CBSE Test Paper - 03

Chapter - 9 Financial Management

1. Short-term Investment Decision is also known as ____ **(1)**
   a. Dividend Decision
   b. None of these
   c. Working capital
   d. Capital Budgeting
2. The main objective of financial planning is to ensure that_________ **(1)**
   a. Purchase of raw material
   b. Enough funds are available at the right time
   c. Dividend is paid to shareholders on the right time
   d. Purchase of fixed assets
3. __________ means estimating the funds requirement of a business and determining the sources of funds for current and fixed assets and future expansion prospects. **(1)**
   a. Dividend Decisions
   b. Financial Planning
   c. Working Capital
   d. Capital Structure
4. A decision to acquire a new and modern plant to upgrade an old one is a: **(1)**
   a. None of the above
   b. Investment decision
   c. Working capital decision
   d. Financing Decision
5. What is working capital? **(1)**
6. "Both debt and equity have equal amount of risk." Comment **(1)**
7. Name the major determinant of dividend decision. **(1)**
8. 'Cost of debt' is lower than the cost of 'Equity Share Capital'. Give reason why even then a company cannot work only with the debt. **(1)**
9. Amar is doing his transport-business in Delhi. His buses are generally used for the tourists going to Jaipur and Agra. Identify the working capital requirements of Amar giving reason in support of your answer. Further Amar wants to expand and diversify

his transport-business. Explain any two factors that will affect his fixed capital requirements. **(3)**

10. Define ‘Current Assets’. Give examples of such assets. **(3)**
11. The Return on Investment (ROI) of a company ranges between 10%-12% for the past three years. To finance in future fixed capital needs, it has the following option for borrowing debts.
    Option A: Rate of Interest 90%
    Option B: Rate of Interest 13%
    Which source of debts, Option A or Option B is better? Give reason in support of your answer. Also, state the concept used in taking the decision. **(4)**
12. Explain the following as factors affecting financing decision
    i. Cost
    ii. Cash flow position of business
    iii. Control considerations
    iv. Floatation cost **(4)**
13. Gaurav Industries needs to raise funds of Rs.30,00,000. Its expected earnings before interest and taxes (EBIT) are Rs.2,00,000. The company wishes to use more of debt content as compared to equity to raise earning per share (EPS) of equity shareholders. The debt is available at interest of 10%. As a finance Manager, advise whether the company should prefer more of debt or more of equity to have higher EPS. Give reasons in support of your answer. **(5)**
14. How are the shareholders likely to gain with loan components in capital employed? Explain with suitable example. **(5)**
15. Kay Ltd. is a company manufacturing textiles. It has a share capital of Rs 60 lakhs. In the previous year, it's earning per share was Rs. 0.50. For diversification, the company requires an additional capital of Rs. 40 lakhs. The company raised funds by issuing 10% debentures for the same. During the year, the company earned a profit of Rs. 8 lakhs on the capital employed. It paid tax @ 40%.
    a. State whether the shareholders gained or lost, in respect of earning per share on diversification. Show your calculations clearly.
    b. Also, state any three factors that favor the issue of debentures by the company as part of its capital structure. **(6)**

Answer

1. c. Working capital
   Explanation:
   Short term investment decisions are the decisions related with the bills receivables, inventories, levels of cash and debtors etc. These decisions are also known as working capital decisions.
2. b. Enough funds are available at the right time
   Explanation:
   The process of estimating the fund requirement of a business and specifying the sources of funds is called financial planning. The objective of financial planning are
   - To ensure availability of funds whenever these are required
   - To see that the firm does not raise resources unnecessarily
3. b. Financial Planning
   Explanation:
   Financial planning means deciding in advance how much to spend, on what to spend according to funds at your disposal. In financial planning finance manager analyses various short term and long term investment plans and selects the most appropriate.
4. b. Investment decision
   Explanation:
   The Investment decision refers to the decision of investing funds in different assets. It can be long term or short term. A Long term Investment decision is also called 'Capital Budgeting Decision' . It involves investing the finance in capital assets like making investment in a new machine to replace an existing one, etc.
5. Working capital is the excess of current assets over current liabilities.

