CBSE Class 12 Business Studies Question Paper 2022 with Solution PDF-Set 66/1/3

Question Paper with Solutions

Conducted by the Central Board of Secondary Education (CBSE)

Time Allowed: 2 hours **Maximum Marks: 40**

General Instructions

(i) This question paper contains **12** questions.

(ii) Question numbers **1 – 4** are of **2** marks. These are Short Answer Type Questions and are to be answered in **30-50** words.

(iii) Question numbers **5 – 8** are of **3** marks. These are Short Answer Type Questions and are to be answered in **50-80** words.

(iv) Question numbers **9 – 12** are of **5** marks. These are Long Answer Type Questions and are to be answered in **80-120** words.

(v) There is no over-all choice in the question paper. However internal-choice has been given in **1** question of **3** marks and **2** questions of **5** marks each.

(vi) This question paper contains Case/Source Based questions.

1. Identify and state the function of management which ensures that the organisational resources are being used effectively and efficiently for the achievement of pre-determined goals. [2 marks]

Solution:

Concept:

- Controlling is the management function that checks whether actual performance conforms to predetermined goals and standards.
- It helps managers ensure effective and efficient use of organisational resources through corrective action.

Step 1: Identify the function from the clue The function is **controlling**. The decisive words are 'resources are being used effectively and efficiently' for 'pre-determined goals'. Management must check whether work actually produces the intended results while avoiding unnecessary waste of resources.

Step 2: State its meaning Controlling means measuring actual performance, comparing it with the standards laid down, identifying deviations and taking corrective action wherever necessary. Thus, managers monitor whether activities are proceeding according to plans and remedy shortcomings so that organisational objectives are achieved. The function therefore connects planned goals with actual results.

Step 3: Conclusion The function is **controlling**: measuring and comparing actual performance with standards and taking corrective action to ensure achievement of organisational goals.

Quick Tip to Solve: When the clue is checking actual results or efficient resource use against predetermined goals, identify controlling.

2. Identify and state the step in the process of staffing under which the charge of the job is given to the selected employee and he/she is introduced to his/her superiors, subordinates and colleagues. [2 marks]

Solution:

Concept:

- Placement and orientation follow selection and appointment in the staffing process.
- Placement assigns the job; orientation familiarises the new employee with the organisation and the people at work.

Step 1: Identify the staffing step The step is **placement and orientation**. The question gives both parts of this step: giving the employee charge of the job indicates placement, while introducing the employee to superiors, subordinates and colleagues indicates orientation.

Step 2: Explain the two activities **Placement** means the selected employee occupies the post or position for which he or she has been selected and is given responsibility for the assigned work. **Orientation** means introducing the new employee to other employees and familiarising him or her with the organisation, its rules and policies. Together they help the selected person begin work with a clear understanding of the job and workplace relationships.

Step 3: Conclusion The step is **placement and orientation**: assignment of the selected employee to the job and introduction to the organisation and its people.

Quick Tip to Solve: Separate the two clues: charge of the job means placement; introduction to people and the organisation means orientation.

3. Give the meaning of 'Informal Communication'. [2 marks]

Solution:

Concept:

- Communication is the exchange of information and understanding between people.
- Informal communication arises through social interaction and does not follow the formally prescribed organisational channels.

Step 1: State the meaning **Informal communication** is communication that takes place without following the formal lines or channels of communication established by the organisation. It develops from personal contact, friendship and social relationships among employees rather than from an officially prescribed reporting relationship.

Step 2: Explain its nature It can flow in any direction, regardless of the authority levels or departments of the people involved. For example, employees from different departments may exchange information during a lunch break without routing it through their departmental heads. The network through which such information travels is commonly called the **grapevine**. It is the absence of a prescribed official route, rather than the topic of the message, that makes communication informal.

Step 3: Conclusion Informal communication is the exchange of information through social and personal relationships without following the organisation's prescribed formal communication channels.

Quick Tip to Solve: To distinguish informal communication, check whether the message follows official reporting channels; a grapevine message does not.

