend payments until certain debt ratios are maintained. Bondholders may require no dividend above a certain level.

MEMORY TRICK

Trick for 10 Dividend Decision factors — "E-S-G-C-S-T-S-L-A-C":

Earnings, Stability of earnings, Growth opportunities, Cash flow, Shareholder preference, Taxation, Stock market reaction, Legal constraints, Access to capital market, Contractual constraints.

Recall: "Every Stable Growing Company Should Think Smartly — Legal Access Comes."

Topic 3 Financial Planning

A. Meaning

DEFINITION

Financial Planning is the process of estimating the funds required for a business and deciding their sources — to ensure that adequate funds are available for smooth and effective operations.

Simple: Thinking ahead — 'How much money will we need next year? Where will it come from? How do we make sure we always have enough?'

B. Objectives of Financial Planning

11. Ensure that adequate funds are available when needed — neither too much nor too little.
12. Ensure that the firm does not raise funds unnecessarily (excess funds = idle, wasted).
13. Ensure that the firm does not face shortage of funds at critical times.
14. Ensure smooth financial operations — salaries paid on time, suppliers paid, taxes filed.

C. Importance of Financial Planning

Point	Explanation
Makes the firm future-ready	Planning anticipates fund requirements in advance — no last-minute scrambles for money.
Links the present with the future	Bridges current financial position and future goals — creates a clear financial roadmap.
Avoids business shocks and surprises	Identifies potential cash shortfalls, excess capital situations, and high-risk periods in advance.
Helps coordinate activities	Finance plan coordinates with production, marketing, HR plans — ensuring all departments get the funds they need.
Reduces wastage and duplication	Planned funds are used optimally — no excess raising, no idle funds.
Basis for financial control	The financial plan becomes the standard against which actual financial performance is measured.

EXAM TIP

Exam tip: Financial Planning questions are often 3-mark questions asking for 'any three importance' or 2-mark 'meaning' questions. Always include the phrase 'ensures adequate funds' and 'avoids shortage and surplus' — these are the most CBSE-recognised phrases.

Topic 4 Capital Structure

A. Meaning

DEFINITION

Capital Structure refers to the mix or composition of long-term sources of finance — specifically the ratio between long-term debt and equity — used by a company to fund its assets and operations.

Simple: A recipe of how a business is funded long-term. Example: 40% debt + 60% equity = a '40:60 debt-equity capital structure'.

Optimal Capital Structure: The mix that minimises the cost of capital and maximises the market value of the firm (share price). It is the **goal** of the financing decision.

EXAMPLE

Example:

Company X: ₹100 crore total capital = ₹30 crore debt + ₹70 crore equity (Debt:Equity = 30:70)

Company Y: ₹100 crore total capital = ₹60 crore debt + ₹40 crore equity (Debt:Equity = 60:40)

Y has higher financial leverage — more risky but potentially higher EPS if business earns more than interest rate.

Note: The **10 factors affecting capital structure** are the SAME as the 10 factors affecting the **financing decision**. Refer to Topic 2.2 (Financing Decision) — do NOT repeat separately.

Topic 5 Fixed Capital

A. Meaning

DEFINITION

Fixed Capital refers to the capital invested in fixed (long-term) assets — assets that are not meant for sale but are used for production purposes over a long period.

Examples of fixed assets: Land, buildings, plant, machinery, vehicles, computers, furniture.

Simple: Money locked up in things that last many years and help produce goods/services — NOT for immediate sale.

B. 7 Factors Affecting Fixed Capital Requirements

These **7 factors** determine **how much a business needs to invest in fixed assets**. A common **4-5 mark question**.

1. Nature of Business

Explanation: Manufacturing companies need heavy machinery, large plants, big warehouses — very high fixed capital. Service companies (banks, IT firms, coaching) need minimal fixed assets — lower fixed capital.

EXAMPLE

A steel plant needs ₹5,000 crore in fixed assets. A software company like Infosys needs mainly computers and office space — comparatively much less.

Keywords: manufacturing vs service, nature of activity, asset intensity

2. Scale of Operations

Explanation: Larger scale = larger production = more and larger machines, bigger factories, more vehicles. Smaller scale = lower fixed capital requirement.

EXAMPLE

Maruti's Gurugram plant (1 million cars/year) needs far more fixed capital than a small car assembly unit making 10,000 cars/year.

Keywords: scale, size, volume, output level

3. Technology Used

Explanation: Capital-intensive technology (robots, automation) requires heavy investment in machines. Labour-intensive production uses less fixed capital but more human labour.

EXAMPLE

A fully automated bottling plant for Coca-Cola uses expensive robotic machines — high fixed capital. A small artisanal bakery uses mainly human labour — low fixed capital.

Keywords: capital intensive, labour intensive, technology, automation

4. Growth Prospects

Explanation: A company expecting rapid future growth must invest more in fixed assets NOW to have capacity ready for future demand. Conservative growth = lower fixed capital investment.

EXAMPLE

Jio invested ₹1.5 lakh crore in fixed assets (towers, fibre) before it had 100 million customers — anticipating massive future growth.

