Case Studies – (Chapter - 9) Financial Management, BST Class 12

Case Studies – (Chapter - 9) Financial Management

Q. 1. Arun is a successful businessman in the paper industry. During his recent visit to his friend’s place in Mysore, he was fascinated by the exclusive variety of incense sticks available there. His friend tells him that Mysore region in known as a pioneer in the activity of Agarbathi manufacturing because it has a natural reserve of forest products especially Sandalwood to provide for the base material used in production. Moreover, the suppliers of other types of raw material needed for production follow a liberal credit policy and the time required to manufacture incense sticks is relatively less. Considering the various factors, Arun decides to venture into this line of business by setting up a manufacturing unit in Mysore.

In context of the above case:

1. Identify of the above case:
2. Identify the three factors mentioned in the paragraph which are likely to affect the working capital requirements of his business.

Ans.

1. Investment decision has been taken by Arun. Investment decision seeks to determine as to how the firm’s funds are invested in different assets. It helps to evaluate new investment proposals and select the best option on the basis of associated risk and return. Investment decision can be long term or short-term. A long-term investment decision is also called a Capital Budgeting decision
2. The three factors mentioned in the paragraph which are likely to reduce the working capital requirements of his business are as follows:
   1. Available of raw material:
   2. Production cycle:
   3. Credit availed:

Q. 2. ‘Adwitiya’ is a company enjoying market leadership in the food brands segment. It’s portfolio includes three categories in the Foods business namely Snack Foods, Juices and
Confectionery. Keeping in the with the growing demand for packaged food it now plans to introduce ready-To-Eat Foods. Therefore, the company has planned to undertake investments of nearly Rs. 450 crores for its new line of business. As per the current financial report, the interest coverage ratio of the company and return on investment is higher. Moreover, the corporate tax rate is high.

In context of the above case:

1. As a financial manager of the company, which source of finance will you opt for debt or equity, to raise the required amount of capital? Explain by giving any two suitable reasons in support of your answer.
2. Why are the shareholder's of the company like to gain from the issue of debt by the company?

Ans.

1. As a financial manager of the company, I will opt for debt to raise the required amount of capital.

I support my decision by giving the following reasons:

1. Interest coverage ratio:
2. Tax rate:
   1. The shareholders of the company are likely to gain from the issue of debt by the company because the return on investment is higher. It helps a company to take advantage of trading on equity to increase the earnings per share.

Q. 3. Computer Tech Ltd., is one of the leading information technology outsourcing services providers in India. The company provides business consultancy and outsourcing services to its clients. Over the past five years the company has been paying dividends at high rate to its shareholders. However, this year, although the earnings of the company are high, its liquidity position is not so good. Moreover, the company plans to undertake new ventures in order to expand its business.

In context of the above case:

1. Give any three reasons because of which you think Computer Tech Ltd. has been paying dividends at high rate to its shareholders over the past five years.
2. Comment upon the likely dividend policy of the company this years by stating any two reasons in support of your answer.
Ans.

1. Computer Tech Ltd. has been paying dividends at high rate to its shareholders over the past five years because of the following reasons:
   1. Earnings:
   2. Cash flow position:
   3. Access to capital market:
      1. This year the company is likely to follow a conservative dividend policy because of the following reasons:
         1. The cash flow position of the company is not god and dividends are paid in cash.
         2. The company may like to retain profits to finance its expansion projects. Retained profits do not involve any explicit cost and are considered to be the cheapest source of finance.

Q. 4. Bhuvn inherited a very large area of agricultural land in Haryana after the death of his grandfather. He plans to sell this piece of land and use the money to set up a small scale paper factory to manufacture all kinds of stationary items from recycled paper. Being an amateur in business, he decides to consult his friend Subhash who works in a financial consultancy firm. Subhash helps him to prepare a blue print of his future business operations on the basis of sales forecast in next five years. Based on these estimates, he helps Bhuvan to assess the fixed and working capital requirements of business.

