Model Answer/suggested solution **Business Finance**

M. Com (1st Semester) Examination, 2013 **Paper Code: AS-2368**

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Note: These model answers are a depiction of important points which an examinee must have to mention to secure high marks in particular question. The length of the answer may vary as per the examinee's understanding, interpretation and his/her ability to comprehend the content.

Q.1 Short answer type question: **2x10=20 marks**

a) Name the three main financial decisions in a business.

Ans.

i. Investment Decision.
ii. Financing Decision.
iii. Dividend Decision.

b) Discuss two main considerations in formulating financial plan.

Ans.

i. Nature of the Industry…..
ii. Standing of the Concern…
iii. Future Plans of the Concern….
iv. Availability of Sources….

- **Brief explanation is required for any two.**

c) What do you understand by working capital?

Ans. Funds are needed for short term purpose for the purchase of raw materials, payment of wages and other day to day expenses etc. these funds are known as working capital. Working capital refers to that part of firms capital which is required for financing short term or current assets such as cash, debtors, inventories etc. Working capital is needed for carrying out day to day operations of the business smoothly.

d) Write two disadvantages of inadequate working capital.

Ans. I) Difficulties in meeting even day to day commitments may create operational inefficiencies.

ii) Fixed asset may not be efficiently utilized and this may lower down the rate of return on investments.

iii) It cannot buy its requirement in bulk and cannot avail of discounts etc.

iv) It cannot pay its short term liabilities in time. Thus it will lose its reputation and shall not be able to get good credit facilities.

e) **Give the two methods for slowing the cash outflow.**

Ans.

i. Payment on the last date…….
ii. Payment through drafts……
iii. Adjusted Payroll Funds…….

f) **What is ploughing back of profits?**

Ans. Ploughing back of profits means that the company is used to finance the requirements of the company through undistributed or retained profits. The main feature of this method is that it is an internal source of finance. A good company does not distribute its entire earnings in the form of dividend but rather retains a part of it every year.

g) **What do you mean by External Financing?**

Ans. External Finance is a way in which a company raises financing through sources other than using its own money. This most commonly involves issuing equity shares of the company, such as selling stocks. It can also include taking out loan. External financing usually involves getting cash from outside source without giving goods and services in return. E.g Raising funds through issuing shares, debentures etc.

h) **Who are called as indigenous bankers?**

Ans. Indigenous bankers are generally the private money lenders which used to provide short term finance to the sole proprietorship and partnership firms. They are called mahajans and sahukars in India. They used to charge very high rates of interest and exploit the customers to the largest possible extent. But now a day with the development of commercial banks they have lost their monopoly.

i) **What is debenture?**

Ans. A debenture is a part of borrowed capital and is an acknowledgement of debt. A debenture may be defined as an acknowledgement of debt by the company. The debenture holders are entitled to periodical payment of interest at a fixed rate and are also entitled to redemption as per the terms of debenture issue. The debenture holders are the creditors of the company.

j) **List out two important features of underwriting.**

Ans. i) In the context of company underwriting means a responsibility or giving a guarantee that the securities offered to the public will be subscribed for.

ii) Underwriters gets commission on issue of shares at 5% of the issue price of shares and in case of debentures at 2.5% of the issue price of debentures.

Q.2 Long answer type question: **10 x 4=40 marks**

a) **“Finance function is the procurement of fund and its effective utilization in the business”. Elaborate this statement and analyse the nature and scope of finance function.**

Ans. In this question students are expected to write about how the finance is important for any business concern and what are the sources through which funds can be raised eg. Shares, debentures, Long term loans etc. and the implications attached with them. Moreover, students are also expected to write how the utilization of funds can be made effective and can be used in more profitable manner, so that no difficulty can be faced by the firm regarding repayment of these funds.

Further students should also write about the traditional & modern approach of finance function. Students are also expected to write about the how the finance function helps in the decision making process in the business management and scope relating to it.

b) **Explain the concepts and kinds of financial planning. Why is it necessary for successful business operation?**

Ans. Finance planning means pre determination policies for acquiring total capital for the business along with the nature and proper management of the said capital. Finance planning literally means to decide the structure of the future capital related progammes. The time at which funds will be raised should be carefully decided so that finances are raised at a time when these are needed. The next step of the finance is to decide the pattern of financing. There are number of ways of raising funds. The selection of various securities should be done very carefully. The funds may be raised by issuing shares, debentures, raising of loans etc.

Kinds of Finance Planning

Finance planning can be divided into three types on the basis of time:

- **Short term financial planning:** It is drafted for a year or less in any business.
- **Medium term financial planning:** this planning includes the financial plan between 1 to 5 years.
- **Long term financial planning:** This planning is done for more than five years.

Financial planning is required for any organization due to the following reasons:

1. Successful promotion of the business
2. Success of the entire firm.
3. Proper coordination in source of capital
4. Expansion and development of business.
5. Replacement of assets.
6. Adequate liquidity.
7. Adequate return on the capital required.