4. KLM Bank Ltd. is a leading bank with various branches across the country. On 27th Jan. 2022, it faced a sudden temporary shortage in cash balance in one of its branches. On the same day, it was decided by its directors to borrow funds from another bank for two days to maintain its cash reserve ratio.

Identify and explain the money market instrument used by KLM Bank Ltd. to meet its short term funds requirement. [2 marks]

Solution:

Concept:

- The money market supplies short-term finance. Call money is short-term finance repayable on demand, generally used by banks to adjust their temporary cash positions.
- Banks borrow from one another through the inter-bank call-money market to maintain the cash

reserve ratio required by the Reserve Bank of India.

Step 1: Identify the instrument from the case The instrument is **call money**. The clues are that KLM Bank needs funds for "two days", will borrow "from another bank", and wants to "maintain its cash reserve ratio". This is a temporary inter-bank cash adjustment rather than long-term finance.

Step 2: Explain how call money meets the need Call money is an inter-bank short-term borrowing arrangement with a maturity period from one day to fifteen days. A bank with surplus cash lends to a bank facing a temporary shortage. The borrowing bank pays interest at the call rate, which changes with the demand for and supply of funds. Thus, KLM Bank can borrow the required cash for two days and repay it when its temporary shortage ends.

Step 3: Conclusion KLM Bank uses **call money**, an inter-bank money-market instrument, to obtain funds for two days and maintain its required cash reserve ratio.

Quick Tip to Solve: Link the three clues together: borrowing between banks, a very short period, and maintenance of cash reserves point to call money.

5. State any three factors affecting working capital requirements of a company. [3 marks]

Solution:

Concept:

- Working capital finances day-to-day operations through current assets such as inventories, debtors and cash. Its requirement depends on how much money remains tied up in the operating cycle.
- The nature and scale of business, and the credit policy followed towards customers, are important determinants of the working capital a company needs.

Step 1: State the effect of the nature of business **Nature of business:** A trading concern generally requires less working capital than a manufacturing concern because it need not process raw materials into finished products. A manufacturing concern must finance raw materials, work-in-progress and finished-goods stocks. A service enterprise generally requires comparatively little inventory and therefore a lower amount of working capital.

Step 2: State the effect of the scale of operations **Scale of operations:** A company operating on a large scale normally requires more working capital in absolute terms because it must hold larger inventories and maintain higher levels of debtors and operating cash. A smaller company generally needs a lower amount to support its day-to-day activities.

Step 3: State the effect of credit allowed **Credit allowed:** A liberal credit policy towards customers increases working capital requirements because sales revenue remains tied up in debtors for a longer period before collection. A strict credit policy or cash sales enable quicker recovery of funds and reduce the amount required for financing routine operations.

Step 4: Conclusion Three factors affecting working capital requirements are **nature of business, scale of operations, and credit allowed to customers**. Each affects the funds tied up in current assets and daily operations.

Quick Tip to Solve: For each factor, state its direction: more stock, larger operations or slower collection usually means a higher working capital requirement.

6. Explain how controlling helps in 'accomplishing organisational goals' and 'judging accuracy of standards'. [3 marks]

Solution:

Concept:

- Controlling means measuring actual performance, comparing it with predetermined standards and taking corrective action to secure the desired results.
- Standards are the criteria against which performance is assessed. A sound control system both guides action towards organisational goals and tests whether these criteria remain realistic.

Step 1: Explain accomplishment of organisational goals **Accomplishing organisational goals:** Controlling measures progress towards organisational goals and brings to light deviations, if any. Managers compare actual results with the standards set while planning. When performance falls short, they identify the cause and take corrective action, such as improving a work method or providing necessary resources. This keeps activities on the right track and ensures that operations are performed according to plans. Thus, controlling helps the organisation move towards its predetermined objectives instead of allowing errors to continue unchecked.

Step 2: Explain the review of standards **Judging accuracy of standards:** A good control system enables management to verify whether the standards set are accurate and objective. While analysing deviations, managers review whether the standard itself was appropriate rather than automatically blaming employees. An efficient control system also keeps a careful check on changes in the organisation and its environment. This information helps management review and revise standards in the light of such changes, so future comparisons use suitable benchmarks.

