Commerce

Class - XII

Chap - 2

Capital - Fixed and Working

4. The amount of business finance required [illegible] depending upon its nature and size. It also varies from [illegible]
5. The availability of finance determines the scale of operations of business.

2.2 IMPORTANCE OF FINANCE FOR BUSINESS

Finance is the lifeblood of business. No business firm can carry on its operations smoothly and successfully without the availability of right amount of funds at the right cost and at the right time. In the absence of finance, the production and selling of goods and services are not possible. The success of a business enterprise depends, to a great extent, on the manner in which it raises, employs and disburses its funds. In business, finance is required (*a*) for establishing an enterprise; (*b*) for purchase of fixed assets and current assets, *i.e.* for carrying on present operations; and (*c*) for expansion, growth and modernisation of business. In modern business, the significance of business finance has increased due to increase in the scale of business, use of capital-intensive techniques, shortage of finance and increase in competition. Adequate finance provides the following benefits to a business concern:

1. The firm can meet its liabilities in time. Prompt payment of debts helps in raising its credit-standing. As a result, the firm can easily borrow funds as and when necessary.
2. The firm can take advantage of business opportunities. For example, it can buy materials in bulk at a low price.
3. The firm can carry on its business smoothly and without any interruptions.
4. The firm can replace its plant and machinery in time, thereby improving the efficiency of its operations.
5. The firm can face recession, trade cycles and other crises more easily and confidently.

Every business enterprise requires finance to start its operations, to carry on its activities and to expand and grow. The availability of finance determines the size and scale of operations of any business. Proper use of funds is necessary for profitable working and sound health of business. Adequate funds enable a business enterprise to buy the necessary assets and to meet its liabilities in time. Finance helps it to avail of various business opportunities and to face trade cycles and other crisis.

2.3 SOURCES OF FINANCE FOR DIFFERENT TYPES OF BUSINESS FIRMS

The term 'capital' refers to the investment made in an enterprise for the purpose of earning profits. In business capital is required for both production as well as distribution of goods and services. Capital requirements differ according to the nature and size of business. Requirements of capital and sources of capital for different types of business firms are given below:

1. **Capital for Sole Proprietorship Business:** A sole proprietor operates at a small scale and, therefore, requires a limited amount of capital. The proprietor brings in his own

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6. Degree of Risk : The degree of risk which an enterprise is willing to assume influences financial planning. If an enterprise raises funds by issuing shares there is little risk because it is not necessary to pay dividend if profits are inadequate. But too much dependence on shares may dilute control of the company. Therefore, ratio between equity and debt capital is decided keeping in view the profits and management attitudes of business.

2.5 FACTORS AFFECTING CAPITAL STRUCTURE

Capital structure means the composition or make up of the amount of long term funds. According to C.W. Gerstenberg, "Capital structure means the type of securities to be issued and the proportionate amounts that make up the capitalisation." Long term funds can be obtained from :

(*a*) owners, and (*b*) borrowers. Ownership funds consist of share capital, and retained earnings. Borrowed funds include debentures, and long term loans. The ratio between equity (owned funds) and debt (borrowed funds) is called **capital gearing** or financial leverage. When the proportion of debt is high, it is called **high gearing or Working on thin equity**. On the other hand, when equity dominates the capital structure, it is known as **low gearing or working on thick equity**.

The factors affecting capital structure are given below : yoppleying 2016

1. Trading on Equity (Financial Leverage) a way : Equity means the ownership funds of a company and trading means taking advantage of. Therefore, trading on equity implies borrowing funds at reasonable cost with the help of share capital. When a company uses borrowed funds in the regular conduct of business along with equity capital it is said to be trading on equity. When the rate of earnings of a company is higher than the rate of interest at which funds are borrowed, equity shareholders can get higher earning per share because the difference is distributed among them. Suppose in the above example, the amount of earnings is ₹ 20 lakh for both the companies. The rate of interest on debentures is 12 per cent and the rate of dividend on preference shares is 14 percent, then the earnings per share for equity shareholders will be as follows:

When debt and preference capital is used in the capital structure, earnings per share increase due to two reasons. *First*, the rate of return on investment is more than the rate of interest and dividend payable on debt and preference capital respectively. *Secondly*, interest paid on debt is deducted from profits while calculating tax.