In context of the above case:

1. Identify the type of financial service that Subhash has offered to Bhuvan.
2. Briefly state any four points highlighting the importance of the type of financial service identified in part (a)

Ans.

1. Financial planning is the type of financial service that Subhash has offered to Bhuvan.
2. The four points highlighting the importance of financial planning are as follows:
   1. It ensures smooth running of a business enterprise by ensuring availability of funds at the right time.
   2. It helps in anticipating future requirements of a funds and evading business shocks and surprises.
   3. It facilitates co-ordination among various departments of an enterprise like marketing and production function, through well-defined policies and procedures.
4. It increases the efficiency of operations by curbing wastage of funds, duplication of efforts, and gaps in planning.

Q. 5. 'Madhur Milan' is a popular online matrimonial portal. It seeks to provide personalized match making service. The company has 80 offices in India, and is now planning to open offices in Singapore, Dubai and Canada to cater to its customers beyond the country. The company has decided to opt for the sources of equity capital to raise the required amount of capital.

In context of the above case:

1. Identify and explain the type of risk which increases with the higher use of debt.
2. Explain briefly any four factors because of which you think the company has decided to opt for equity capital.

Ans.

1. Financial risk of the company increases with the higher use of debt. This is because issue of debt involves fixed commitment in terms of payment of interest and repayment of capital. Financial risk refers to a situation when a company is unable to meet its fixed financial charges.
2. The factors because of which the company has decided to opt for equity capital are as follows:
   1. Capital market conditions:
   2. Fixed operating cost:
   3. Cash flow position:
   4. Risk:

Q. 6. Wooden Peripheral Pvt. Ltd. is counted among the top furniture companies in Delhi. It is known for offering innovative designs and high quality furniture at affordable prices. The company deals in a wide product range of home and office furniture through its eight showrooms in Delhi. The company is now planning to open five new showrooms each in Mumbai and Bangalore. In Bangalore it intends to take the space for the showrooms on lease whereas for opening showrooms in Mumbai, it has collaborated with a popular home furnishing brand, 'Creations.'

1. Identify the factors mentioned in the paragraph which are likely to affect the fixed capital requirements of the business for opening new showrooms both in Bangalore and Mumbai separately.
2. “With an increase in the investment in fixed assets, there is a commensurate increase in the working capital requirement.” Explain the statement with reference to the case above.

Ans.

1. The fixed capital requirements of Wooden Peripheral Pvt. Ltd. for opening new showrooms in Bangalore will be relatively less as its taking space on lease, so only rentals have to be paid.

Similarly, its fixed capital requirement for opening showrooms in Mumbai will be reduced as its going to share the costs with another company through collaboration.

1. It’s true that, “With an increase in the investment in fixed assets, there is a commensurate increase in the working capital requirements,” Like in the above case, Wooden Peripheral Pvt. Ltd. is planning to investment in new showrooms. Consequently, its requirement of working capital will increase s it will need more money to stock goods, pay electricity bills and salaries to staff. Also, it intends to take the space for the showrooms I Mumbai on lease so it will have to pay rentals.

Q. 7. Krishna Ltd. is manufacturing steel at its plant at Noida. Due to economic growth, the demand for steel is also growing. The company is planning to set up a new steel plant at Gurgaon. It needs Rs. 800 crore to start the new plant. It decides to raise Rs. 300 crore through debentures, Rs. 200 crore through long-term loan from banks and Rs. 200 crore by issue of equity share to the public. It decided to finance the remaining amount by utilizing its reserves and surplus.

1. State the importance of financial planning for this company.
2. What is the capital structure of this company? Explain.
3. Identify the financial decision involved when the company decides to raise Rs. 800 crore from different sources of funds.
4. How will the dividend decision of Krishna Ltd. be affected? Explain. (6 marks)

Ans.