Step 3: Conclusion Controlling contributes to goal achievement by detecting deviations and initiating corrective action. It also judges the accuracy of standards through performance feedback and environmental review, allowing management to revise unsuitable standards when necessary.

Quick Tip to Solve: Separate the two roles: comparing results with standards keeps work on course; reviewing the standards themselves tests whether the benchmark is sound.

7. Nandita Srivastava is the Human Resource Manager of 'TM Infrastructure Ltd.' It is one of the largest construction companies in India. The company handles projects worth more than ₹ 18,000 crore.

The responsibilities of Nandita Srivastava include searching and hiring suitable people for different posts in the organisation.

To measure certain characteristics of potential candidates, who apply for various vacancies, she is required to conduct a series of selection tests appropriate for different posts. These tests will help her to predict for which job the applicant will be successful, if hired.

Explain any two types of selection tests that may be conducted by Nandita Srivastava to select the most suitable persons. [3 marks]

Solution:

Concept:

- Selection tests measure particular characteristics of candidates and help predict their likely success in a job. The tests chosen should suit the requirements of the post.
- The case states that Nandita must 'measure certain characteristics of potential candidates' and predict 'for which job the applicant will be successful'. This describes the use of selection tests during staffing.

Step 1: Explain an intelligence test **Intelligence test:** This is a psychological test used to measure an individual's level of intelligence. It indicates the candidate's learning ability and capacity to make decisions and judgements. Questions may assess reasoning, comprehension and the ability to understand relationships. Nandita can use the results to assess whether an applicant has the mental ability needed to understand instructions and handle the intellectual demands of a particular post. The test measures general mental capacity rather than merely knowledge of a specific job already learnt.

Step 2: Explain an aptitude test **Aptitude test:** This test measures an individual's potential for learning new skills. It indicates the person's capacity to develop and become proficient in a particular activity after suitable training. For example, a test of mechanical aptitude can help assess potential for work requiring an understanding of mechanical relationships. Nandita can therefore use an appropriate aptitude test to predict how well a candidate could learn the requirements of the vacancy. This differs from a trade test, which measures skills and proficiency the candidate already possesses.

Step 3: Conclusion Nandita may conduct intelligence tests to assess general learning, judgement and decision-making ability, and aptitude tests to assess the potential to acquire the skills required for particular jobs. These two tests help match candidates' abilities and potential with the demands of the available posts.

Quick Tip to Solve: Remember the distinction: intelligence concerns general mental ability, whereas aptitude concerns the potential to learn a particular skill; trade tests assess existing proficiency.

8(a). What is meant by non-monetary incentives ? State any two non-monetary incentives. [3 marks]

Solution:

Concept:

- Motivation is the process of stimulating people to act towards organisational goals. Incentives encourage employees by satisfying their needs.
- Non-monetary incentives primarily satisfy psychological, social and emotional needs, such as recognition, responsibility and belongingness, rather than directly providing money.

Step 1: Explain the meaning of non-monetary incentives **Meaning:** Non-monetary incentives are rewards or benefits that motivate employees without directly involving a monetary payment. They appeal to needs such as status, recognition, self-esteem and self-actualisation. For example, an employee may be encouraged by appreciation of good work or by being trusted with greater responsibility. The emphasis is on the satisfaction the employee receives from the job and the organisation.

Step 2: State two suitable incentives **Employee recognition programmes:** Recognising an employee's good performance through appreciation, a certificate or a public acknowledgement makes the employee feel valued. Recognition satisfies the need for esteem and encourages continued good performance.

Employee empowerment: Giving employees greater autonomy and authority to take decisions concerning their work makes them feel that their skills and judgement matter. The resulting sense of responsibility and ownership motivates them to perform better.

Step 3: Conclusion Non-monetary incentives motivate by satisfying needs other than direct financial gain. Employee recognition programmes and employee empowerment are two such incentives.

Quick Tip to Solve: Link each non-monetary incentive to the psychological need it satisfies: recognition builds esteem, while empowerment provides autonomy and responsibility.