Financial leverage has two main implications. First use of fixed charge securities will increase return to equity shareholders only if rate of fixed charge is lower than the returns on investment. Second, use of fixed charge securities involves risk and threat of insolvency because debt has to be repaid along with interest even when the company is in loss. The financial leverage employed by a company will depend on the degree of risk the company is willing to take. Basically, it is a trade off between return and risk.

capital. In a sole proprietorship, owned capital consists of the owner's own contribution and retained profits credited to his capital account at the end of each financial year. In addition, the proprietor can raise loans from his friends and relatives. He may also borrow money from banks and financial institutions. Short-term loans for working capital may be obtained from commercial banks. Long term loans for purchase of fixed assets are available from State Financial Corporations and other financial institutions. Central and State Governments provide special financial assistance to small scale unity in order to encourage entrepreneurship and self employment. A sole proprietor may also buy raw materials and finished goods on credit from the suppliers. But this facility is available for a short period.

2. Capital for Partnership Firm: Capital requirements as well as the capital base of a partnership is bigger than that of a sole trader business. The owned capital is contributed by the partners is an agreed ratio. Retained profits credited to the accounts of partners also constitute a part of owned capital. A partnership firm can also raise loans from commercial banks and financial institutions. Sometimes, partners also advance loans to the firm. The firm can buy machinery and equipment on instalment/hire purchase basis. It can obtain short-term credit from suppliers of raw materials and finished goods.

3. Capital for Joint Stock Company: A joint stock company generally requires large amount of capital. A public company can raise huge capital through issue of shares. In addition to share capital it can utilise retained profits in the form of reserves. It can raise borrowed capital through debentures and loans. Long-term loans can be obtained from financial institutions. Short-term loans are available from commercial banks.

2.4 MEANING OF FINANCIAL PLANNING

Financial planning is the process of estimating the financial requirements of an organisation specifying the sources of funds and ensuring that enough funds are available at the right time. Possible shortage and surplus of funds are forecast so that necessary steps are taken in advance to meet these situations. Financial planning seeks to achieve the following objectives:

(*i*) To ensure availability of funds whenever these are required. A proper estimate of funds needed for different purposes and the time at which the funds are needed is made. The possible sources of these funds are also specified.

(*ii*) To ensure that there are no idle funds by putting surplus funds to the best possible use.

Financial planning includes both short term as well as long term planning. Short term planning is usually in the form of annual budgets. Long term planning takes the form of capital budgeting.

A suitable financial plan is essential for the success of every business enterprise. It should provide for (*i*) Accurate estimate of the total capital requirements, and (*ii*) selection of right methods or sources of finance for raising the estimated capital.

Financial planning plays a very significant role in the smooth and effective functioning company should be able to generate enough cash inflows to meet its fixed commitments on debt. A projected cash flow statement can be prepared to judge future cash flows or liquidity position of the company.

5. Cost of Financing : In a good financial structure, the cost of capital should be reasonably low. Cost of capital depends upon the prevailing rate of interest, return expected by potential investors, expenses and administrative expenses. Issue expenses or floatation costs of shares are high. Normally, the cost of debt is lower than that of equity. A company should estimate and compare the cost of alternative sources of finance before making a choice among them. High rates of tax make debt financing more attractive. In addition to cost, several legal formalities are involved in the issue of shares and debentures.

6. Period and Purpose of Financing : For funds required for permanent investment equity shares are the appropriate choice. Debentures and preference shares are preferable for medium-term finance. Modernisation and expansion programmes may better be financed through preference shares and debentures. Finance needed for expansion of capacity may be raised through fixed charge securities as expansion is likely to increase the earning capacity of the company.