Keywords: growth, expansion, future capacity, investment

5. Diversification

Explanation: A company that diversifies into new products or new businesses needs additional fixed assets for each new venture.

EXAMPLE

When Reliance entered retail (from petrochemicals), it had to invest in thousands of retail stores, warehouses, and logistics infrastructure — massive fixed capital addition.

Keywords: diversification, new product, new venture, expansion

6. Financing Alternatives / Lease vs Buy

Explanation: A company can lease fixed assets instead of buying them — reducing fixed capital requirement significantly. Renting office space vs buying it = very different fixed capital implications.

EXAMPLE

Airlines lease most of their aircraft instead of buying — this dramatically reduces their fixed capital requirement. IndiGo leases 95%+ of its fleet.

Keywords: lease, buy, rent, own, asset acquisition method

7. Level of Collaboration / Outsourcing

Explanation: If a company outsources certain production processes (e.g. packaging, logistics), it needs less fixed capital itself. Higher collaboration = lower own fixed asset requirement.

EXAMPLE

Apple does NOT own most manufacturing plants — it outsources to Foxconn. Apple's fixed capital is mainly in design labs and tech infrastructure. Foxconn carries the manufacturing fixed capital.

Keywords: outsourcing, collaboration, make or buy, vertical integration

MEMORY TRICK

Memory trick — "N-S-T-G-D-F-L":

N — Nature of business

S — Scale of operations

T — Technology used

G — Growth prospects

D — Diversification

F — Financing alternatives (lease vs buy)

L — Level of collaboration / outsourcing

Recall: "Now Smit Teaches Good Data Fundamentals Logically."

Topic 6 Working Capital

A. Meaning

DEFINITION

Working Capital refers to the capital (funds) required for day-to-day operations — financing the current assets of a business.

Gross Working Capital = Total Current Assets

(Cash + Bank + Debtors + Inventory + Short-term investments)

Net Working Capital = Current Assets – Current Liabilities

Positive NWC = current assets > current liabilities → business can meet short-term obligations.

Simple analogy: Working capital is the **fuel** that keeps the business engine running daily. Fixed capital is the engine itself. You need both.

B. Types of Working Capital

Type	Meaning	Example
Permanent / Fixed Working Capital	The minimum level of current assets always needed to keep operations running — even in the slowest period.	A school always needs at least ₹5 lakh in cash for salaries, utilities, even in the off-season.
Temporary / Variable Working Capital	Extra working capital needed during peak/seasonal periods — over and above the permanent minimum.	A Diwali gift company needs extra cash and inventory in October–November.
Gross Working Capital	Total investment in all current assets.	Total current assets = ₹80 lakh.
Net Working Capital	Current assets minus current liabilities.	CA ₹80 lakh – CL ₹30 lakh = NWC ₹50 lakh.

C. 10 Factors Affecting Working Capital Requirements

This is the **most tested topic in this chapter** — 5-mark and 6-mark questions appear almost every year. Know all 10 factors clearly.

1. Nature of Business

Explanation: Manufacturing firms need lots of raw material, WIP, finished goods — high working capital. Trading firms have faster inventory turnover — moderate. Service firms (banks, IT) have minimal inventory — very low working capital.

EXAMPLE

A textile mill holds 3 months of cotton, work-in-process yarn, finished fabric inventory → very high WC. A courier company mainly holds fuel and packing materials → low WC.

Keywords: manufacturing, service, trading, inventory, nature

2. Scale of Operations

Explanation: Larger operations require more raw material, more debtors, more cash on hand. Working capital requirement grows proportionally with scale.

EXAMPLE

Hindustan Unilever (100+ products, pan-India) needs far more working capital than a regional soap brand.

Keywords: scale, size, volume, proportional

3. Business Cycle

Explanation: During boom (economic growth), sales are high — more debtors, more inventory needed → higher WC. During recession, sales slow → lower WC needed.

EXAMPLE

During India's post-COVID recovery (2022), consumer companies saw surging demand and needed 30-40% more working capital to fund higher inventory and debtors.

Keywords: boom, recession, economic cycle, demand

4. Seasonal Factors

Explanation: Businesses with seasonal demand need MORE working capital in peak season and LESS in off-season. They must plan for the peak.

EXAMPLE

A raincoat manufacturer needs huge inventory of raw material and finished goods before monsoon (June). In December, WC falls drastically.

Keywords: seasonal, peak, off-season, cyclical demand

5. Production Cycle (Operating Cycle)

Explanation: The operating cycle = time from buying raw material → producing → selling → collecting cash. Longer the cycle, more WC needed because money is 'stuck' longer.

EXAMPLE

Shipbuilding: takes 2–3 years from raw material to finished ship → very long operating cycle → very high WC. A fast-food restaurant: cycle is minutes → very low WC.

Keywords: operating cycle, production cycle, length, cash conversion

6. Credit Allowed to Customers (Debtors)

Explanation: More credit given to customers = higher debtors = more WC needed. Liberal credit policy → high WC. Strict credit policy → lower WC.

