1. Introduction to Corporate Finance

Q.1 A) Select the correct answer from the options given below and rewrite the statements. (Answers)

1. ......is related to money and money management.

a) Production

b) Marketing

<u>**c) Finance**</u>

2. Finance is the management of .... affairs of the company.

<u>**a) monetary**</u>

b) marketing

c) production

3. Corporation finance deals with the acquisition and use of .... by business corporation.

a) goods

<u>**b) capital**</u>

c) land

4. Company has to pay .... to government.

<u>**a) taxes**</u>

b) dividend

c) interest

5. .... refers to any kind of fixed assets.

a) Authorised capital

b) Issued capital

<u>**c) Fixed capital**</u>

6. .... refers to the excess of current assets over current liabilities.

<u>**a) Working capital**</u>

b) Paid-up capital

c) Subscribed capital

7. Manufacturing industries have to invest .... amount of funds to acquire fixed assets.

<u>**a) huge**</u>

b) less

c) minimal

8. When the population is increasing at high rate, certain manufacturers find this as an opportunity to .... business.
a) close
b) expand
c) contract

9. The sum of all .... is gross working capital.
a) expenses
b) current assets
c) current liabilities

10. .... means mix up of various sources of funds in desired proportion.
a) Capital budgeting
b) Capital structure
c) Capital goods

B) Match the pairs.

Group 'A'	Group 'B'
a) Capital budgeting	1) Sum of current assets
b) Fixed capital	2) Deals with acquisition and use of capital
c) Working capital	3) Fixed liabilities
d) Capital structure	4) Sum of current liabilities
e) Corporate finance	5) Fixed assets
	6) Investment decision
	7) Financing decision
	8) Deals with acquisition and use of assets
	9) Mix up of various sources of funds
	10) Product mix

Answers

Group 'A'	(Answers)
a) Capital budgeting	1) Investment decision
b) Fixed capital	2) Fixed assets
c) Working capital	3) Sum of current assets
d) Capital structure	4) Mix up of various sources use of assets

e) Corporate finance	5) Deals with acquisition and use of capital

C) Write a word or a term or a phrase which can substitute each of the following statements.

1. A key determinant of success of any business function.
Ans: Finance

2. The decision of finance manager which ensures that firm is well capitalised.
Ans: Financing Decision

3. The decision of finance manager to deploy the funds in systematic manner.
Ans: investment decision

4. Capital needed to acquire fixed assets which are used for longer period of time.
Ans: Fixed Capital

5. The sum of current assets.
Ans: Working Capital

6. The excess of current assets over current liabilities.
Ans: Gross working capital

7. The process of converting raw material into finished goods.
Ans: Product Cycle

8. The boom and recession cycle in the economy.
Ans: Business cycle

9. The ratio of different sources of funds in the total capital.
Ans: Capital structure

10. The internal source of financing.
Ans: Retained earnings

D) State whether the following statements are true or false.

1. Finance is related to money and money management.
Ans: True

2. Business firm gives green signal to the project only when it is profitable.
Ans: True

3. Corporate finance brings coordination between various business activities.
Ans: True

4. Fixed capital is also referred as circulating capital.
Ans: False

5. Working capital stays in the business almost permanently.
Ans: False

6. The business will require huge funds, if assets are acquired on lease basis.
Ans: False

7. The business dealing in luxurious products will require huge amount of working capital.
Ans: True

(8) A firm with large scale operations, will require more working capital.
Ans: True

(9) Liberal credit policy creates a problem of bad debts.
Ans: True

(10) Financial institutions and banks cater to the working capital requirement of business.
Ans: True

E) Find the odd one.

1. Land and Building, Plant and Machinery, Cash.
Ans: Cash

2. Debenture Capital, Equity Share Capital. Preference Share Capital.
Ans: Debenture Capital

3. Fixed Capital, Capital Structure, Working Capital.
Ans: Capital Structure

F) Complete the sentences.
1. Initial planning of capital requirement is made by **Finance Manager.**

2. When there is boom in economy, sales will **Increase.**

3. The process of converting raw material into finished goods is called **Production cycle.**

4. During recession period sales will **Decrease.**

G) Select the correct option from the bracket.