7. Capital Market Conditions : The state of capital market influences the choice of securities to be issued. During boom investors are willing to take risk and invest in equity shares. But in a bearish market, or down swing investors prefer safe investment. Therefore, preference shares and debentures carrying a fixed rate of return are likely to be more marketable in a depression.

8. Statutory Requirements : Banking companies are prohibited from issuing any type of security except equity shares. Government of India has laid down norms of debt-equity ratio and ceilings on public deposits. The Companies Act and SEBI guidelines must be observed while raising funds from the public. Thus, state regulations regarding the issue of securities have a bearing on capital structure.

9. Needs of Investors : Investors' attitudes and requirements regarding income and risk is an important consideration in designing capital structure. A company may issue securities of different kinds and varying denominations to meet the likings of potential investors. Enterprising investors who prefer capital gains and a say in the management of the company can be lured by issuing equity shares. Debentures and preference shares are issued to attract those investors who desire a regular return and safety of investment.

10. Cash Flow Position : The ability of the company to generate enough cash flows to meet its fixed commitments also influences the capital structure. The company may be earning sufficient profits but it may not be generating cash inflows at the time of payment of interest and loan instalments. The company should analyse its liquidity position and prepare projected cash flow statements before deciding debt equity ratio.

2.6. MEANING OF FIXED CAPITAL

Fixed capital refers to the funds required for acquisition of fixed assets. Fixed assets are used permanently for business operations. These assets are meant for generating income. Land and building, plant and machinery, furniture and fixtures, motor vehicles, etc. are

	Company A ₹	₹
Net Profits before tax and interest	20,00,000	20,00,000
Less interest	3,60,000	1,20,000
	16,40,000	18,80,000
Less taxes @ 50%	8,20,000	9,40,000
	8,20,000	9,40,000
Less preference dividend	1,40,000	—
	6,80,000	9,40,000
Earnings per share = $\frac{\text{Profits after perf. divid.}}{\text{No. of Equity shares}}$	= ₹ 6.8	2.35

Trading on equity is, however, desirable only when:

(*a*) The rate of earnings is higher than the rate of interest and the rate of preference dividend.

(*b*) The company's earnings are stable and regular to pay at least the interest on debentures.

(*c*) There are sufficient fixed assets to offer as security to the lenders. When the proportion of debt and equity is such that it results in increase in shareholders' wealth, the capital structure may be called optimum.

2. Exercise of Control : In a company, equity shareholders have voting rights and, therefore, control of the company lies in their hands. If the promoters of the company want to retain control in their own hands, they may not issue additional equity shares to the public. In such a case, more funds can be raised by issuing debentures and preference shares. This factor is particularly important in closely held companies whenever promoters have low shareholding.

3. Need for Flexibility : A good capital structure should be flexible so that adjustments can be made whenever the need arises. Debentures and preference shares can be paid off whenever the company feels necessary. But equity shares cannot be paid off during the life-time of a company. However, debentures and preference shares are generally not issued in initial stages because they involve a fixed burden of payments on the company's earnings. While raising debt, the company should ensure that there are minimum restrictions in loan agreements.

4. Nature of Business : Companies enjoying regular and liberal earnings, e.g. public utilities can afford to have high capital gearing. On the other hand, business firms which are subject to wide fluctuations in demand and earnings may find it safer to depend more on equity capital and preference shares. New and stagnant firms may find it more difficult to issue debentures and preference shares than well-established and growing companies. The

6. Mode of Acquiring Fixed Assets: A business firm which purchases fixed assets on cash down basis requires huge amount of fixed capital. On the other hand, an enterprise which acquires land and building, plant and machinery and other fixed assets on lease or hire purchase will need less fixed capital.

7. Intangible Assets: The amount invested in acquiring goodwill, patents, copyrights, etc., also influence the amount of fixed capital needed for business.

Fixed Capital at a Glance

Meaning : The capital invested in fixed assets.