1. Financial planning will help the company in avoiding business shocks and surprises. It will reduce waste and duplication of efforts.
2. Capital structure refers to the mix between owners funds and borrowed funds. It is calculated as debt equity ratio
i.e., **Debit**

**Equity**

For Krishna Ltd.

Debt = Debentures + Long tgerm loans from banks = 300 + 200 = Rs. 500 crore.

Equity = Share capital + Reserves and surplus (or retained earnings)

= 200 + 100 = Rs. 300 crores.

Therefore, debt equity ratio = \( \frac{500}{300} = 1.67 : 1 \)

1. Financing decision
2. Since the company have growth opportunities of setting up a new steel plant at Gurgaon, it retains Rs. 100 crore out of profits to finance the required investment. So, it is likely to pay less dividend. However, since the company makes more debt financing than funding through equity, it implies that cash flow position of the company is strong. Therefore, it can pay higher dividend.

Q. 8. Cost of debt is less than cost of equity. Still a company cannot go with entire debt. Why?

Ans. Because debt is more risky for a business, since payment of interest and return principal amount is compulsory for the business. Any default in meeting these commitments may force the business to go into liquidation. That is, increased use of debt increases financial risk of a business (*the chance that a firm would fail to pay interest on debt and the principal amount*).

Q. 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 requirement of Amar giving reason in support of your answer. Further Amar wants to expand and diversify his Transport business. Enumerate any four factors that will affect his fixed capital requirements.(3Marks)

Ans. Working capital requirements of Amar would be less as it is a SERVICE industry.
Factors which will affects his fixed capital requirements are:

1. Scale of operations
2. Financing alternatives
3. Growth prospects
4. Diversification

Q. 10. Yogesh, a business man is engaged in publishing and selling of Ice-creams. Identify the working capital requirement of Yogesh giving reason in support of your answer. (1 Mark)

Ans. Working capital requirements of Yogesh would be less as it is a TRADING business.

Q. 11. Manish is engaged in business of garments manufacturing. Identify the working capital requirement of Manish giving reason in support of your answer. (1 Mark)

Ans. Working capital requirements of Manish would be less as it is a MANUFACTURING business. So raw material needs to be converted into finished goods before any sales can become possible.

Q. 12. The directors of a manufacturing company are thinking of issuing Rs. 20 crores worth additional debentures for expansion of their production capacity. This will lead to an increase in debt equity ratio from 2 : 1 to 3 : 1. What are the risks involved in it? What factors other than risk do you think the directors should keep in view before taking the decision? Name any four factors. (3 Marks)

Ans. Higher use of debt increases the fixed financial charges of a business because payment of interest and return of principal amount is compulsory. Any default in meeting these commitments may force the business to go into liquidation. As a result, increased use of debt increases the financial risk of a business. Financial risk is the chance that a firm would fail to meet its payment obligations.

Other factors affecting this decision are:

1. Cost
2. Cash flow position
3. Control
4. Return on investment (ROI)
Q. 13. Amit is running an ‘Advertising agency’ and earning a lot by providing this service to big industries. State whether the working capital requirement of the firm will be ‘less’ or ‘more’. Give reason in support of your answer. 1 Mark)

Ans. Less working capital is required as service industries which usually do not have to maintain inventory require less working capital.

Q. 14. Tata International Ltd. earned a net profit of Rs. 50 crores. Ankit the finance manager of Tata International Ltd. wants to decide how to appropriate these profits. Identify the decision that Ankit will have to take and also discuss any five factors which help him in taking this decision. (6 Marks)

Ans. Dividend decision

Factors affecting dividend decision.

1. Earnings:
2. Stability of earnings:
3. Stability of dividends:
4. Growth opportunities:
5. Cash flow position:

Q. 15. Shalini, after acquiring a degree in Hotel Management and Business administration took over her family food processing company of manufacturing pickles, jams and squashes. The business was established by her great grandmother and was doing reasonably well. However the fixed operating costs of the business were high and the cash flow position was weak. She wanted to undertake modernization of the existing business to introduce the latest manufacturing processes and diversify into the market of chocolates and candies. She was very enthusiastic and approached a finance consultant, who told her that approximately Rs. 50 lakh would be required for undertaking the modernization and expansion programme. He also informed her that her stock market was going through a bullish phase.