EXAMPLE

A B2B industrial supplier gives 90-day credit to clients → large debtor balance → high WC.
A retail supermarket collects cash immediately → low WC from debtors.

Keywords: debtors, credit policy, receivables, collection period

7. Credit Availed from Suppliers (Creditors)

Explanation: More credit TAKEN from suppliers = less cash paid immediately = lower WC needed. Supplier credit is FREE short-term financing.

EXAMPLE

A retailer gets 60-day credit from all its FMCG suppliers → can stock the shelves without paying immediately → lower WC requirement.

Keywords: creditors, trade credit, payables, supplier terms

8. Operating Efficiency

Explanation: Efficient firms convert raw material to finished goods and collect cash faster — lower WC needed. Inefficient firms have high wastage, slow production, slow collections — higher WC.

EXAMPLE

Toyota's 'Just-in-Time' manufacturing: raw material arrives just when needed, waste is minimal → one of the lowest WC ratios in the auto industry.

Keywords: efficiency, JIT, waste reduction, lean, productivity

9. Availability of Raw Material

Explanation: If raw material is scarce or supply is uncertain, businesses hold larger safety stocks → higher WC. If supply is reliable, they hold less stock → lower WC.

EXAMPLE

During chip shortage (2021-22), auto companies stockpiled semiconductors → dramatic rise in WC. Normally, they use JIT.

Keywords: raw material, stock, safety stock, supply chain, scarcity

10. Level of Competition

Explanation: High competition may force businesses to offer more credit to retain customers AND hold larger, more varied inventory for faster delivery → both increase WC.

EXAMPLE

In a competitive market like e-commerce, companies offer 30-day free returns and next-day delivery → both require higher WC (more inventory, more receivables buffer).

Keywords: competition, credit terms, inventory range, market pressure

MEMORY TRICK

Memory trick — Group into 3 clusters:

Cluster 1 — Business Profile: Nature (1), Scale (2), Business cycle (3), Seasonal (4), Production cycle (5)

Cluster 2 — Cash Flow: Credit allowed (6), Credit availed (7), Operating efficiency (8)

Cluster 3 — External: Raw material availability (9), Competition (10)

Quick recall: "NSBSP – CCoE – RA–C": Nature, Scale, Business cycle, Seasonal, Production cycle — Credit given, Credit taken, Operational efficiency — Raw material, Competition.

Section 7 Difference Tables

7.1 Fixed Capital vs Working Capital

Basis	Fixed Capital	Working Capital
Meaning	Capital invested in long-term (fixed) assets.	Capital used for day-to-day (current) operations.
Nature of assets	Fixed / long-term assets: land, building, plant, machinery.	Current assets: cash, debtors, inventory, short-term investments.
Time horizon	Long-term — assets last 5, 10, 20+ years.	Short-term — assets converted to cash within one year.
Purpose	To build productive capacity.	To fund daily operations and maintain liquidity.
Example	Buying a factory (₹5 crore).	Buying raw material stock (₹50 lakh).
Decision type	Investment decision (Capital Budgeting).	Working capital management (short-term investment decision).
Liquidity	Low — cannot be quickly converted to cash.	High — current assets are liquid.

7.2 Gross Working Capital vs Net Working Capital

Basis	Gross Working Capital	Net Working Capital
Meaning	Total investment in all current assets.	Current Assets minus Current Liabilities.
Formula	$GWC = \text{Total Current Assets}$	$NWC = \text{Current Assets} - \text{Current Liabilities}$
Focus	Focus on gross assets — no adjustment for liabilities.	Focus on net liquidity position.
Positive / Negative	Always positive (total current assets cannot be negative).	Can be positive (healthy) or negative (risk of insolvency).
Example	CA = ₹80 lakh → GWC = ₹80 lakh	CA ₹80 lakh – CL ₹30 lakh = NWC ₹50 lakh

7.3 Wealth Maximisation vs Profit Maximisation

Basis	Profit Maximisation	Wealth Maximisation
Objective	Maximise short-term profit.	Maximise long-term shareholder wealth (share price).
Time value of money	Ignores.	Considers — ₹1 now is worth more than ₹1 later.
Risk	Ignores risk level.	Considers risk-adjusted returns.
Quality of earnings	Ignores — any profit counts.	Considers — sustainable, transparent earnings only.
CBSE verdict	Inadequate as sole objective.	Correct and recommended objective.

7.4 Permanent vs Temporary Working Capital

Basis	Permanent Working Capital	Temporary Working Capital
Meaning	Minimum WC required even in the slowest period.	Extra WC required during peak season.
Nature	Constant / fixed throughout the year.	Variable — rises in peak, falls in off-peak.
Financed by	Long-term sources (term loans, equity).	Short-term sources (bank overdraft, trade credit).
Example	A school needs at least ₹5 lakh WC always.	Same school needs ₹10 lakh extra in June (admission season).