OR

8(b). State any three benefits of training to the organisation. [3 marks]

Solution:

Concept:

- Training is the systematic process of improving an employee's knowledge and skills for performing a particular job. It is an important part of staffing.
- An organisation benefits from training when its workforce performs existing jobs more effectively and becomes better prepared for changing work requirements.

Step 1: Explain the gain in efficiency **Systematic learning and less wastage:** Training provides a planned way of acquiring job-related skills. Employees learn correct methods instead of depending only on trial and error. This reduces wastage of time, effort and materials and improves the efficient use of organisational resources. A trained worker can understand the work procedure before repeatedly

making avoidable mistakes on the job.

Step 2: State two further organisational benefits **Higher productivity and profits:** Training increases employees' knowledge and proficiency. They can perform their tasks more accurately and efficiently, improving both the quantity and the quality of output. Better performance and more effective use of resources contribute to greater productivity and higher profits for the organisation.

Preparation of future managers: Training equips employees with knowledge and skills needed for more responsible positions. It helps the organisation develop a pool of capable people who can take over when managerial positions fall vacant. Thus, the organisation is better prepared to meet its future staffing needs from within.

Step 3: Conclusion Three benefits of training to the organisation are systematic learning with less wastage, higher employee productivity and profits, and preparation of future managers.

Quick Tip to Solve: Keep the answer focused on organisational gains: reduced wastage, improved output and a supply of trained people for future managerial vacancies.

9(a). Explain the following rights of a consumer as per the Consumer Protection Act, 2019 :

(i) Right to be heard.

(ii) Right to Safety [5 marks]

Solution:

Concept:

- Consumer Protection explains the rights that safeguard consumers against exploitation. These rights require businesses to consider consumer interests and supply goods and services responsibly.
- The right to be heard ensures consideration of consumer interests and grievances; the right to safety protects consumers against goods and services hazardous to life and health.

Step 1: Explain the right to be heard **(i) Right to be heard:** A consumer has the right to be heard and to be assured that consumer interests receive due consideration at appropriate forums. A consumer who is dissatisfied with a good or service can raise a grievance rather than remain silent about the loss or inconvenience suffered. The consumer's complaint and point of view should receive proper attention.

Channels for expressing grievances: Businesses should provide arrangements through which customers can communicate their complaints and have them attended to. Consumer organisations can also help consumers represent their interests. Thus, this right gives consumers a voice in matters affecting them and supports the presentation of their grievances before the appropriate consumer forum. For example, a buyer can bring a complaint about a defective appliance to the seller's grievance mechanism and seek consideration of the complaint.

Step 2: Explain the right to safety **(ii) Right to safety:** A consumer has the right to be protected against the marketing of goods and services that are hazardous to life and health. The protection is especially relevant to products such as electrical appliances, medicines and food, where poor quality or unsafe design can cause injury or illness. The business must give due importance to safety rather than expose the buyer to avoidable hazards.

Use the protection in buying decisions: Consumers should purchase products that conform to prescribed safety standards and check the appropriate quality certification wherever applicable. For example, an electrical appliance bearing the ISI mark indicates conformity to the relevant standards. Consumers should also read and follow instructions for safe use. This right concerns protection from danger; the separate right to be heard concerns the consumer's opportunity to express a grievance and have consumer interests considered.

Step 3: Conclusion The right to be heard assures a consumer that grievances and interests will receive due consideration at appropriate forums. The right to safety protects the consumer against goods and services hazardous to life and health. Together, they provide both a voice against exploitation and protection from unsafe consumption.

Quick Tip to Solve: Link "heard" with a consumer's voice and consideration of complaints; link "safety" with protection of life and health. Give the meaning of each right before adding an example.

OR

9(b). (i) Define a 'Consumer' as per the Consumer Protection Act, 2019.

(ii) As per the Consumer Protection Act, 2019, upto what value of defective goods or deficient services, can a complaint be filed at 'District Commission' ?

(iii) Within how many days can an appeal against the order of District Commission be made if any of the parties is not satisfied by its order ? [5 marks]

Solution:

Concept:

- Consumer Protection explains who is entitled to seek protection when goods are defective or services are deficient. A consumer obtains goods or services for consideration, rather than obtaining them free of charge.
- The Consumer Protection Act, 2019 provides a three-tier redressal machinery. In the textbook provisions tested here, the District Commission deals with consideration paid up to Rs 1 crore, and an appeal from its order lies to the State Commission within 45 days.