Group 'A'	Group 'B'
a) Financing decision	**1) To have a right amount of capital**
b) Fixed capital	2) Longer period of time.
c) Investment decision	**3) Deploy funds in systematic manner.**
d) Working Capital	4) Circulating capital
e) Combination of various sources of funds	**5) Capital structure**

(To have right amount of capital, Deploy funds in systematic manner, Fixed capital, Working capital, Capital structure)

H) Answer in one sentence.
(1) Define corporate finance.

Ans. According to Henry Hoagland, "Corporate finance deals primarily with the acquisition and use of capital by business corporation."

(2) What is fixed capital?

Ans. Fixed capital is that portion of capital which is invested in fixed assets such as land, building, furniture, etc.

(3) Define working capital.

Ans. Gerstenbergh defines it as "The excess of current assets over current liabilities."

(4) What is production cycle?

Ans. The process of converting raw material into finished goods is called production cycle.

(5) Define capital structure.

Ans. According to R. H. Wessel, "The long term sources of funds employed in a business enterprise."

I) Correct the underlined words and rewrite the following sentences.
(1) Finance is needed to pay dividend to debenture holders.

Ans. Finance is needed to pay interest to debenture holders.

(2) When there is recession in economy sales will increase.

Ans. When there is boom in economy sales will increase

(3) Share is an acknowledgement of loan raised by company.

Ans. Debenture is an acknowledgement of loan raised by company.

(4) Equity shares carry dividend at fixed rate.

Ans. Preference shares carry dividend at fixed rate.

Q.2 Explain the following terms / concepts.

1. Financing decision
(a) The business firm has access to capital market to fulfil its financial needs. The firm has multiple choices of sources of financing.

(b) Different type of securities like shares, debentures etc. can be issued to raise funds. Funds may also be borrowed from financial institutions and lenders. The finance manager must ensure that the firm is well capitalised.

2. Investment decision
(a) Investment decisions refer to the decisions regarding utilization of funds raised by the firm. It relates to the selection of assets in which funds are to be invested.

(b) The funds can be invested in two types of assets, namely:

• Long term assets or fixed assets

• Short term assets or current assets

3. Fixed capital
Ans: (a) Fixed capital refers to capital invested in fixed assets. Fixed Capital is invested in long term assets such as land, building, equipment, etc.

(b) Investor invests money in fixed capital to make future profit. Fixed capital is usually required at the time of establishment of the company.

4. Working capital
Ans. (a) Working capital is the capital which is used to carry out the day to day business activities. The business firm has to arrange capital for making investment in short term assets such as cash, account receivable, inventory, etc.

(b) The capital invested in these assets is referred as Working Capital. Investor invests money in working capital for getting immediate return.

Q.3 Study the following case / situation and express your opinion.

(1) The management of Maharashtra State Road Transport Corporation', wants to determine the size of working capital.

(a) Being a public utility service provider, will it need less working capital or more?

Ans. Being a public utility service provider, it will need less working capital.

(b) Being a public utility service provider, will it need more Fixed Capital?

Ans. Yes. Being a public utility service provider, it will need more fixed capital.

(c) Give one example of public utility service that you come across on day-to day basis.

Ans. BEST Brihanmumbai Electric Supply and Transport undertaking is an example of public utility service.

(2) A company is planning to enhance it's production capacity and is evaluating the possibility of purchasing new machinery whose cost is 2 crore or has alternative of machinery available on lease basis.

(a) What type of asset is machinery?

Ans. Machinery is fixed assets. This is because, it stays with a company for long period of time.

(b) Capital used for purchase of machinery is fixed capital or working capital?

Ans. Capital used for purchase of machinery is fixed capital. It is the capital which stays in company almost permanently.