   Working Capital = Current Assets - Current Liabilities

6. The given statement is incorrect. There is more risk in case of debt as it involves interest commitment and repayment of principal amount.
7. The main determinant for dividend decision is earnings as the dividend is paid out of current and past years earnings.
8. A company cannot be formed without equity. Cost of debt is lower but a company cannot depend upon debt only. For starting a company, the owner's fund is extremely significant and essential. Moreover, the use of only debt capital creates a fixed liability on the company.
9. Working capital requirements of Amar would be less as transport company is a service industry. Further, the dealing is mainly on a cash basis rather than credit basis. Working capital requirements of Amar would include payment of salaries to staff, fuel charges, maintenance and upkeep of buses etc.
   Two factors which will affect his fixed capital requirements
   i. **The scale of Operations** The larger the size of a business, the greater is the amount of fixed capital required in terms of the purchase of new and better luxury buses. It will result in the higher requirement of the fixed capital in order to accomodate new luxury buses.
   ii. **Diversification** A diversified firm needs more fixed capital to meet its requirement of fixed assets of various divisions, which could be in terms of more offices and also servicing centres for buses etc.In this case, since, Amar would be diversifying his business, so he would open additional offices which will increase the requirement of fixed capital for the purchase of building and other assets.
10. Current assets are those assets which are expected to get converted into cash or cash equivalents within a period of one year. These assets provide liquidity to the firm, that is why sufficient investment in current assets is required to meet the short term obligations. Current Assets contribute towards the working capital of the business. An increase in the Current Assets leads to an increase in the working capital of the business and vice versa. Example of Current Assets : Marketable Securities, Debtors, Bills Receivables, cash in hand and cash at bank, Inventories, etc.
11. Out of the two available sources of debt according to me, Option A is better as the cost

of debt is less than the return on Investment which is the prerequisite to maximizing returns to the shareholders/trading on equity. Since the rate of Interest is 9%. Whereas the Return on Investment (ROI) of a company ranges between 10%-12% for the past three years.

This decision is based on the concept of Trading on Equity. Trading on Equity refers to the increase in the earnings per share by employing the sources of finance carrying a fixed financial charge like debentures (interest is paid at a fixed rate or preference shares (dividend is paid at a fixed). Trading on equity is the financial process of using debt to produce gain for the residual owners. The practice is known as trading on equity because it is the equity shareholders who have only interest (or equity) in the business income. When the amount of borrowing is relatively large in relation to capital stock, a company is said to be 'trading on this equity' but where borrowing is comparatively small in relation to capital stock, the company is said to be trading on thick equity.

The two conditions necessary for taking advantage of trading on equity are :

a. The rate of return on investment should be more than the rate of interest.
b. The amount of interest paid should be tax deductible.

12. i. **Cost:** The cost of raising funds through different sources are different. A prudent financial manager would normally opt for a source which is the cheapest. Debt carries a fixed operating cost, however, tax deductibility makes it a sought after the source.
    ii. **Cash flow position of business:** A stronger cash flow position may make debt financing more viable than funding through equity as the company finds itself in a better position to afford the fixed operating cost. Therefore, in order to take advantage of cheap finance, companies prefer debt to equity.
    iii. **Control considerations:** The ultimate control of the company is that of the equity shareholders. Greater the number of equity shareholders, the greater will be the control in the hands of more people. This is not a good situation, Therefore, from this point of view, the equity share capital should be avoided. In order to concentrate the control in fewer hands, debt should be chosen as a source.
    iv. **Floatation cost:** From the point of view of floatation costs, higher the floatation cost, less attractive the source becomes. In case of Equity financing, the floatation cost tends to be higher and thus debt financing is preferable in such case.

13. Gaurav Industries should use less of debt (preferebly no debt) to have higher EPS because current return on investment (ROI) is less than cost of debt. The prevailing ROI can be calculated as:

   ROI $= \frac{EBIT}{Total\ Investment} \times 100$

   Here, EBIT=2,00,000

   and Total investment =30,00,000

   Thus,ROI $= \frac{2,00,000}{30,00,000} \times 100$

   ROI=6.66%

   So, ROI is 6.66 % < 10%. When ROI is less than interest rate on debt, then EPS falls with rise in use of debt. So, the company should prefer more of equity to have higher EPS.

14. With a debt component m the total capital, shareholder; are likely to have the benefit of a higher rate of return on the share capital. This is because debt/loan carries a fixed charge and the amount of interest paid is deductible from the earnings before tax payment. The benefit to the shareholders will be realized only if the average rate of return on total capital invested in more than the rate of interest payable on loan/debt, For example, Let us consider two public companies X Ltd and Y Ltd.
   The following calculation will show how trading on equity increases the return on equity shares

   i.