1. Keeping the above considerations in mind, name the source of finance Shalini should not choose for financing the modernization and expansion of her food processing business. Give one reason in support of your answer.
2. Explain any two other factors, apart from those stated in the above situation, which Shalini should keep in mind while taking this decision. (6 Marks)

Ans.

1. Debt

Any one reason

1. Due to weak cash flow position, the firm may not be able to honour fixed cash payment obligations.
2. Increased fixed operating cost will increase the business risk therefore debt should not be issued as it further increases the financial risk.
3. The stock market condition being bullish, the investors will prefer to buy equity shares.

1. Other factors which Shalini would keep in mind are:
   1. Return on Investment
   2. Tax rate

Q. 16. ‘Indian Logistics’ has its own warehousing arrangements at key locations across the country. Its warehousing services help business firms to reduce their overheads, increase efficiency and cut down distribution time.

State with reason, whether the working capital requirements of ‘India Logistics’ will be high or low. (1 Mark)

Ans. Low, as it is a service industry, which usually do not have to maintain inventory.

Q. 17. ‘Sarah Ltd.’ is a company manufacturing cotton yarn. It has been consistently earning good profits for many years. This year too, it has been able to generate enough profits. There’s is availability of enough cash in the company and good prospects for growth in future. It is a well managed organization and believes in quality, equal employment opportunities and good remuneration practices. It has many shareholders who prefer to receive a regular income from their investments.

It has taken a loan of Rs. 40 lakhs from IDBI and is bound by certain restrictions on the payment of dividend according to the terms of loan agreement.
The above discussion about the company leads to various factors which decide how much of the profits should be retained and how much has to be distributed by the company.

Quoting the lines from the above discussion identify and explain and four such factors.

(6 Marks)

Ans. Factors affecting dividend decision: (Any four)

1. Stability of earnings

It has been consistently earning good profits for many years'.

Stability of earnings affects dividend decision as a company having stable earnings is in a position to declare higher dividends.

1. Cash Flow position

‘There is available of enough cash in the company’.

A good cash flow positions is necessary for declaration of dividend.

1. Growth Prospects

‘Good prospects for growth in the future.’

If a company has good growth opportunities, it pays out less dividend.

1. Shareholders’ preference

‘It has many shareholders who prefer to receive regular income from their investments.’

Shareholder’s preference is kept in mind by the management before declaring dividends.

1. Contractual constraints

‘It has taken a loan of Rs. Rs. 40 Lakhs from IDBI and … agreement.’

Which taking dividend decision, companies keep in mind the restrictions imposed by the lenders in the loan agreement.

Q. 18. Shubh Ltd. is manufacturing steel at its plant in India. It is enjoying a buoyant demand for its products as economic growth is about 7%-8% and the demand for steel is growing. The company has decided to set up a new steel plant to cash on the increased demand. It is estimated that it will require about Rs. 2000 crore to set up and about Rs. 500 crore of working capital to start the new plant.
1. State the objective of financial management for this company.
2. Identify and state the decision taken by the finance manager in the above case.
3. State any two common factors affecting the fixed and working capital requirements of Shubh Ltd. (6 Marks)

Ans.

1. Objectives of financial management of this company are:
   1. To ensure availability of sufficient funds from different sources at reasonable costs.
   2. To ensure effective utilization of such funds.
   3. To ensure safety of funds procured by creating reserves, reinvesting profits, etc.

Value: Maximisation of shareholders’ wealth.

1. Investment decision

It relates to how the firm’s funds are invested in different assets – fixed assets and working capital.