(c) Does the size of a business determine the fixed capital requirement?

Ans. Yes, the size of a business determine the fixed capital requirement. Large size business have high fixed capital requirements and vice versa.

Q.4 Distinguish between the following.

1. Fixed Capital and Working Capital.

Ans:

Fixed Capital:	Working Capital
(1) Meaning Fixed capital refers to any kind of physical capital i.e. fixed assets.	Working capital refers to current assets minus current liabilities.
(2) Nature: It stays in business almost permanently i.e. for more than one accounting year.	It stays in business for short period of time. Thus, working capital is circulating capital.
(3) Pu Fixed Capital is invested in long term assets such as land, building equipment, etc.	Working capital is invested in short term assets such as cash, account receivable, inventory, etc.
(4) So Fixed Capital funding can come from issuing shares, debentures, long term loan, etc.	Working Capital funding can come from short term loan, deposits, trade credit, etc.
(5) Objective of investor: Investor invests money in fixed capital to make future profit.	Investor invests money in working capital for getting immediate return.
(6) Risk Involved: Risk involved in fixed capital is high	Risk involved in working capital is less as compared to fixed capital.
(7) Factors affecting: The factors affecting fixed capital are:• Nature of Business Size of Business Scope of Business, etc.	The factors affecting working capital are:• Business Cycle • Production Cycle • Volume Cycle, etc.

Q.6 Justify the following statements.

1. The firm has multiple choices of sources of financing.

Ans: Justification:
(a) Finance is the life-blood of the organisation.
The business firm has access to capital market to fulfil its financial needs.

(b) The firm has multiple choices of sources of financing. Different types of securities like shares, debentures etc. can be issued to raise funds.

(c) Funds may also be borrowed from financial institutions and lenders. The finance manager must ensure that the firm is well capitalised.
(d) Thus, it is rightly justified that, the firm has multiple choice of sources of financing.

2. There are various factors affecting the requirement of fixed capital.
Ans: Justification: There are various factors affecting requirement of fixed capital. Some of them are as follows:

(a) Nature of Business: The nature of business plays a vital role in determining fixed capital requirement.
For instance, manufacturing company needs more fixed capital as compared to a trading company. This is because, trading company does not need plant, machinery, etc.

(b) Size of business: The companies which are operating at large scale require more fixed capital as they need more machineries and other assets.
Whereas, small scale business need less amount of fixed capital. Hence, the size of firm, either in terms of its assets or sales, affects the need of the fixed capital.

(c) Scope of business: Scope of business is the maximum extent up to within which a business can act or perform its business activities. If scope of business is vast, it needs higher fixed capital. For instance, a company involved in multiple activities like manufacturing processing and assembling usually needs substantial amount of fixed capital. Similarly, if scope of business is limited, then it requires less fixed capital. For instance, if a company does only assembling activities, it needs fewer amount of fixed capital.

(d) Extent of lease or rent: If companies can arrange financial and leasing facilities easily then they require less fixed capital as they can acquire assets on easy instalments instead of paying huge amount at one time. On the other hand, if easy loan and leasing facilities are not available then more fixed capital is needed as companies will have to buy plant and machinery by paying huge amount together.

(e) Choice of Technique: Those manufacturing enterprises which make use of

modern and automatic machines need a large amount of fixed capital.
On the other hand, those enterprises in which production is carried out mainly through labour, need less fixed capital.

(3) Fixed capital stays in the business almost permanently.

Ans. Justification:

(a) Fixed capital refers to capital invested in fixed assets. Fixed Capital is invested in long term assets such as land, building, equipment, etc.

(b) Investor invests money in fixed capital to make future profit. It is a permanent capital.

(c) Fixed capital is usually required at the time of establishment of the company.

(d) However, existing companies may also need such capital for their:
Expansion and development, • Replacement of equipment, etc.
Thus, it is rightly justified that, fixed capital stays in the business almost permanently as it is invested in fixed assets.

