

**BCM SCHOOL, BASANT AVENUE, DUGRI ROAD, LUDHIANA**

**ANSWERKEY OF ASSIGNMENT CH 9**

**CLASS XII**

**B.STUDIES**

**MM: 15**

**Q1. How does an optimum capital structure help in maximizing the value of a firm? (1)**

**Answer:** By achieving the right mix of debt and equity, the overall cost of capital reduces and profitability increases, thus maximizing the firm's market value.

**Q2. Why is fixed capital decision considered irreversible? (1)**

**Answer:** Because investment in fixed assets is large and long-term, and reversing such decisions leads to heavy losses or financial burden.

**Q3. How do working capital needs differ in seasonal businesses?(1)**

**Answer:** Seasonal businesses require higher working capital during peak season to manage inventory and operations and lower working capital during off-season.

**Q4. A company manufactures air coolers. Due to the summer season arriving early, the company expects a rise in demand. To fulfill orders on time, it wants to maintain higher levels of inventory and provide credit to wholesalers for bulk purchases. (3)**

**Questions:**

- a) Identify the type of financial decision being discussed.
- b) Which two factors affecting this decision are highlighted?
- c) How will this decision benefit the company?

**Answer:**

a) **Working Capital Decision**

b) **Factors:** Nature of business (seasonal), Policy of credit sales

c) It will ensure **smooth production**, timely supply of goods and **increase in sales volume**, enhancing revenue.

**Q5. Sunrises Ltd., dealing in readymade garments, is planning to expand its business operations in order to cater to the international market. For this purpose, the company needs an additional 80,00,000 to replace machines with modern machinery of higher production capacity. The company wishes to raise the required funds by issuing debentures. The debt can be issued at an estimated cost of 10%. The EBIT for the previous year of the company**

**was 8,00,000, and the total capital investment was 1,00,00,000. Suggest whether the issue of debenture would be considered a rational decision by the company. Give reasons to justify your answer. (4)**

**ANS:** A company is able to issue debentures for fundraising when the debt cost is less than the cost of capital.

In this question, the cost of capital of Sunrises Limited is 10% which is 8,00,000, as the total capital is 80,00,000.

Now, the return on investment is calculated as

ROI = Return / Investment

= 8,00,000/1,00,00,000

= 8 %

Assuming that the company will be operating with the same efficiency, the additional investment of 80,00,000 will have an ROI of 8%, which will amount to 6,40,000.

The cost of debt will be 8,00,000, which is more than the ROI of 6,40,000. Therefore, it is advisable for a company not to issue a debenture when the cost of debt is higher than the cost of capital

**Q 6.**Gagan Electronics Ltd. is planning to expand its business by installing advanced machinery worth ₹10 crores. The finance manager suggests raising funds mainly through debt as interest is tax deductible. However, the CEO is concerned that too much borrowing may increase the company's dependency on creditors and lower the confidence of shareholders.

**Questions:**

1. Which financial decision is being taken here?
2. Explain any four factors that should be considered while making this decision.

**Answer:**

1. **Capital Structure / Financing Decision**
2. Factors to be considered:
  - **Cost of debt vs equity:** Debt is cheaper but increases financial risk
  - **Control considerations:** Equity dilutes ownership, debt does not
  - **Cash flow position:** Regular interest payments require strong cash inflows
  - **Risk and return:** High debt increases risk but may increase returns if managed well