1. Factors affecting fixed and working capital requirements of Shubh Ltd.:
   1. Nature of business:
   2. Scale of operations:

Q. 19. In a company profits are high and in future less scope of expansion exists. The company has decided to distribute less amount of share of profits to its shareholders.

   1. Identify of share of profits to its shareholders.
   2. State any one value which is affected by the company’s decision. (3 Marks)

Ans.

1. Dividend decision

This decision involves how much of the profit earned by the company (after paying tax) is to be distributed to the shareholder and how much of it should be retained in the business.

1. Value affected: Shareholders’ wealth will not be maximized.

Q. 20. A company’s earnings before interest and tax is Rs. 7 lac. It pays 10% interest on its debt. Total investment of company is rs. 50 lac.

   1. Advise company whenever it should include debt or equity to raise its capital.
   2. Name the concept related to this.
3. Will be company’s decision to raise funds from debt or equity will change if company’s EBIT becomes 3 lac.

Ans.

1. Company should prefer debt to raise fund as debt is gainful for equity shareholders till ROI > Rate of Interest.

In the above case ROI = \( \frac{\text{EBIT}}{\text{Total Income}} \times 100 \)

Total Income

\[ = 7 \times 100 = 14\% \]

1. 

2. 

14 > 10 so debt it more suitable.

1. The concept is leverage effect or trading in equity.

2. Yes company’s decision will change if EBIT becomes 3 lac, because with 3 lac ROI will become less than interest.

\[ \text{ROI} = \frac{\text{EBIT}}{50} = 6\% \]

Interest = 10%

6% < 10%

So, now company must prefer equity to raise capital.

Q. 21. Storage Solution Ltd. is a large warehousing network company operating through a chain of warehouses at 40 different locations across India. The company now intends to undertake computerization of its owned warehouses as it seeks to provide better value added and cost effective solutions for scientific storage and preservation services to the market participants dealing in agricultural products including farmers, traders, etc.

In context of the above case:
1. How is the decision to undertake computerization of owned warehouses likely to affect the fixed capital requirements of its business?
2. Name any two sources that company may use to finance the implementation of this plan.

Ans.

1. The decision to undertake computerization of owned warehouses will increase the fixed capital requirements of its business both in present and future as after sometime, the technology being used will become obsolete and need up gradation.
2. The company may use retained earnings and take loans from financial institutions to implement this plan.

Q. 22. Visions Ltd. is a renowned multiplex operator in India. Presently, it owns 234 screens in 45 properties at 20 locations in the country. Considering the fact that the there is a growing trend among the people to spend more of their disposable income on entertainment, two years back the company had decided to add more screens to its existing set up and increase facilities to enhance leisure, food chains etc. it had then floated an initial public offer of equity shares in order to raise the desired capital. The issue was fully subscribed and paid. Over the year, the sales and profits of the company have increased tremendously and it has been declaring higher dividend and the market price of its shares has increased manifolds.

In context of the above case:

1. Name the different kinds of financial decisions taken by the company by quoting lines from the paragraph.
2. Do you think the financial management team of the company has been able to achieve its prime objective? Why or why not? Give a reason in support of your answer.

Ans.

1. The different kinds of financial decisions taken by the company are as follows:
   1. Investment decision:
   2. Financing decision:
   3. Dividend decision:
1. Yes, the financial management team of the company has been able to achieve its prime objective i.e. wealth maximization of the shareholders by maximizing the market price of the shares of the company.
Q. 23. Wireworks Ltd. is a company manufacturing different kinds of wires. Despite fierce competition in the industry, it has been able to maintain stability in its earnings and as a policy, uses 305 of its profits to distribute dividends. The small investors are very happy with the company as it has been declaring high and stable dividend over past five years.

In context of the above case:

1. State any one reason because of which the company has been able to declare high dividend by quoting line from the paragraph.
2. Why do you think small investors are happy with the company for declaring stable dividend?

Ans.

1. \textit{Stability in earnings}:

“Despite fierce competition in the industry, it has been able to maintain stability in its earnings.”