(4) Capital structure is composed of owned funds and borrowed funds.

Ans. Justification:

(a) Capital structure constitutes two words i.e.
capital and structure. 'Capital' refers to investment of funds in the business while 'structure' means arrangement of different components in proper proportion.

(b) Thus, capital structure means 'mix-up of various sources of funds in desired proportion'. A company can raise its capital from different sources i.e. owned capital or borrowed capital or both.

(c) The owned capital consists of equity share capital, preference share capital, reserves and surplus. On the other hand, borrowed capital are debentures, loans, etc. Proportion of different sources are used in capital structure.
(d) Thus, it is rightly justified that, capital structure is composed of owned funds and borrowed funds.

(5) There are various factors affecting the requirement of working capital.

Ans. Justification:

There are various factors affecting requirement of working capital. Some of them are as follows:

(a) Nature of business: The requirement of working capital depends on the nature of business. The nature of business is usually of two types:

• Manufacturing Business and

• Trading Business.

- In the case of manufacturing business it takes a lot of time in converting raw material into finished goods. Therefore, more working capital is required.

- On the contrary, in case of trading business the goods are sold immediately after purchasing or sometimes the sale is affected even before the purchase itself. Therefore, less working capital is required.

(b) Size of Business: There is a direct link between working capital and the size of business. In other words, more working capital is required in case of big organisation. Whereas, less working capital is required in case of small organisation.

(c) Business cycle:
The need for the working capital is affected by various stages of the business.
For instance, • During the boom period, the demand of a product increases and sales also increases. Thus, more working capital is required.
During the depression period, the demand declines and it affects both the production and sales of goods. Thus, less working capital is required.

(d) Production cycle:
Production cycle means the time involved in converting raw material into finished product. When the period of production cycle is more, more working capital will be needed. On the contrary, when period of production cycle is less, less working capital will be needed.

(e) Volume of cycle: This is the most important factor affecting size of working capital. The volume of sale and the size of working capital are directly related with each other. For instance, if the volume of sales is more, there is an increase in amount of working capital. But if the volume of sale is less, there is a decrease in amount of working capital.

Q.7 Answer the following questions.

1. Discuss the importance of corporate finance.

Ans: IMPORTANCE OF CORPORATE FINANCE :
In the functional management of business enterprise, importance is given to production, finance, marketing and personnel activities. Among all these activities, utmost importance is given to financial activities. The importance of corporate finance may be discussed as follows -

1. Helps in decision making : Most of the important decisions of business enterprise are determined on the basis of availability of funds. It is difficult to perform any function of business enterprise independently without finance.
Every decision in the business is needed to be taken keeping in view of it's impact on profitability. There may be number of alternatives but the management is required to select the best one which will enhance profitability. Business organisation can give green signal to the project only when it is financially viable. Thus corporate finance plays significant role in decision making process.

2. Helps in Raising Capital for a project: Whenever a business firm wants to start a new venture, it needs to raise capital. Business firm can raise funds by issuing shares, debentures, bonds or even by taking loans from the banks.

3. Helps in Research and Development : Research and Development must be undertaken for the growth and expansion of business. Detailed technical work is essential for the execution of projects. Research and Development is lengthy process and therefore funds have to be made available through out the research work. This would require continuous financial support.

4. Helps in smooth running of business firm: A smooth flow of corporate finance is needed so that salaries of employees are paid on time, loans are cleared on time, raw material is purchased whenever required, sales promotion of existing products is carried out smoothly and new products can be launched effectively.

5. Brings coordination between various activities : Corporate finance plays significant role in control and co-ordination of all activities in an organisation. For e.g. Production will suffer, if finance department does not provide adequate finance for the purchase of raw materials and meeting other day-to-day financial requirements for smooth running of production unit. Due to this, sales will also suffer and consequently the income of concern as well as rate of profit will be affected. Thus efficiency of ever department depends upon the effective financial management.