Step 1: Define a consumer of goods **(i) Purchase of goods:** A consumer is a person who buys any goods for a consideration which has been paid or promised, or partly paid and partly promised, or under any system of deferred payment. The definition includes any user of such goods, other than the buyer, when that use is made with the buyer's approval. A person obtaining goods for resale or for a commercial purpose is excluded. However, buying and using goods exclusively to earn one's livelihood by means of self-employment is not treated as a commercial purpose for this exclusion.

Step 2: Include a consumer of services **(i) Hiring or availing services:** A consumer also includes a person who hires or avails any service for a consideration paid or promised, partly paid and partly promised, or payable under a system of deferred payment. It includes a beneficiary of the service other than the person who hires or avails it, provided that the beneficiary uses it with that person's approval. A person availing a service for a commercial purpose is excluded. The purchase or hiring

may take place through offline or online transactions; the method of placing the order does not remove consumer protection.

Step 3: State the District Commission limit **(ii) Pecuniary jurisdiction:** Under the provisions of the Consumer Protection Act, 2019 used in this question, a complaint can be filed before the District Commission where the value of goods or services paid as consideration does not exceed **Rs 1 crore**. Thus the upper limit is inclusive: consideration of exactly Rs 1 crore falls within this limit. The relevant basis is the consideration paid for the goods or services, rather than an arbitrary amount of compensation demanded by the complainant.

Step 4: State the appeal period and forum **(iii) Appeal:** A party dissatisfied with the District Commission's order may prefer an appeal to the **State Commission within 45 days from the date of the order**. The answer must identify both the appellate body and the period: it is the State Commission that reviews an order of the District Commission. This appellate remedy is distinct from filing the original complaint before the District Commission.

Step 5: Conclusion A consumer buys goods or hires or avails services for consideration, including an approved user or beneficiary, subject to the exclusions stated above. For the Act's textbook provisions tested in this paper, the District Commission's limit is **up to Rs 1 crore**, and an appeal against its order can be made to the **State Commission within 45 days**.

Quick Tip to Solve: For this three-part question, separate eligibility, pecuniary jurisdiction and appeal: define the consumer first, then give the District Commission limit, and finally name the State Commission with the 45-day period.

10. Differentiate between 'Primary Market' and 'Secondary Market' on any five basis. [5 marks]

Solution:

Concept:

- The capital market comprises the primary market for new securities and the secondary market for securities that have already been issued.
- The key distinction is the destination of the investor's money: a new issue finances the issuing enterprise, whereas a resale transfers an existing investment between investors.

Step 1: Identify the nature of each market The **primary market**, also called the new issue market, enables an enterprise to issue securities to investors for the first time. The **secondary market**, also called the stock market, enables investors to buy and sell securities already in existence. Compare both markets on the same basis in each row, rather than listing unrelated features.

Step 2: Compare the markets on five bases

Basis	Primary market	Secondary market
Nature of securities	Deals in new securities issued for the first time by an enterprise.	Deals in existing securities that have already been issued.
Parties to the transaction	Securities are sold by the issuing company to investors, directly or through intermediaries.	Securities are bought and sold by investors among themselves; the issuing company is not the seller in these resale transactions.
Flow of funds	Funds move from investors to the issuing company, which receives the proceeds of the issue.	Funds move from the purchasing investor to the selling investor; the company receives no fresh funds from the resale.
Role in capital formation	Directly promotes capital formation by providing funds for setting up enterprises, expansion, diversification or modernisation.	Indirectly promotes capital formation by providing liquidity and marketability to existing securities, encouraging investors to subscribe to new issues.
Determination of price	The price is determined by the issuing company's management, including through the prescribed book-building process where applicable.	Prices are determined by demand and supply for securities in the market and can change continuously.

Step 3: Conclusion Thus, the primary market creates and sells new securities to raise funds for an enterprise, while the secondary market provides a mechanism for transferring existing securities between investors. The five paired bases are nature of securities, parties, flow of funds, contribution to capital formation and determination of price.

