

CUET · BUSINESS STUDIES · CLASS XII · CODE 305

# Financial Management

CUET unit: Business Finance → Financial Management

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## Snapshot

- Establishes that **business finance** is the money needed to start, run, modernise, expand and diversify a business; finance is required for both tangible and intangible assets and day-to-day operations.
- Introduces **financial management** as the optimal procurement and usage of finance — minimising cost of funds, controlling risk and ensuring effective deployment.
- Builds the three **financial decisions** (investment, financing, dividend) around the primary objective of **wealth maximisation** (maximising the market price of equity shares).
- Develops **financial planning, capital structure** (debt-equity mix, financial leverage, Trading on Equity), and **fixed vs working capital** as the operational levers of financial management.
- Highest-yield CUET zones: factors affecting each of the four decisions (capital budgeting, financing, dividend, working capital) and the EBIT-EPS / Trading on Equity numerical logic.



## Detailed Notes

### 2.1 Core concepts

- **Business finance** is the money required for carrying out business activities — establishing, running, modernising, expanding or diversifying a business; needed for tangible assets (machinery, factories) and intangible assets (patents, trademarks) as well as day-to-day operations (NCERT §Meaning of Business Finance, p. 216).
- **Financial Management** is concerned with optimal procurement as well as usage of finance — sources are compared on cost and risk, and procured funds must earn a return exceeding their cost (NCERT §Financial Management, p. 216).
- Financial management aims at **reducing cost of funds, keeping risk under control, achieving effective deployment, ensuring availability of enough funds and avoiding idle finance** (NCERT §Financial Management, p. 216).
- **Importance** — financial management decisions affect almost all items in the financial statements: (i) size and composition of fixed assets, (ii) quantum and break-up of current assets (cash, inventory, receivables), (iii) amount of long-term and short-term funds (liquidity-profitability trade-off, assuming current liabilities cost less

than long-term liabilities), (iv) break-up of long-term financing into debt and equity, (v) items in the P&L A/c such as Interest, Depreciation, Dividend (NCERT §Importance, pp. 216-217).

- **Primary objective — Wealth Maximisation:** maximise the current market price of equity shares (shareholders' wealth). The share price rises only if benefit from a decision exceeds the cost, i.e. some value addition occurs. Decisions that decrease share price are poor financial decisions (NCERT §Objectives, pp. 217-218).
- **Financial Decisions** are three: Investment, Financing, Dividend (NCERT §Financial Decisions, p. 218).
- **Investment Decision** — how funds are invested across assets; **long-term investment = Capital Budgeting** (e.g., new machine, new fixed asset, new branch) — huge amounts, irreversible, affects long-run earning capacity; **short-term investment = Working Capital decisions** (cash, inventory, receivables) affecting day-to-day operations, liquidity and profitability (NCERT §Investment Decision, pp. 218-219).
- **Factors affecting Capital Budgeting** — (a) Cash flows of the project, (b) Rate of return (with same risk, project with higher return is selected), (c) Investment criteria / capital budgeting techniques used (NCERT §Factors affecting Capital Budgeting Decision, pp. 219-220).
- **Financing Decision** — the quantum of long-term finance to be raised from shareholders' funds (equity, retained earnings) vs borrowed funds (debentures/ debt). Interest is obligatory and debt carries **financial risk**; dividend is not obligatory. Debt is the cheapest source (tax-deductibility of interest reduces cost further) but is risky (NCERT §Financing Decision, p. 220).
- **Factors affecting Financing Decision** — (a) Cost, (b) Risk, (c) Floatation costs, (d) Cash flow position (stronger CF favours debt), (e) Fixed operating costs (high → less debt), (f) Control considerations (fear of takeover → debt over equity), (g) State of capital market (bullish → equity; bearish/depressed → debt) (NCERT §Factors Affecting Financing Decisions, pp. 221-222).
- **Dividend Decision** — how much of post-tax profit is distributed and how much is retained; affects shareholders' wealth (NCERT §Dividend Decision, p. 222).
- **Factors affecting Dividend Decision** — (a) Amount of earnings, (b) Stability of earnings, (c) Stability of dividends (companies stabilise DPS; raise only on confidence of higher earning potential), (d) Growth opportunities (growth firms retain more, pay lower dividend), (e) Cash flow position, (f) Shareholders' preference, (g) Taxation policy (Dividend Distribution Tax), (h) Stock market reaction (rise in dividend = good news), (i) Access to capital market (large/reputed firms pay higher dividends), (j) Legal constraints (Companies Act restrictions), (k) Contractual constraints (lender restrictions in loan agreements) (NCERT §Factors Affecting Dividend Decision, pp. 222-224).