6.Promotes expansion and diversification : Modern machines and modern techniques are required for expansion and diversification. Corporate finance provides money to purchase modern machines and technologies. Therefore finance becomes mandatory for expansion and diversification of a company.

7. Managing Risk : Company has to manage several risks, such as sudden fall in sales, loss due to natural calamity, loss due to strikes, etc. Company needs financial aid to manage such risks

8. Replace old assets : Assets such as plant and machinery become old and outdated over the years. They have to be replaced by new assets. Finance is required to purchase new assets.

9. Payment of dividend and interest : Finance is needed to pay dividend to shareholders, interest to creditors, banks, etc.

10. Payment of taxes/fees : Company has to pay taxes to Government such as Income Tax, Goods and Service Tax (GST) and fees to Registrar of Companies on various occasions. Finance is needed for paying the taxes and fees.

2. Discuss the factors determining working capital requirement.

Ans: Meaning and Definition of Working Capital.

(a) Working capital is the capital which is used to carry out the day to day business activities. The business firm has to arrange capital for making investment in short term assets such as cash, account receivable, inventory, etc.

(b) The capital invested in these assets is referred as 'Working Capital. Investor invests money in working capital for getting immediate return.

(c) According to Gerstenbergh, "Working capital is the excess of current assets over liability". This approach is called Net Working Capital.

Factors affecting working capital requirement :
There is no precise standards to measure working capital adequacy. Management has to determine the size of working capital in the light of certain aspects of business firm and economic environment within which the firm operates.

1. Nature of business :
Firms engaged in manufacturing essential products of daily consumption would need relatively less working capital as there would be constant and sufficient cash

inflow in the firm to take care of liabilities. Likewise public utility concerns have to maintain small working capital because of continuous flow of cash from their customers.

Public utility concern : These concerns provide services such as transport, gas, electricity, etc. On the contrary, if the business is dealing in luxurious products, it requires huge amount of working capital, as sale of luxurious items are not frequent. Trading/merchandising firms which are concerned with distribution of goods have to carry big inventories of goods to meet customer's demand and have to extend credit facilities to attract customers. Hence they need large amount of working capital. Merchandising firms are those which are concerned with buying and selling of goods, either as wholesaler or retailer, without altering the physical form of goods.

2. Size of business :
The size of business also affects the requirement of working capital. A firm with large scale operations will require more working capital.

3 Volume of sales: This is the most important factor affecting size of working capital. The volume of sales and size of working capital are directly related with each other. If volume of sales increases, there is an increase in the amount of working capital and vice a versa.

4. Production cycle: The process of converting raw material into finished goods is called production cycle.
If the period of production cycle is longer, then firm needs more amount of working capital. If manufacturing cycle is short, it requires less working capital.

5. Business cycle: When there is a boom in the economy, sales will increase. This will lead to increase in investment in stocks. This requires additional working capital. During recession, sales will decline and hence the need of working capital will also decline.

6. Terms of purchases and sales: If the firm does not get credit facility for purchases but adopts liberal credit policy for its sales, then it requires more working capital. On the other hand if credit terms of purchases are favourable and terms of credits sales are less liberal, then requirement of cash will be less. Thus working capital requirement will be reduced.

7. Credit control: Credit control includes the factors such as volume of credit sales, the terms of credit sales, the collection policy, etc. If credit control policy is sound, it is possible for the company to improve it's cash flow. If credit policy is liberal, it

creates a problem of collection of funds.
It can increase possibility of bad debts. Therefore a firm requires more working capital. The firm making cash sales requires less working capital.

8. Growth and Expansion :
The working capital requirement of a firm will increase with growth of a firm. A growing company needs funds continuously to support large scale operations.

9. Management ability :
The requirement of working capital is reduced if there is proper co-ordination between production and distribution of goods. A firm stocking on heavy inventory calls for higher level for working capital.

10. External factors :
If financial institutions and banks provide funds to the firm as and when required, the need for working capital is reduced.