Section 9 All Memory Tricks at One Place

Topic	Trick	Expansion
3 Financial Decisions	I-F-D	Investment, Financing, Dividend
4 factors in Investment Decision	C-R-R-I	Cash flows, Rate of return, Risk, Investment criteria
10 factors in Financing Decision	C-I-D-R-C-T-F-C-F-R	Cash flow, ICR, DSCR, ROI, Cost of debt, Tax, Flexibility, Control, Floatation, Regulation
10 factors in Dividend Decision	E-S-G-C-S-T-S-L-A-C	Earnings, Stability, Growth, Cash flow, Shareholder pref, Tax, Stock market, Legal, Access to mkt, Contractual
7 factors in Fixed Capital	N-S-T-G-D-F-L	Nature, Scale, Technology, Growth, Diversification, Finance alternatives, Level of collaboration
10 factors in Working Capital	NSBSP-CCoE-RC	Nature, Scale, Business cycle, Seasonal, Prod cycle, Credit given, Credit taken, Efficiency, Raw material, Competition

Section 10 Case Study Practice

Case Study 1 — Easy (Identify the Financial Decision)

CASE STUDY

Case: Read each situation and identify the financial decision involved.

- (a) The board of directors of XYZ Ltd. is deciding whether to set up a new manufacturing plant costing ₹50 crore.
- (b) The CFO of ABC Ltd. is evaluating whether to raise funds through a bank loan at 11% or by issuing equity shares.
- (c) The management of Bright Ltd. decided to pay 40% of this year's profits as dividend and retain the remaining 60%.
- (d) PQR Ltd. is evaluating whether to buy new delivery trucks or lease them for 5 years.

Answers:

- (a) **Investment Decision (Capital Budgeting)** — deciding to invest ₹50 crore in a fixed asset (new plant).
- (b) **Financing Decision** — choosing between debt (loan at 11%) and equity (issue shares) to fund the business.
- (c) **Dividend Decision** — allocating profit between dividend (40%) and retained earnings (60%).
- (d) **Investment Decision** — specifically the factor 'Financing Alternatives / Lease vs Buy' within fixed capital decision.

Keywords: investment decision, capital budgeting, financing decision, dividend decision, retained earnings.

Case Study 2 — Moderate (Trading on Equity)

Item	Option A: All Equity	Option B: Debt + Equity
EBIT	₹4,00,000	₹4,00,000
Less: Interest (10% on ₹10 lakh)	NIL	₹1,00,000
EBT	₹4,00,000	₹3,00,000
Less: Tax (30%)	₹1,20,000	₹90,000

Item	Option A: All Equity	Option B: Debt + Equity
EAT (Profit for equity holders)	₹2,80,000	₹2,10,000
No. of equity shares	20,000 shares	10,000 shares
EPS	₹14 per share	₹21 per share

CASE STUDY

Case: 'Sunrise Manufacturing Ltd.' has total capital of ₹20 lakh. Currently, the capital is entirely equity (20,000 shares of ₹100 each). The company earns EBIT of ₹4 lakh and pays 30% tax. The management is considering restructuring capital to ₹10 lakh equity + ₹10 lakh debt at 10% interest.

Q1: Calculate EPS under both options.

Q2: Is the use of debt beneficial? Explain using the concept of Trading on Equity.

Answer Q2: Yes, debt is beneficial here. EPS rose from ₹14 to ₹21 by using debt. This is **Trading on Equity / Financial Leverage** — using debt at 10% interest while the business earns 20% ROI (₹4 lakh on ₹20 lakh). The surplus (10%) goes to equity shareholders, boosting EPS.

Caution in answer: Add — 'However, if EBIT falls or ROI drops below 10%, the debt magnifies losses — financial leverage is a double-edged sword.'

Keywords: trading on equity, financial leverage, EPS, debt, equity, EBIT, interest, tax shield.

Case Study 3 — Difficult / HOTS (Working Capital Factors)

CASE STUDY

Case: 'FrostBite Ice Cream Ltd.' makes ice cream. Its peak season is April–September. The company sources cream and sugar from suppliers who give 30-day credit. It sells entirely on cash basis (no credit to retailers). The company has invested in automated production lines. Recently, sugar prices have been volatile, forcing the company to stock 3 months of sugar inventory. Its competitors offer 45-day credit to retailers, but FrostBite does not.

Q1: Identify and explain FOUR factors from the case that affect FrostBite's working capital requirements.

Q2: Suggest one change in credit policy that could reduce working capital requirements.

Answer Q1:

(i) **Seasonal factors** — peak April–September → FrostBite needs high WC in summer for raw material and production, lower WC in winter. Seasonal demand directly drives WC

volatility.

(ii) **Availability of raw material** — volatile sugar prices force FrostBite to stock 3 months of sugar as safety stock → significantly increases WC tied up in raw material inventory.

(iii) **Credit availed from suppliers** — 30-day credit from cream/sugar suppliers reduces immediate cash requirement → partially reduces WC need.

(iv) **Credit allowed to customers** — FrostBite sells on cash (no credit to retailers) → zero debtor balance → lower WC. Competitor advantage: customers prefer suppliers with credit terms.