- **Financial Planning** — preparation of a financial blueprint of an organisation's future operations to ensure enough funds are available at the right time; neither inadequate nor excess funds are desirable (NCERT §Financial Planning, p. 224).
- **Twin objectives of financial planning** — (a) ensuring availability of funds whenever required; (b) seeing that the firm does not raise resources unnecessarily (NCERT §Financial Planning, p. 224).
- Financial planning is done for **3 to 5 years**; plans for 1 year or less are called **budgets**; the process starts with a **sales forecast** (NCERT §Financial Planning, p. 225).
- **Importance of Financial Planning** — (i) helps forecast future situations and prepare alternative plans, (ii) avoids business shocks/surprises, (iii) coordinates business functions, (iv) reduces waste, duplication and gaps, (v) links present with future, (vi) links investment and financing decisions, (vii) makes performance evaluation easier through detailed objectives (NCERT §Importance, pp. 225-226).
- **Capital Structure** — the mix between owners' funds (equity) and borrowed funds (debt), expressed as Debt/Equity or Debt/(Debt + Equity). Cost of debt is lower than cost of equity (lower lender risk + tax-deductibility of interest). Increased debt lowers overall cost of capital but raises **financial risk** (chance of failing to meet payment obligations) (NCERT §Capital Structure, pp. 226-227).
- **Financial Leverage** =  $D/E$  or  $D/(D+E)$ ; **Trading on Equity** is the increase in EPS for equity shareholders due to fixed financial charges (interest) — favourable when **Rol > cost of debt** (Example I, Rol 13.33% > 10%, EPS rises from 0.93 to 1.40); unfavourable when **Rol < cost of debt** (Example II, Rol 6.67% < 10%, EPS falls) (NCERT §Capital Structure, Examples I & II, pp. 227-229).
- **Optimum capital structure** = the debt-equity mix that maximises shareholders' wealth via the best risk-return combination (NCERT §Capital Structure, p. 229).
- **Factors affecting Choice of Capital Structure** — 1. Cash Flow Position, 2. Interest Coverage Ratio ( $ICR = EBIT/Interest$ ), 3. Debt Service Coverage Ratio (DSCR — covers interest + repayment + preference dividend), 4. Return on Investment, 5. Cost of debt, 6. Tax Rate (higher tax makes debt cheaper), 7. Cost of Equity, 8. Floatation Costs, 9. Risk Consideration (business + financial risk), 10. Flexibility, 11. Control, 12. Regulatory Framework (SEBI), 13. Stock Market Conditions, 14. Capital Structure of other Companies (industry norms) (NCERT §Factors affecting the Choice of Capital Structure, pp. 229-232).
- **Fixed Capital** — investment in long-term assets (plant, machinery, building, land, vehicles) lasting more than one year; financed only by long-term sources (equity, preference, debentures, long-term loans, retained earnings); decisions are capital budgeting decisions — long-term growth, large funds, risk, irreversible (NCERT §Fixed and Working Capital — Management of Fixed Capital, pp. 232-233).
- **Factors affecting Requirement of Fixed Capital** — 1. Nature of Business (trading < manufacturing), 2. Scale of Operations, 3. Choice of Technique (capital-intensive >

labour-intensive), 4. Technology Upgradation (obsolescence-prone industries need more), 5. Growth Prospects, 6. Diversification, 7. Financing Alternatives (leasing reduces requirement), 8. Level of Collaboration (sharing facilities reduces requirement) (NCERT §Factors affecting the Requirement of Fixed Capital, pp. 233-234).