1. The small investors are happy with the company for declaring stable dividend as they enjoy a regular income on their investment.

Q. 24. Manoj is a renowned businessman involved in export business of leather goods. As a responsible citizen, he chooses to use jute bags for packaging instead of plastic bags. Moreover, on the advice of his friends, he decides to use jute for manufacturing aesthetic handicrafts, keeping in view the growing demand for natural goods. In order to implement his plan, after conducting a feasibility study, he decides to set up a separate manufacturing unit for producing varied jute products.

In context of the above case:

1. Identify the type of investment decision taken by Manoj by deciding to set up a separate manufacturing unit for producing jute products.
2. State any two factors that he is likely to consider while taking this decision.

Ans.

1. Capital budgeting decision has been taken by Manoj.
2. The factors affecting Capital Budgeting Decision are as follows:
   1. Cash inflows:
   2. Rate of return:
Q. 25. Well-being Ltd. is a company engaged in production of organic foods. Presently, it sells its products through indirect channels of distribution. But, considering the sudden surge in the demand for organic products, the company is now inclined to start its online portal for direct marketing. The financial managers of the company area planning to use debt in order to take advantage of trading on equity. In order to finance its expansion plans, it is planning to raise a debt capital of Rs. 40 lakhs through a loan @ 10% from an industrial bank. The present capital base of the company comprises of Rs. 9 lakh equity shares of Rs. 10 each. The rate of tax is 30%.

In the context of the above case:

1. What are the two conditions necessary for taking advantage of trading on equity?
2. Assuming the expected rate of return on investment to be same as it was for the current year i.e. 15%, do you think the financial managers will be able to meet their goal. Show your workings clearly.

Ans.

1. The two conditions necessary for taking advantage of trading on equity are:
   - The rate of return on investment should be more than the rate of interest.
   - The amount of interest paid should be tax deductible.

2.

<table>
<thead>
<tr>
<th>Sources</th>
<th>Situation 1 Amount (in Rs.)</th>
<th>Situation 2 Amount (in Rs.)</th>
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</thead>
<tbody>
<tr>
<td>Equity shares</td>
<td>90,00,000</td>
<td>90,00,000</td>
</tr>
<tr>
<td>10% Debentures</td>
<td>NIL</td>
<td>40,00,000</td>
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<tr>
<td>Total Capital</td>
<td>90,00,000</td>
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<tr>
<td>EBIT</td>
<td>13,50,000</td>
<td>19,50,000</td>
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<tr>
<td>Less: Interest</td>
<td>--</td>
<td>- (4,00,000)</td>
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<tr>
<td>EBT</td>
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<tr>
<td>Less: Tax @ 30%</td>
<td>- (4,05,000)</td>
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<tr>
<td>EAT</td>
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<tr>
<td>No. of shares of Rs. 10 each</td>
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<tr>
<td>EPS</td>
<td>9,45,000/9,00,000 = 105</td>
<td>10,85,000/9,00,000 = 121</td>
</tr>
</tbody>
</table>

Yes, the financial managers will be able to meet their goal as the projected EPS, with the issue of debt, is higher than the present EPS.

Q. 26. 'Ganesh Steel Ltd.' is a large and credit-worthy company manufacturing steel for the Indian market. It now wants to cater to the Asian market and decides to invest in new hi-tech machines. Since the investment is large, it requires long-term finance. It decides to raise funds by issuing equity shares. The issue of equity shares involves huge floatation cost. To meet the expenses of floatation cost the company decides to tap the money-market.
1. Name and explain the money-market instrument the company can use for the above purpose.
2. What is the duration for which the company can get funds through this instrument?
3. State any other purpose for which this instrument can be used.

Ans.

1. Commercial Paper:

It is a unsecured promissory note issued by large and credit worthy companies to raise short terms funds at lower rates of interest than the prevailing market rates.

1. 15 days to one year.
2. It can also be used for seasonal and working capital needs

By sumit shukla……………..