- **Brief explanation are required for each point.**

c) **Explain the traditional and modern concepts of working capital. How is it classified?**

Ans. Traditional concept: According to this concept working capital is of two types:

i. Gross working capital: The total current asset of any firm is its gross working capital. Current assets are those assets which can be converted into cash during the accounting year. It includes cash, bank balance, short term investment, debtors, receivables and stock.

ii. Net working capital: The excess of current assets over current liabilities is the net working capital. If the current assets and current liabilities are equal, working capital would be nil. If the current assets exceeds current liabilities, the working capital will be positive, else it will be negative.

Modern Concept: This is the new concept of working capital which is also called operating cycle concept. According to this concept," working capital is the liquid portion of the total enterprise capital which constitute a margin for meeting obligation with the ordinary operating cycle of the business." In a manufacturing concern, the working capital cycle starts with the purchase of raw materials, and ends with the realization of cash from the sale of finished goods. This cycle involves purchase of raw materials, its conversion into stock of finished goods through work in progress, conversion of finished stock into sales, debtors and receivables and ultimately realization of cash and this cycle continues again from cash to purchase of raw materials and so on.

Classification of Working capital:

i. Gross working Capital.
ii. Net working capital.
iii. Permanent working capital
iv. Variable working capital.

- **Brief explanation is required for each point.**

d) What do you understand by receivables? What factor influence the size of receivables?

Ans. Receivables represent amount owed to the firm by customers as a result of sale of goods or services in the ordinary course of business. Receivables result from credit sales. A concern is required to allow credit sales in order to expand its sales volume. It is not always possible to sell goods on cash basis only. Sometimes, other concern in that line might have established a practice of selling goods on credit.

Factors influencing the size of receivables:

i. Size of credit sales.
ii. Credit Policies.
iii. Expansion plans.
iv. Terms of trade relating to period of credit allowed.
v. Paying habits of customers**.**

- **Brief explanation is required for each point.**

e) What is over capitalization? Discuss the effects of over capitalization.

Ans. Over Capitalisation refers to that state of affairs when earning of the company do not justify the amount of capital invested in its business. Over capitalization means more capital than actually required and therefore, In overcapitalized concern, the invested funds are not properly used.

Suppose a company earns Rs. 500000 and the normal rate of return expected is 10 % then capitalization at Rs.500000 would be 500000x 100/10= Rs.5000000 a fairly capitalized situation. But suppose the

capital employed by this company is Rs. 6000000. Then the company is over capitalized by to the extent of Rs.1000000. the new rate of earnings now would be 500000/6000000 x 100=8.33%. Thus, a result of over capitalization, the rate of earnings has dropped from 10% to 8.33%.

Effects of over capitalization:

From the point of view of the company

a) Loss of market: Over capitalized company fail to produce goods at competitive costs and hence often lose their market to competitors.

b) Difficulty in obtaining capital: With the disappearance of reduction of dividends, the market value of the shares falls, and the investors lose confidence in the company. The credit of the company suffers a setback. Should a company require more funds for the purposes of bringing about any improvement or acquiring new assets, it will find it extremely difficult to raise the necessary fund from the market.

c) Liquidation of the company: Because of reduced earnings, there is a loss of goodwill and loss of confidence of the investors which results into liquidation of the company.

(d) Loss of Goodwill: It is often found that an over-capitalized company has to go into liquidation, unless drastic steps are taken to re-organise the share capital. Re-organisation would again mean considerable loss of goodwill.

From the point of view of society

(a) Loss to Customers: Over-capitalisation is an indication of reduced efficiency. An over-capitalized concern is compelled to raise the prices of its products. With diminished efficiency it is usually not able to maintain the quality of its products. Thus, the public is a loser both as regards price an quality.

(b) Loss to workers: An over-capitalized company may try to raise its profits by effecting cuts in wages of workers. This may affect industrial relations.

(c) Since an over-capitalized concern is unable to compete with other concerns, it may have to close down. The closure of a few companies in this manner may well become the cause of general panic and alarm. This would affect the interests of the creditors. The workers would also lose their jobs.

(d) Over-capitalisation results in misapplication of society's resources. The capital lying idle or being under-utilised by an over-capitalized concern can be better utilised by other concerns which are in need of funds.

From the shareholders' point of view

(a) Fall in the value of shares: Over-capitalisation means depreciation of investment. The shares of an over-capitalized company sell below par in the market. Originally the shareholders may have paid much more for them.

(b) Reduced Dividend: The shareholders have also to suffer due to a low return on their investment which, too, is not always certain and regular.

(c) Unacceptable as collateral securities: The shares of an over-capitalized company have relatively small value as security for loans which a shareholder may like to raise. Banks and other financial institutions do not lend money against such securities. Hence it is very difficult for the shareholders to borrow money against the security of their shares.

f) What is short term financing? Discuss the sources of short term financing.

Ans.

Short term finance refers to money that is needed for financial activities carried out for less than one year. These funds are usually used for day to day operations such as payment of wages, inventory ordering, advertisement expenses and so on. It is required for meeting the short term needs of working captal.Short term funds can be used over and over again.