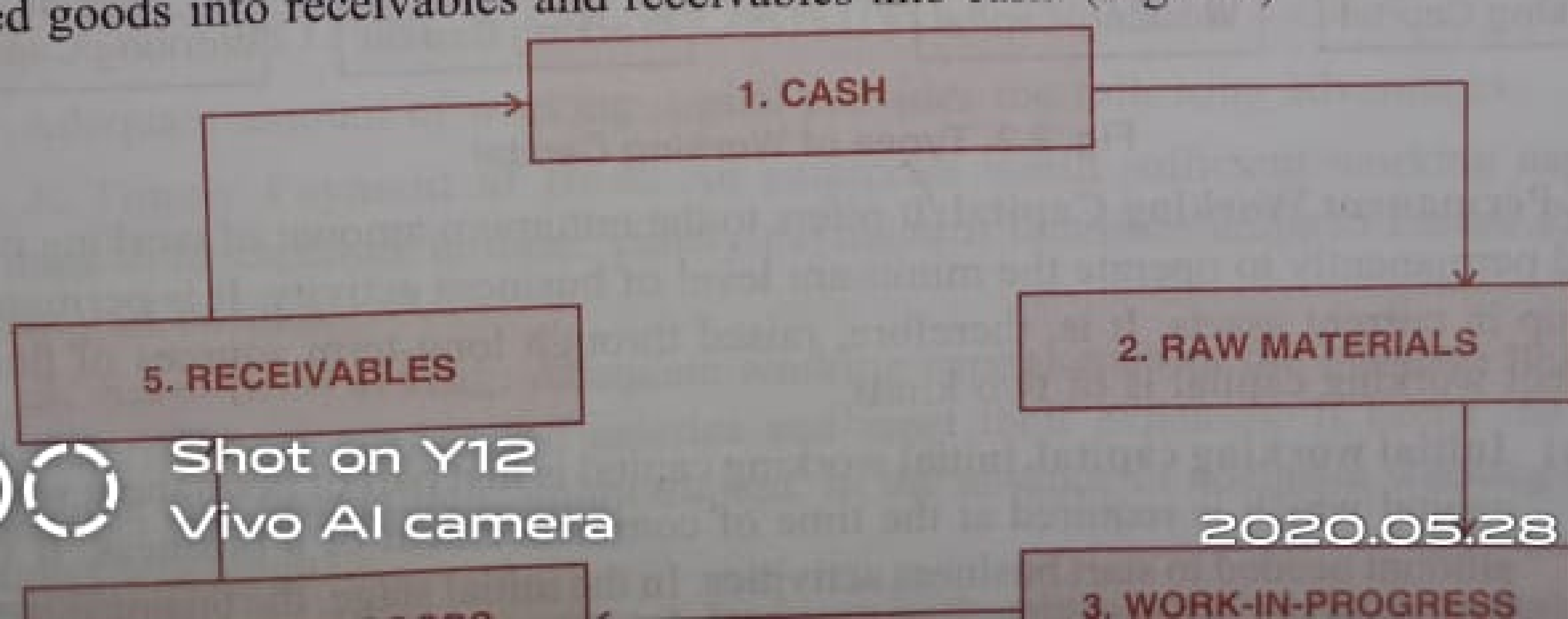
Factors: (*i*) Nature of business (*ii*) Size of business
(*iii*) Types of products (*iv*) Method of production
(*v*) Diversity of product lines (*vi*) Mode of acquiring fixed assets
(*vii*) Intangible assets

2.8. MEANING OF WORKING CAPITAL

Working capital means the capital invested in working assets or current assets such as cash, stock of goods, debtors and short-term investments, etc. It represents the liquid funds which are required for the day-to-day operations of an enterprise. According to *Shubin,* "working capital is the amount of funds necessary to cover the cost of operating the enterprise. Working capital in a going concern is a revolving fund. It consists of cash receipts from sales which are used to cover the cost of current operations."

Working capital is also known as *circulating capital or revolving capital* because it keeps on circulating or revolving in business. It is invested, recovered and reinvested repeatedly during the operating cycle of business. According to *Gerstenberg*, "circulating capital means current assets of a company that are changed in the ordinary course of business from one from to another as for example, from cash to inventories, inventories to receivables, receivables into cash".