Answer Q2: FrostBite could offer **15-day credit** to retailers instead of zero credit — this would attract more retailers and grow sales, improving operating efficiency and reducing per-unit WC cost. However, this would **increase WC** through higher debtors. A better strategy: negotiate **60-day credit from suppliers** (instead of 30 days) — this would **reduce** WC without losing sales volume.

Keywords: seasonal, raw material, credit availed, credit allowed, debtors, creditors, cash basis, working capital.

Section 11 Exam-Oriented Questions & Answers

A. One-mark Questions

Q1. Define financial management in one line.

Ans. Financial management is concerned with optimal procurement and effective utilisation of funds to maximise owner's wealth.

Q2. What is the primary objective of financial management?

Ans. Wealth maximisation — maximising the long-term market value of equity shares.

Q3. Name the three financial decisions.

Ans. Investment Decision, Financing Decision, and Dividend Decision.

Q4. What is Trading on Equity?

Ans. Using borrowed funds (debt) at a fixed interest cost to earn a higher return, thereby increasing Earnings Per Share of equity shareholders.

Q5. What is Gross Working Capital?

Ans. Total investment in all current assets of a business.

Q6. What is Net Working Capital?

Ans. Current assets minus current liabilities.

Q7. Name two types of working capital based on time.

Ans. Permanent (Fixed) Working Capital and Temporary (Variable) Working Capital.

Q8. Give one factor that reduces working capital requirement.

Ans. Credit availed from suppliers (trade credit from creditors reduces immediate cash outflow).

B. Three-mark Questions

Q1. Why is wealth maximisation considered a better objective than profit maximisation?

Ans. Wealth maximisation considers the TIME VALUE OF MONEY — recognising that ₹1 received today is worth more than ₹1 received next year.

Ans. It considers RISK — not all profits are equal. High-risk profits are less valuable than stable, sustainable profits.

Ans. It considers QUALITY OF EARNINGS — only transparent, sustainable earnings contribute to long-term shareholder wealth, not one-time windfalls.

Q2. Explain the concept of financial leverage with an example.

Ans. Financial leverage (Trading on Equity) means using debt at a fixed interest cost to generate returns higher than the cost of debt — and passing the surplus to equity shareholders.

Ans. This increases EPS of equity shareholders beyond what they would earn without debt.

Ans. Example: If a firm borrows at 10% and earns 18% return — the extra 8% goes to equity shareholders, boosting EPS. This is financial leverage in action.

Q3. State any three factors affecting the working capital requirements of a business.

Ans. (i) Nature of Business — manufacturing firms need high WC (raw material, WIP, finished goods); service firms need minimal WC.

Ans. (ii) Seasonal Factors — demand peaks in certain seasons requiring extra WC for inventory build-up. Example: raincoat manufacturers in pre-monsoon.

Ans. (iii) Credit Allowed — if the firm gives long credit periods to customers, more funds are tied in debtors, requiring higher WC.

C. Five & Six-mark Questions

Q1. Explain the factors affecting the requirement of Fixed Capital in a business.

Ans. The following factors determine how much a business needs to invest in fixed assets:

- **Nature of Business:** Manufacturing firms need heavy fixed assets; service firms need minimal.
- **Scale of Operations:** Larger scale = larger machines, bigger plants = higher fixed capital.
- **Technology Used:** Capital-intensive (automated) technology needs heavy machinery investment.
- **Growth Prospects:** High growth expectation → invest in more capacity today.
- **Diversification:** New products/businesses require additional fixed assets.
- **Financing Alternatives:** Leasing instead of buying reduces fixed capital requirement.
- **Level of Collaboration:** Outsourcing production reduces own fixed capital (Apple-Foxconn model).

Q2. Explain any five factors affecting the capital structure of a business.

Ans.

- **Cash Flow Position:** Strong cash flows allow more debt — firm can service interest reliably.
- **Return on Investment:** If ROI > cost of debt, debt is beneficial (leverage works). If ROI < cost, avoid debt.

- **Tax Rate:** Interest on debt is tax-deductible → higher tax rate makes debt cheaper.
- **Control:** Debt doesn't dilute ownership. Companies wanting to retain control prefer debt over equity.
- **Cost of Debt:** Low interest rates make debt more attractive. High rates push companies toward equity.

D. MCQs

Q1. Trading on Equity means —

- (a) Equity shareholders trading their shares
- (b) Using debt to increase EPS of equity shareholders
- (c) Converting debt to equity
- (d) Trading shares on stock exchange

Ans. (b) Using debt at fixed interest to earn higher returns, increasing EPS for equity shareholders.

Q2. Which of the following INCREASES working capital requirement?

- (a) Shorter production cycle
- (b) More credit availed from suppliers
- (c) Selling on cash basis
- (d) Liberal credit given to customers

Ans. (d) Liberal credit given to customers — increases debtors, increasing WC needed.

Q3. The correct objective of financial management is —

- (a) Maximise sales
- (b) Maximise profit
- (c) Maximise shareholder wealth
- (d) Minimise costs

Ans. (c) Maximise shareholder wealth (wealth maximisation).