There are a number of sources of short-term finance which are listed below:

i. **Trade credit** --- Trade credit refers to credit granted to manufactures and traders by the suppliers of raw material, finished goods, components, etc. Usually business enterprises buy supplies on a 30 to 90 days credit. This means that the goods are delivered but payments are not made until the expiry of period of credit. This type of credit does not make the funds available in cash but it facilitates purchases without making immediate payment. This is quite a popular source of finance.

ii. **Bank credit** -- Commercial banks grant short-term finance to business firms which is known as bank credit. When bank credit is granted, the borrower gets a right to draw the amount of credit at one time or in installments as and when needed. Bank credit may be granted by way of loans, cash credit, overdraft and discounted bills. This included Loans, Cash Credit and discounting of Bills and Overdraft.

iii. **Customers' advances** -- Sometimes businessmen insist on their customers to make some advance payment. It is generally asked when the value of order is quite large or things ordered are very costly. Customers' advance represents a part of the payment towards price on the product (s) which will be delivered at a later date. Customers generally agree to make advances when such goods are not easily available in the market or there is an urgent need of goods. A firm can meet its short-term requirements with the help of customers' advances.

iv. **Installment credit** -- Installment credit is now-a-days a popular source of finance for consumer goods like television, refrigerators as well as for industrial goods. You might be aware of this system. Only a small amount of money is paid at the time of delivery of such articles. The balance is paid in a number of installments. The supplier charges interest for extending credit. The amount of interest is included while deciding on the amount of installment. Another comparable system is the hire purchase system under which the purchaser becomes owner of the goods after the payment of last installment. Sometimes commercial banks also grant installment credit if they have suitable arrangements with the suppliers.

v. **Counter Trade** --- Counter trade is a method of financing trade, but goods rather than money are used to fund the transaction. It is a form of barter. Goods are exchanged for the other goods. This form of business for private enterprises is diminishing in local trading but for international trade is still a popular way of funding the business activities.

vi. **Commercial Banks**: Commercial Banks are the most important source of short term capital. The major portion of working capital loans are provided by commercial banks.the different forms in which bank normally provide loans and advances are cash credit, overdraft, purchasing and discounting of bills.

vii. **Indigenous Bankers:** Indigenous bankers are generally the private money lenders which used to provide short term finance to the sole proprietorship and partnership firms. They are called mahajans and sahukars in India. They used to charge very high rates of interest and exploit the customers to the largest possible extent. But now a day with the development of commercial banks they have lost their monopoly.

f) What are the sources and forms external financing?

Ans. External Finance is a way in which a company raises financing through sources other than using its own money. This most commonly involves issuing equity shares of the company, such as selling stocks. It can also include taking out loan. External financing usually involves getting cash from outside source without giving goods and services in return. E.g Raising funds through issuing shares, debentures etc. **External financing** is the phrase used to describe funds that firms obtain from outside of the firm. It is contrasted to internal financing which consists mainly of profits retained by the firm for investment. There are many kinds of external financing. External financing is generally thought to be more expensive than internal financing, because the firm often has to pay a transaction cost to obtain it.

External sources and forms.

- **Loans** - This is where the banks start to come into play. Banks will lend for either short-term or long-term purposes, but the nature of the loan will tend to differ. The main types are:
  - **Overdrafts** - This is a short-term facility where you can spend money, to an agreed limit, as you want. The bank will charge interest on any overdraft amount. They may only offer this as a short-term facility, but it can be very valuable for firms to fill short-term shortages of working capital or any possible brief cash flow problems.
  - **Long-term loans** - Long-term loans usually refer to lending over five years. The bank lends you a sum of money for a set time at an agreed rate of interest. It is more expensive than an overdraft, but lasts longer. The bank may well want some sort of guarantee for this type of loan to ensure that they get it back. It could perhaps be secured against an asset of the business.
  - **Debentures** - A debenture is specialised form of loan. It is effectively a loan from people to the firm that will be repaid at a fixed date. Between the issue of the debenture and the maturity date, the firm will pay a set level of interest. They are a common way for businesses to raise money and are relatively low risk, though this will depend on the stability of the business.
- **Shareholders** - Limited companies or plcs can issue shares. These shares can be issued at a certain price though this price will depend on the profitability of the company and its prospects, so how successful the issue is will depend on how the markets view this.
- **Factoring debts** - The firm may be able to sell their debts to a specialist debt-factoring company. This means that the firm sells their debts to the factoring company who pay them a proportion of the debts immediately. In this way the firm raises some immediate finance. The debt factoring company make their money by collecting the whole debt when it is due (having only paid the original firm a proportion of the debt)
- **Preference shares:** The preference shares are those shares which carry preferential rights as to the payment of dividend at a fixed rate and as to the repayment of capital. Preference share holders do not have the voting rights but it may be redeemable during the life time of the company.
- **Right Issue:** Right issue new shares to the existing shareholders. Shares issue this way generate goodwill and maintain the predictability of shareholders governance.

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