In a manufacturing concern the operating cycle involves conversion of cash into raw materials, raw materials into work in progress, work in progress into finished goods, finished goods into receivables and receivables into cash. (Fig. 2.1)



examples of fixed assets. These assets are not fixed in value. Rather they are needed for long-term and cannot be disposed of without breaking up the business. Fixed capital is also known as *'block capital'* because it is blocked up in fixed assets for the life time of the enterprise.

According to Shubin, "fixed capital means the funds required for the acquisition of those assets that are to be used over and over for a long period such as land, building, machinery, equipment and tools". In the words of Wheeler, "fixed capital is invested in fixed or long term assets. The amount of fixed capital needed, therefore, varies directly with the amount of fixed assets owned or used by a business".

Fixed capital is required for establishing a new enterprise as well as for modernisation, expansion and diversification of an existing enterprise. Therefore, fixed capital provides the cornerstone of business. Fixed capital is raised through long-term sources of finance such as shares, debentures and retained earnings and long-term loans.

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2.7. FACTORS AFFECTING FIXED CAPITAL

The following factors are considered for determining the amount of fixed capital of a business enterprise.

1. Nature of Business: The amount of fixed capital varies from industry to industry. Manufacturing enterprises require heavy investment in fixed assets such as land and buildings and plant and machinery. Public utility undertakings like railways, city transport undertakings and electricity supply concerns also require heavy investment in fixed assets. But trading concerns require less investment in fixed capital.

2. Size of the Business: The scale of operations also determines the amount of fixed capital. A large sized enterprise requires a greater amount of fixed capital than a small scale firm. For example, a giant steel company such as the Tata Iron and Steel Company (TISCO) needs a huge investment in fixed capital as compared to mini steel plant. A large amount of fixed capital is necessary for a high volume of production.

3. Nature of Products: The types of products produced also determines the amount of fixed capital. A company manufacturing capital goods like machinery, engines, etc., will require a large amount of fixed capital. On the other hand, a firm producing consumer products like soaps, hair oil, toothpaste, etc., will need small amount of fixed capital. Similarly, firms operating in heavy industries such as ship-building require greater fixed capital than firms operating in light industries such as sugar mill.

4. Method of Production: A company employing capital intensive techniques of production such as automatic machinery requires higher amount of capital as compared to a company employing labour intensive techniques such as hand tools. For example, a powerloom plant requires much more fixed capital than a handloom unit.

5. Diversity of Product Lines: A multi-product company manufacturing diversified products requires more fixed capital than a firm manufacturing a single product. Similarly, an enterprise manufacturing each part of finished product by itself requires a greater amount of fixed capital as compared to a firm which buys component parts from outside and simply assembles them in its own factory.

(b) **Regular working capital.** It means that part of permanent working capital which is required for the continuous business operations. It represents the excess of current assets over current liabilities. It consists of enough cash to meet short-term obligations, to build up inventory and enough stock of finished goods to ensure quick delivery to customers.

2. Temporary or Variable Working Capital: It is the working capital that is required in addition to the permanent working capital. It is required to meet seasonal and special needs of business. It is fluctuating in nature and is, therefore known as variable working capital. The amount of temporary working capital depends upon the extent of extra demand in season and exigencies of urgent circumstances. It is generally raised from short-term sources of finance. Temporary working capital is of two types:

(a) **Seasonal Working Capital.** It means the extra working capital required during a particular season. Firms dealing in products of a seasonal nature (e.g., woollen garments, fans, umbrellas, etc.) require more working capital during the busy season. According to Gerstenberg, "Beyond their initial and regular circulating capital most business will require at stated intervals a larger amount of current assets to fill the demands of the seasonal busy periods". When the busy season begins, additional working capital is required to buy raw materials and pay extra labour.

For example, sugarcane, wheat, cotton, etc., are to be purchased in bulk during the season when these items are produced.