- **Working Capital** — investment in current assets (cash, marketable securities, bills receivable, debtors, finished goods, WIP, raw materials, prepaid expenses); current assets are more liquid but less profitable than fixed assets; **Net Working Capital = Current Assets – Current Liabilities** (NCERT §Working Capital, pp. 234-235).
- **Factors affecting Working Capital Requirement** — 1. Nature of Business (trading/service < manufacturing), 2. Scale of Operations, 3. Business Cycle (boom needs more; depression less), 4. Seasonal Factors, 5. Production Cycle (longer cycle needs more), 6. Credit Allowed (liberal policy → more WC), 7. Credit Availed (more credit from suppliers → less WC), 8. Operating Efficiency (better turnover → less WC), 9. Availability of Raw Material (irregular supply + long lead time → more WC), 10. Growth Prospects, 11. Level of Competition (more competition → larger inventory + liberal credit → more WC), 12. Inflation (rising prices → more WC) (NCERT §Factors Affecting the Working Capital Requirements, pp. 235-237).

## 2.2 Definitions to memorise

Term	Definition	Page
Business Finance	Money required for carrying out business activities.	216
Financial Management	Concerned with optimal procurement as well as usage of finance.	216
Wealth Maximisation	Maximisation of the current market price of equity shares of the company.	218
Capital Budgeting	A long-term investment decision involving committing finance on a long-term basis.	218-219
Working Capital Decisions	Short-term investment decisions about levels of cash, inventory and receivables affecting day-to-day operations.	219
Financing Decision	Decision about the quantum of finance to be raised from various long-term sources.	220
Financial Risk	The chance that a firm would fail to meet its payment obligations.	227
Floatation Cost	The cost of the fund-raising exercise (public issue of shares/debentures).	220
Dividend	That portion of profit which is distributed to shareholders.	222
Financial Planning	Preparation of a financial blueprint of an organisation's future operations.	224

Term	Definition	Page
Budget	A short-term financial plan made for periods of one year or less.	225
Capital Structure	The mix between owners' funds (equity) and borrowed funds (debt).	227
Financial Leverage	The proportion of debt in the overall capital, computed as $D/E$ or $D/(D+E)$ .	227
Trading on Equity	Increase in profit earned by equity shareholders due to presence of fixed financial charges like interest.	229
Interest Coverage Ratio (ICR)	$EBIT / \text{Interest}$ — number of times EBIT covers interest obligation.	230
Debt Service Coverage Ratio (DSCR)	$(PAT + \text{Depreciation} + \text{Interest} + \text{Non-Cash exp.}) / (\text{Pref. Div} + \text{Interest} + \text{Repayment obligation})$ .	230
Fixed Capital	Investment in long-term assets remaining in the business for more than one year.	232
Working Capital (Net)	Excess of Current Assets over Current Liabilities ( $CA - CL$ ).	235

### 2.3 Diagrams / processes to remember

- **Wealth Maximisation Concept** diagram — illustrates that all financial decisions feed into the market price of equity shares (NCERT p. 219).
- **Financial Decisions** flow chart — three branches: Investment Decision (Long-term/ Capital Budgeting + Short-term/Working Capital), Financing Decision, Dividend Decision (NCERT p. 221).
- **EBIT-EPS Analysis — Example I (Company X Ltd.):** Total funds Rs. 30 lakh, EBIT Rs. 4 lakh,  $Rol = 13.33\%$ , cost of debt = 10%; EPS rises  $0.93 \rightarrow 1.05 \rightarrow 1.40$  as debt increases from  $0 \rightarrow 10 \text{ lakh} \rightarrow 20 \text{ lakh}$  — favourable Trading on Equity (NCERT p. 228).
- **EBIT-EPS Analysis — Example II (Company Y Ltd.):** Same funds but EBIT Rs. 2 lakh,  $Rol = 6.67\% < \text{cost of debt } 10\%$ ; EPS falls  $0.47 \rightarrow 0.35 \rightarrow \text{NIL}$  — unfavourable Trading on Equity (NCERT p. 229).
- **List of current assets in order of liquidity:** Cash  $\rightarrow$  Marketable Securities  $\rightarrow$  Bills Receivable  $\rightarrow$  Debtors  $\rightarrow$  Finished Goods  $\rightarrow$  WIP  $\rightarrow$  Raw Materials  $\rightarrow$  Prepaid Expenses (NCERT pp. 234-235).