Q4. Fixed Capital is invested in —

- (a) Cash and debtors
- (b) Raw material inventory
- (c) Long-term fixed assets
- (d) Short-term investments

Ans. (c) Long-term fixed assets such as land, building, and machinery.

Q5. Which of these is a factor affecting Dividend Decision?

- (a) Technology used

- (b) Operating cycle
- (c) Growth opportunities
- (d) Level of collaboration

Ans. (c) Growth opportunities — high growth firms retain earnings instead of paying dividend.

E. Assertion–Reason

Q. Assertion (A): A manufacturing company generally requires more working capital than a service company.

Reason (R): Manufacturing companies hold large inventories of raw material, WIP and finished goods, which require significant current asset financing.

Options: (a) A and R both true, R correctly explains A. (b) A and R both true, R does NOT explain A. (c) A true, R false. (d) A false, R true.

Ans. (a) — Both are true and R correctly explains A. Manufacturing involves holding raw material, WIP, and finished goods — all current assets that require working capital financing.

Section 12 Board Exam Answer Writing Guide

Case-study trigger table — Identify the concept

If the case mentions...	Concept / Decision
Investing in land, building, machinery, new plant	Investment Decision / Fixed Capital Decision
Choosing between bank loan and equity shares / debt-equity ratio	Financing Decision / Capital Structure
How much profit to distribute / retained earnings / dividend payout	Dividend Decision
Using debt to increase EPS / borrowing at lower rate than ROI	Trading on Equity / Financial Leverage
Cash tied up in inventory, debtors, day-to-day operations	Working Capital Management
Manufacturing company needs more funds than service company	Nature of business → WC factor
Festival season / monsoon demand surge — extra inventory needed	Seasonal factor → WC factor
Company outsources production to reduce capital requirement	Level of collaboration → Fixed Capital factor
Company leases assets instead of buying	Financing alternatives → Fixed Capital factor
Promoters want to keep 70% control / avoid dilution	Control factor → Financing Decision factor

EXAM TIP

Smit Sir's 3-step formula for this chapter's case studies:

Step 1: Find the key action — 'investing in', 'raising funds by', 'distributing profit', 'holding inventory', 'leasing vs buying'.

Step 2: Map to decision — Investment / Financing / Dividend / Fixed Capital / Working Capital.

Step 3: If the question asks for factors — name the SPECIFIC factor from the list (not generic), explain it in 1-2 lines, and link to the case.

Section 13 Common Doubts Students Ask

Doubt 1: Sir, what is the difference between Investment Decision and Financing Decision?

Smit Sir's answer: Investment Decision = WHERE to use money (which assets to buy).
Financing Decision = WHERE to GET money (debt or equity). Two opposite directions —
Investment = money going out; Financing = money coming in.

Doubt 2: Sir, is Trading on Equity always beneficial?

Smit Sir's answer: NO. It works ONLY when $ROI > \text{interest rate}$. If $ROI < \text{interest rate}$, debt amplifies losses instead of gains. High debt also increases financial risk — if EBIT falls, interest must still be paid. So leverage is a double-edged sword.

Doubt 3: Sir, what is the difference between Fixed Capital and Working Capital?

Smit Sir's answer: Fixed Capital = invested in long-term assets (lasting years) — like land, machinery. Working Capital = invested in current assets (lasting < 1 year) — like inventory, cash, debtors. Fixed capital builds capacity; working capital runs daily operations.

Doubt 4: Sir, why is cash flow different from profit for dividend decision?

Smit Sir's answer: Profit = accounting figure (may include non-cash items like depreciation, credit sales). Cash = actual money available. A company can show high profit but have low cash (if sales are on credit). Dividends require CASH — so cash flow, not profit, determines dividend payment capacity.

Doubt 5: Sir, why does using debt reduce tax?

Smit Sir's answer: Interest paid on debt is an expense — it is deducted before calculating taxable income. So if interest is ₹1 lakh and tax rate is 30%, you pay ₹30,000 less tax. The government effectively subsidises part of the interest cost. This is called the Tax Shield of debt.

Doubt 6: Sir, why does issuing equity shares dilute control?

Smit Sir's answer: When you issue new equity shares, you bring in new shareholders. The total number of shares increases. Original shareholders now own a SMALLER percentage. Example: You owned 100% of 1,000 shares. You issue 1,000 more shares. Now you own 50%. Your control is diluted from 100% to 50%.

Doubt 7: Sir, what is operating cycle and why does it affect working capital?

Smit Sir's answer: Operating cycle = the time between paying for raw material and receiving cash from customers. Longer cycle = money is 'locked up' for longer → more WC needed. Shorter cycle = money circulates faster → less WC needed. Shipbuilding (2-year cycle) needs far more WC than a fast-food restaurant (2-hour cycle).

Doubt 8: Sir, why is lease vs buy a factor affecting FIXED capital?