(b) **Special Working Capital.** It refers to extra funds required to meet future contingencies that may arise in business. It is advisable to set up a reserve working capital to act as a cushion in times of emergencies. A business firm must set aside additional funds to cope with unforeseen contingencies such as:

(i) special operations to meet sudden spurt in demand;

(ii) unusually stagnant periods or depression leading to piling up of inventory;

(iii) strikes, lockouts and natural calamities like earthquake, flood, fire, etc.

2.10 IMPORTANCE OF WORKING CAPITAL

Adequate amount of working capital provides the following advantages:

1. Timely Payment of Dues: An enterprise worth sufficient working capital can pay dues to its creditors in time. Timely payment of liabilities helps to ensure short-term solvency of business.

2. Smooth Working: Adequate working capital enables the business to purchase raw materials, pay wages and salaries and meet their expenses. It keeps the flow of production and distribution uninterrupted. In the absence of adequate working capital a business will stagnate.

3. High Credit Worthiness: A business with satisfactory working capital position enjoys high credit standing. Such a business firm can raise loans from banks and financial institutions easily and on more favourable terms.

The term working capital is used in two senses—gross working capital and net working capital.

Gross Working Capital: Gross working capital means the total amount of funds invested in current assets. Current assets are those assets which are converted into cash in the ordinary course of business.

Thus,

Gross working capital = Book value of current assets

Net working capital: It means the excess of current assets over current liabilities. Current assets include cash in hand, cash at bank, sundry debtors, bills receivable, marketable securities, inventory and prepaid expenses. Current liabilities include sundry creditors, bills payable, short-term loans (repayable within one year) and acquired expenses.

Thus,

Net working capital = Current assets – Current liabilities

Need: Working capital is required for the following purposes:

(*i*) to purchase raw materials, spare parts, operating supplies, etc.;

(*ii*) to pay wages and salaries to staff;

(*iii*) to meet day-to-day expenses like fuel, power, rent, taxes, advertising, delivery service, etc.

2.9 TYPES OF WORKING CAPITAL

Working capital can be classified as follows: (Fig. 2.2)