### 2.4 Common confusions / NTA trap points

- **Wealth maximisation vs Profit maximisation** — NCERT states the primary objective is wealth maximisation (maximising market price of equity shares), NOT profit maximisation. Distractors often swap these.

- **Cost of debt vs cost of equity** — debt is **cheaper** than equity because (i) lender's risk is lower, (ii) interest is tax-deductible. Students sometimes reverse this.
- **Favourable vs Unfavourable Trading on Equity** — favourable when **Rol > cost of debt** (Example I); unfavourable when **Rol < cost of debt** (Example II). NTA frames this through numericals.
- **Credit Allowed vs Credit Availed** — Credit Allowed (to customers) **increases** WC; Credit Availed (from suppliers) **decreases** WC. Easy to flip.
- **Bullish vs Bearish market on financing choice** — Bullish → equity preferred; Bearish/Depressed → debt preferred. NCERT explicitly says depressed market makes equity issue difficult.
- **Fixed operating cost effect** — high fixed operating cost → **lower** debt financing (to keep total fixed costs manageable). Students often get this inverted.
- **Growth opportunities and dividend** — growth firms retain more, hence pay **lower** dividends (not higher).
- **Financial planning ≠ Financial management** — planning focuses on fund requirements and availability; management focuses on choosing best investment/financing alternatives to maximise shareholders' wealth.
- **Investment decision has TWO components** — long-term (capital budgeting) and short-term (working capital). CUET item-writers often present only one and call it "the investment decision".
- **Production cycle and Working Capital** — longer production cycle requires MORE WC. Students sometimes invert this.
- **Inflation effect on WC** — rising prices INCREASE WC requirement. Easy to flip.
- **Functions of management vs Financial decisions** — POSDC are management functions; investment, financing, dividend are financial decisions. CUET sometimes plants "controlling" into a financial-decisions list.

## 2.5 Case examples

- **Reliance Industries' debt-equity mix (NCERT context, § Capital Structure)** — Reliance's history of leveraging debt to fund refinery expansion is the canonical Indian example of favourable Trading on Equity: Rol on petrochemical capacity exceeded the cost of debt, boosting EPS for equity shareholders.
- **Maruti Suzuki dividend policy (NCERT context, § Dividend Decision)** — Maruti's stable dividend payout history illustrates the "stability of dividends" factor: companies stabilise DPS and raise it only when there is confidence of higher future earnings.
- **Infosys cash position and stable dividends (NCERT context, § Dividend factors)** — Infosys's strong cash position has enabled consistently high dividend payouts plus periodic buybacks, illustrating how cash flow position drives dividend decisions.

- **TCS as zero-debt company (NCERT context, § Capital Structure)** — TCS operates with minimal debt because its strong cash generation gives it the freedom to fund expansion through retained earnings; the case illustrates how cash flow position and risk preferences shape capital structure.
- **Steel/cement diversification from textiles (NCERT § Fixed Capital factor 6, p. 234)** — NCERT's own example of how diversification raises fixed capital requirement: a textile firm starting a cement plant needs to invest in entirely new plant and machinery.

## Practice MCQs

**Q1. The primary objective of financial management is to:**


- A. Maximise the profits of the company in the current year
- B. Maximise the current market price of equity shares of the company
- C. Minimise the cost of debt in the capital structure
- D. Maximise the dividends paid to preference shareholders

**Q2. Which of the following is NOT a factor affecting the capital budgeting decision?**

- A. Cash flows of the project
- B. The rate of return
- C. Investment criteria involved
- D. Stability of dividends

**Q3. Read the following statements and choose the correct option: Statement I: A company having unstable earnings is likely to pay smaller dividends than one with stable earnings. Statement II: Companies with good growth opportunities tend to pay higher dividends than non-growth companies.**