Smit Sir's answer: If you buy an asset — it appears on your balance sheet as a fixed asset → high fixed capital. If you LEASE — you don't own the asset → it doesn't appear as fixed capital → lower fixed capital requirement. That's why many airlines lease planes instead of buying — it dramatically reduces their fixed capital.

Doubt 9: Sir, is retained earnings the same as profit?

Smit Sir's answer: No. Profit is what the company earns. Retained earnings is the portion of profit NOT paid as dividend — kept inside the business. $\text{Retained earnings} = \text{Profit} - \text{Dividend}$.

Doubt 10: Sir, what is EBIT?

Smit Sir's answer: Earnings Before Interest and Tax — the operating profit of a company before paying interest on loans and before paying income tax. EBIT shows how much the company earns from its core operations, independent of how it is financed.

Section 14 Common Mistakes to Avoid

Mistake 1: Writing 'profit maximisation' as the objective

What students do wrong: 'The objective of financial management is to maximise profits.'

Why it is wrong: CBSE explicitly says profit maximisation is INADEQUATE — it ignores time value of money and risk.

Correct way: Always write: 'The objective is WEALTH MAXIMISATION — maximising the long-term market value of shares — which is superior to profit maximisation.'

Mistake 2: Confusing Financing Decision with Dividend Decision

What students do wrong: Mixing up 'where to get money' and 'what to do with profits'.

Why it is wrong: These are two completely different decisions. Financing = getting money IN. Dividend = distributing money OUT.

Correct way: Financing Decision = debt vs equity. Dividend Decision = retain vs distribute.

Mistake 3: Writing only 3-4 factors when question asks for 5-6

What students do wrong: 'Any five factors of working capital' answered with 3 factors.

Why it is wrong: CBSE marks strictly on number of points. 3 points for a 5-mark question = automatic 2 marks lost.

Correct way: Before starting, quickly count in your head: 'I will write exactly 5 factors.' Use tricks to recall all 10.

Mistake 4: Confusing Gross and Net Working Capital

What students do wrong: 'NWC = total current assets'.

Why it is wrong: Gross WC = total current assets. Net WC = current assets MINUS current liabilities.

Correct way: Net WC has 'net' = something deducted. What is deducted? Current liabilities.

Mistake 5: Saying Trading on Equity always increases EPS

What students do wrong: 'Trading on equity always benefits shareholders.'

Why it is wrong: It benefits ONLY when $ROI > \text{cost of debt}$. When $ROI < \text{cost of debt}$, leverage reduces EPS.

Correct way: Always qualify: 'Trading on equity is beneficial when ROI exceeds the cost of borrowing. Otherwise, it reduces EPS.'

Mistake 6: Mixing fixed capital and working capital factors

What students do wrong: Writing 'nature of business' as a fixed capital factor when asked for working capital factors.

Why it is wrong: Several factors appear in BOTH lists (nature of business, scale of operations, growth prospects). But their meaning differs: for fixed capital = fixed asset requirement; for working capital = current asset requirement.

Correct way: For WC: focus on inventory, debtors, cash cycle, seasonal demand. For FC: focus on machinery, building, equipment requirement.

Section 15 Keywords Bank

Topic	Must-use Keywords
Meaning / Objective	optimal procurement, effective utilisation, wealth maximisation, market value of shares, time value, risk, quality of earnings
Investment Decision	capital budgeting, fixed assets, long-term, cash flows, rate of return, risk, NPV, IRR
Financing Decision / Capital Structure	debt-equity mix, financial leverage, trading on equity, EPS, cost of capital, tax shield, control, floatation cost
Dividend Decision	payout ratio, retained earnings, dividend, growth opportunity, cash flow, stability, shareholder preference
Financial Planning	adequate funds, surplus, shortage, future requirements, financial roadmap, coordination
Fixed Capital	long-term assets, land building machinery, lease vs buy, capital-intensive, scale, technology, collaboration
Working Capital	current assets, current liabilities, gross WC, net WC, operating cycle, permanent, temporary, seasonal, debtors, creditors

Section 16 Quick Revision Notes

QUICK REVISION

Objective: Wealth maximisation (NOT profit maximisation) — considers time value, risk, quality.

3 Financial Decisions: Investment (where to invest) → Financing (debt vs equity) → Dividend (distribute vs retain).

Trading on Equity: Borrow at lower rate, invest at higher rate → surplus goes to equity shareholders → EPS rises. Works ONLY if ROI > cost of debt.

Financial Planning: Estimate fund needs + plan how to meet them → avoid shortage and surplus.

Capital Structure: Mix of long-term debt and equity. 10 factors = C-I-D-R-C-T-F-C-F-R.

Fixed Capital: Investment in long-term assets. 7 factors = N-S-T-G-D-F-L.

Working Capital: Day-to-day operations funding.

Gross WC = Total Current Assets.

Net WC = Current Assets – Current Liabilities.

Types: Permanent (minimum always needed) + Temporary (extra during peak season).

10 WC factors (grouped): Business Profile (Nature, Scale, Business cycle, Seasonal, Prod cycle) + Cash Flow (Credit given, Credit taken, Efficiency) + External (Raw material, Competition).