X Ltd	Amt
Capital(Equity shares of 10 Rs each) Profit Before Interest and Tax(EBIT) (-)Tax @ 50 % Earning After Tax(EAT)	10,00,000* 1,00,000 (50,000) 50,000
Earning Per Share(EPS) = $\frac{\text{Earning After Tax}}{\text{Number of Shares}}$	$\frac{50,000}{1,00,000}$ = 0.50 Rs

   ii.

Y Ltd	Amt
Capital(Equity shares of 10 Rs each) 8% Debentures	10,00,000 8,00,000 2,00,000
Profit Before Interest and Tax(EBIT) (-) Interest @ 8%(of 2,00,000)	1,00,000 (16,000)
Earning before Tax(EBT) (-)Tax @ 50 % Earning after tax (EAT)	84,000 (42,000)
	42,000
Earning Per Share(EPS) = $\frac{\text{Earning After Tax}}{\text{Number of Shareholders}}$	$\frac{42,000}{80,000}$ = 0.525 Rs

Thus, it can be concluded that Y LTD using cost source, i.e. debentures, earn a relatively high rate of return on equity capital.

On the other hand, when the return on investment is less than the rate of interest than the inclusion of more of debt becomes less profitable as it decreases the Earning Per Share.

i.

X Ltd	Amt
Capital(Equity shares of 10 Rs each) Profit Before Interest and Tax(EBIT) (-)Tax @ 50 % Earning After Tax(EAT)	10,00,000* 1,00,000 (50,000) 50,000
Earning Per Share(EPS) = $\frac{\text{Earning After Tax}}{\text{Number of Shares}}$	$\frac{50,000}{1,00,000}$ = 0.50 Rs

ii.

Y Ltd	Amt
Capital(Equity shares of 10 Rs each) 12% Debentures	10,00,000 8,00,000 2,00,000

Profit Before Interest and Tax(EBIT) (-) Interest @ 8%(of 2,00,000)	1,00,000 (24,000)
Earning before Tax(EBT) (-)Tax @ 50 % Earning after tax (EAT)	76,000 (38,000)
	38,000
Earning Per Share(EPS) = $\frac{\text{Earning After Tax}}{\text{Number of Shareholders}}$	$\frac{38,000}{80,000}$ = 0.475 Rs

15. a. Let us presume that the share capital of Rs. 60 lakh is made up of Rs. 6 lakh equity shares assuming that the face value of each share is Rs. 10.

Sources	**Situation 1 (Amount in Rs))**	**Situation 2 Amount (in Rs))**
Equity shares	60,00,000	60,00,000
10 % Debentures	NIL	40, 00,000
Total Capital	60,00,000	1,00,00,000
EBIT	_	8,00,000
Less: Interest	_	- (4,00,000)
EBT	_	4,00,000
Less: Tax @ 40%	_	-(1,60,000)
EAT	*3,00,000	2,40,000
No. of shaers or Rs. 10 each	6,00,000	6,00,000
EPS	0.50	2,40,000/6,00,000 = 0.40

*0.50 $\times$ 6,00,000 = 3,00,000

Consequently EBT/EBIT in situation 1 = Rs. 5,00,000

Thus, on diversification, the earning per share fell down from Rs. 0.50 to Rs. 0.40.

b. A debenture is a type of debt instrument unsecured by collateral. Since debentures have no collateral backing, debentures must rely on the creditworthiness and reputation of the issuer for support. Both corporations and governments frequently issue debentures to raise capital or funds.

Corporations also use debentures as long-term loans. However, debentures of corporations are unsecured. Instead, they have the backing of only the financial viability and creditworthiness of the underlying company. These debt instruments pay an interest rate and are redeemable or repayable on a fixed date. A company typically makes these scheduled debt interest payments before they pay stock dividends to shareholders. Debentures are advantageous for companies since they carry lower interest rates and longer repayment dates as compared to other types of loans and debt instruments.

Thus three factors that favour the issue of debentures by the company as part of its capital structure are as follows:

i. Tax deductibility: Debt is considered to be a relatively cheaper source of finance as the amount of interest paid on debt is treated as a tax-deductible expense.
ii. Flotation cost: The money spent by the company on raising capital through debentures is less than that spent on equity.
iii. Control: The issue of debentures doesn't affect the control of the equity shareholders over the business as the debenture holders do not have the right to participate in the management of the business.