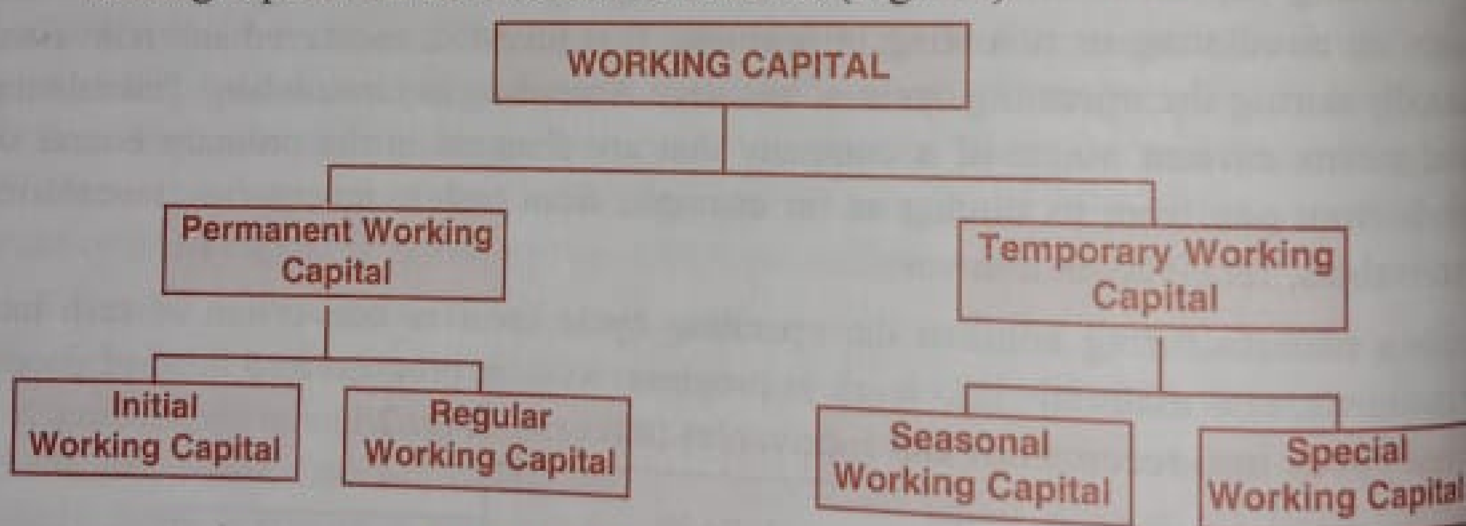

Fig. 2.2. Types of Working Capital

1. Permanent Working Capital: It refers to the minimum amount of working capital required permanently to operate the minimum level of business activity. It is permanently locked up in current assets. It is, therefore, raised through long-term sources of finance. Permanent working capital is of two kinds,

(*a*) **Initial working capital.** Initial working capital is that part of permanent working capital which is required at the time of commencement of a business. It is the amount needed to start business activities. In the initial stage, the business usually does not get credit from suppliers. Therefore, all operating expenses have to be incurred in cash. The capital to meet initial operating expenditure is generally provided by the owners.

3rd

Class - XII

Chap - 2 (Capital - Fixed and working)

Questions:

29/5/2020

Q1. Discuss the importance of Business Finance.

Q2. Discuss the sources of finance for different types of business firms.

Q3. What is financial planning?

Q4. Discuss the factors affecting Capital structure.

Q.5. What is fixed capital? Discuss the factors affecting fixed capital.

Q.6. What is working capital? Discuss the various types of working capital.

Q.7. Discuss the factors affecting working capital.

4. Cash Discount: An enterprise with sufficient liquid funds can take advantage of cash discount. Suppliers offer cash discount in return for prompt payment.

5. Availing Business Opportunities: A business having sufficient working capital can execute special orders at a short notice. It can buy raw materials in bulk during the season. It can hold stocks in order to secure higher prices. The bargaining power and competitive strength of such a business firm are high.

6. Good Relations with Employees: An enterprise having adequate working capital can pay wages and salaries to its employees in time. This helps to improve sense of safety and confidence of employees.

7. Timely Payment of Dividends: Cash is required for payment of dividends. A company may lose its reputation if dividends are not paid in time to shareholders due to shortage of cash.

2.11 FACTORS AFFECTING WORKING CAPITAL

The working capital requirements of an enterprise depend on the following factors:

1. Nature of Business: Manufacturing firms require considerable working capital as they have to build up stock of raw materials and finished products. On the other hand, public utility undertakings require less working capital as they do not have to maintain inventory.

2. Size of Business: Firms carrying on large scale operations and undertaking high volume of production require more working capital than small scale firms. For example, a departmental store needs greater amount of working capital as compared to a hawker.

3. Manufacturing Cycle: It means the time involved in the production of goods. Longer is the time gap between the purchase of raw materials and production of finished goods, higher is the need for working capital.

4. Rapidity of Turnover: Turnover means the speed with which the amount of working capital is recovered by the sale of goods. When the turnover is rapid, the amount of working capital required is small. This is because working capital is locked up in business for a short period.

5. Terms of Purchase and Sale: A business firm requires comparatively small amount of working capital if it buys goods and services on credit and sells them in cash. On the other hand, if it purchases in cash and sells on credit, larger amount of working capital will be required.

6. Credit Policy: When a liberal credit policy is followed, more working capital is required. On the contrary, smaller working capital is needed in case of a tight credit policy.

7. Operating Efficiency: Better utilisation of resources leads to reduction in costs and improves profitability. As a result need for working capital is reduced. High profit margins and flow of regular income from sales also reduce the amount of working capital required in business.

8. Goodwill of Business: An enterprise enjoying good reputation in the market can easily and quickly obtain short-term loans from commercial banks. It requires a less amount of working capital.