Section 17 One-Page Last-Minute Revision Sheet

Read this on exam day. Nothing else.

Chapter in one paragraph

Financial management aims at **wealth maximisation** through three decisions: **Investment (I-F-D)** — where to invest; **Financing** — optimal debt-equity mix; **Dividend** — retain vs distribute. **Trading on Equity** uses debt to boost EPS (works only if ROI > interest rate). **Financial Planning** ensures adequate funds always. **Capital Structure** is the debt-equity mix — 10 factors (C-I-D-R-C-T-F-C-F-R). **Fixed Capital** (long-term assets) has 7 factors (N-S-T-G-D-F-L). **Working Capital** (current assets funding) = Gross WC (total CA) or Net WC (CA-CL) with 10 factors across 3 clusters.

5 must-remember lines

15. Objective = WEALTH maximisation, NOT profit maximisation.
16. 3 decisions: Investment (WHERE to invest), Financing (HOW to fund), Dividend (DISTRIBUTE or RETAIN).
17. Trading on Equity works ONLY when ROI > cost of debt; otherwise it magnifies losses.
18. Net Working Capital = Current Assets MINUS Current Liabilities (not gross).
19. Longer operating cycle → more WC needed (money stuck longer before cash is collected).

Case-study trigger table

If case says...	Concept
Buying machinery, plant, building	Investment Decision / Fixed Capital
Debt vs equity / bank loan vs share issue	Financing Decision / Capital Structure
Dividend paid / profit retained	Dividend Decision
Borrowing at low rate, earning at higher rate → EPS rises	Trading on Equity
Raw material stock / debtors / daily cash need	Working Capital
Seasonal demand surge / monsoon / Diwali	Seasonal factor → WC
Leasing planes / outsourcing production	FC factors — Financing alternatives / Collaboration
Promoters don't want to lose 51% control	Control factor → Financing Decision

Section 18 How Smit Sir Can Teach This Chapter

1. Opening hook

Write on the board: '₹10 LAKH. START A BUSINESS. WHAT ARE YOUR FIRST 3 QUESTIONS?' Students answer — WHERE to invest, HOW to raise money, WHAT to do with profits. Reveal: those 3 questions ARE the chapter.

2. Best Indian examples to use

Concept	Best Indian Example
Trading on Equity	Infosys or TCS using minimal debt — explain why IT companies rarely use debt leverage.
Capital Structure — control factor	Mukesh Ambani keeping >50% Reliance shares — never diluted below control threshold.
Fixed capital — lease vs buy	IndiGo leasing 95% of aircraft fleet — one of world's most capital-efficient airlines.
Fixed capital — collaboration	Apple outsourcing manufacturing to Foxconn — Apple owns mainly design IP, not factories.
Working capital — seasonal	Raincoat manufacturers building inventory in March-May before monsoon season.
Working capital — operating cycle	Shipbuilding (Mazagon Dock) — 2-3 year cycle vs IRCTC food stall — 30-minute cycle.

3. Difficult concepts and how to simplify them

Concept	How to simplify
Trading on Equity	Use the 'OPM (Other People's Money)' story: 'Would you borrow ₹1 lakh at 8% if you could invest it at 18%? Obviously yes. That profit difference = trading on equity.'
Wealth vs Profit maximisation	'Your parents can make ₹10 lakh by selling their house. That's profit. But destroying the house destroys wealth. Financial management chooses sustainable wealth over one-time profit.'
Operating cycle and WC	Draw a circle: Raw Material → Production → Finished Goods → Sales → Debtors → Cash → Raw Material again. The diameter of this circle = how much WC you need.
Gross vs Net WC	'Gross WC = what you own (current assets). Net WC = what you ACTUALLY have after paying what you OWE (current liabilities).' Like: Wallet has ₹500 but you owe friend ₹200 — net is ₹300.

4. Board exam focus areas

- Factors affecting Capital Structure — 5/6-mark (appears almost every year)
- Factors affecting Working Capital — 5/6-mark (appears very frequently)
- Factors affecting Fixed Capital — 4/5-mark
- Trading on Equity — 4/5-mark with numerical example
- Identify the financial decision (case study) — 4-mark

5. Classroom activity

'Finance a Startup' game: Give each group of 4 students a different startup profile (ICE CREAM SHOP / STEEL FACTORY / IT COMPANY / SCHOOL). Ask: What is your fixed capital requirement? What is your working capital requirement? Will you use debt or equity? How much dividend will you pay? Each group presents. By end of class, all 3 decisions + capital + WC are understood experientially.

6. How to end the chapter powerfully

"Every rupee in a business has a cost and a purpose. The manager who knows WHERE to invest it, HOW to fund it, and WHEN to give it back to shareholders — that manager builds lasting wealth. This chapter has given you the financial intelligence to think like a CFO. Use it."

End of Chapter 9

"Beware of little expenses. A small leak will sink a great ship." — Benjamin Franklin

Invest wisely. Fund smartly. Reward shareholders.

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