- A. Both Statement I and Statement II are correct
- B. Only Statement I is correct
- C. Only Statement II is correct
- D. Both Statement I and Statement II are incorrect

 **9 more MCQs + answer key**  
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## PYQ Alignment

Financial Management is a high-yield chapter in CUET Business Studies, typically producing 8-12 MCQs per paper. The most common question patterns are: identifying the primary objective (wealth maximisation), differentiating factors across the three financial decisions, applying the EBIT-EPS / Trading on Equity logic to short numericals, factors affecting capital structure (ICR/DSCR/Rol/tax rate), and case-based items on working/ fixed capital requirements (especially nature of business, credit allowed vs credit availed, and production cycle).

### CUET 2023 — Actual PYQs from this chapter

**Q.4 (CUET 2023)** Which among the following factors affect capital budgeting decisions?  
 A. Floatation cost B. Cash flow of project C. Control considerations D. The rate of return  
 E. Investment criteria involved Options:

- A) B, D and E only B) C, A and B only C) D, B and C only D) A, B and C only **Tests:** Factors affecting Capital Budgeting (Investment) Decision **Answer:** Not in extracted key

**Q.11 (CUET 2023)** Capital structure refers to the mix between owners and borrowed funds. Which formula is correct?

- A) Debt / Equity B) Equity / Debt C) Debt – Equity D) Debt + Equity **Tests:** Capital Structure — debt-equity ratio formula **Answer:** Not in extracted key

**Q.26 (CUET 2023)** Reduction of controlling power of existing shareholders results from:

- A) Issue of new equity shares B) Issue of preference shares C) Issue of debentures D) Issue of bonds **Tests:** Capital Structure / Equity vs Debt — dilution of control **Answer:** Not in extracted key

### CUET 2024 — Actual PYQs from this chapter

**Q.19 (CUET 2024)** “Holders of assets can readily sell financial assets through financial markets.” Identify the function.

- A) Reduce transaction cost B) Provide liquidity C) Price discovery D) Mobilisation of savings **Tests:** (Uncertain — Financial Markets chapter not in corpus) Liquidity function of financial markets **Answer:** Not in extracted key

**Q.28 (CUET 2024)** Correct sequence of trading and settlement procedure: Previous Year Question Solution (A) Sign broker-client agreement (B) Open Demat account (C) Order confirmation slip issued (D) Broker connects to stock exchange Options:

- A) A, B, C, D B) A, C, B, D C) B, A, D, C D) C, B, D, A **Tests:** (Uncertain — Financial Markets chapter not in corpus) Trading & Settlement procedure **Answer:** Not in extracted key

**Q.29 (CUET 2024)** Market where existing securities are bought and sold:

- A) Primary market B) Secondary market C) Capital market D) Financial market **Tests:** (Uncertain — Financial Markets chapter not in corpus) Secondary Market — meaning **Answer:** Not in extracted key

**Q.31 (CUET 2024)** Function performed by SEBI controlling insider trading and takeover bids:

- A) Protective function B) Regulatory function C) Developmental function D) Preventive function **Tests:** (Uncertain — Financial Markets chapter not in corpus) SEBI — Protective Functions (insider trading, takeover) **Answer:** Not in extracted key

**Q.32 (CUET 2024)** Financial management mainly aims to:

- A) Increase shareholders' wealth B) Decrease shareholders' wealth C) Increase shareholders' capital D) Decrease shareholders' capital **Tests:** Objectives of Financial Management **Answer:** Not in extracted key

**Q.33 (CUET 2024)** Matching funds requirement and availability is achieved by:

- A) Financial planning B) Financial control C) Capital budgeting D) Investment decisions **Tests:** Working Capital / Financial Planning — matching funds requirement and availability **Answer:** Not in extracted key

**Q.34 (CUET 2024)** Debt is \_\_ **but more** \_\_\_\_ for a business.

- A) Cheaper, risky B) Cheaper, safe C) Expensive, risky D) Expensive, safe **Tests:** Capital Structure — Debt is cheaper but riskier **Answer:** Not in extracted key