Quick Tip to Solve: Ask who receives the purchase money: if the issuing company receives fresh funds, it is a primary issue; if an existing holder receives the money, it is a secondary-market sale.

11. Gautam Natarajan is the founder of 'Brewed Beans Coffee', a famous chain of 21 outlets in South India, selling high quality filter coffee.

He is known for his leadership and vision. He believes that human resources, are the most important assets of an organisation. He often quotes, "The right people can help you take your business to the top, the wrong people can break your business." This is the reason he considers the function of management that fills the various positions in the organisation structure to be the most critical and fundamental to organisational performance.

(a) Identify the function of management that has been emphasised by Gautam Natarajan.

(b) State any four points of importance of function identified in (a) above. [5 marks]

Solution:

Concept:

- Staffing is the managerial function of finding the right people for the right jobs and filling and keeping filled the positions in the organisation structure.
- The importance of staffing lies in obtaining competent personnel, improving performance, ensuring continuity of management and making optimum use of human resources.

Step 1: Identify the function from the case **(a) Staffing.** Gautam Natarajan emphasises staffing. The decisive clue is the function that "fills the various positions in the organisation structure". His statement that "the right people can help you take your business to the top" also highlights matching suitable employees with organisational jobs. Staffing includes estimating manpower requirements, recruitment, selection, placement, training and development; it ensures that the people needed to perform organisational activities are available.

Step 2: State four points explaining its importance **(b) The following are four points of importance of staffing:**

- **Obtaining competent personnel:** Staffing helps discover and obtain competent people for different jobs. Recruitment attracts suitable applicants and selection chooses those whose abilities meet the requirements of the positions to be filled.
- **Higher performance through the right person on the right job:** By matching an employee's qualifications, abilities and experience with the job, staffing improves individual performance. Appropriate placement helps employees use their strengths effectively and contributes to better organisational results.
- **Continuous survival and growth:** Staffing provides for the future through succession planning for managers. Training and development prepare employees for greater responsibilities, so that capable people are available to occupy important positions as the organisation grows or existing managers leave.
- **Optimum utilisation of human resources:** Staffing helps avoid both overstaffing and understaffing by assessing personnel requirements and placing people appropriately. It prevents wastage of manpower and the high labour costs associated with overstaffing, while ensuring that work is not disrupted by a shortage of employees.

Step 3: Conclusion The function is **staffing**. Its importance is reflected in obtaining competent personnel, securing higher performance by placing the right person on the right job, ensuring continuous survival and growth through succession planning, and using human resources optimally.

Quick Tip to Solve: Use "filling positions in the organisation structure" to identify staffing. State each importance point with its own heading and a brief explanation of the organisational benefit.

12(a). **Anurag Tiwari is a famous news reader. He has recently started a news company 'Axis Media Corporation Ltd.'. The aim of this company is to launch a 24-hour Hindi news channel to broadcast latest news from India and around the world.**

For this new venture, the company will have to decide how to invest funds in different assets. The purchase of few assets like equipment, computers, vehicles, etc. will involve committing the finance on a long-term basis. It will affect earning capacity of the business in the long run. Therefore, the company needs to take the decision to invest in such assets with utmost care.

(a) Identify and state the type of investment decision discussed in the above paragraph.

(b) State any three factors which affect the decision identified in (a) above. [5 marks]

Solution:

Concept:

- Financial Management: an investment decision concerns how a firm's funds are invested in different assets. A long-term investment decision is also called a capital budgeting decision.
- Capital budgeting commits funds to assets that generate benefits over a long period. The amount and timing of cash flows, the expected rate of return and the investment criteria determine the choice of project.

Step 1: Identify and state the investment decision **(a) Long-term investment decision or capital budgeting decision:** This is the decision to invest funds in long-term assets or projects that affect the firm's earning capacity over a long period. Axis Media Corporation Ltd. must choose assets such as equipment, computers and vehicles for its news channel. The phrases "committing the finance on a long-term basis" and "affect earning capacity of the business in the long run" identify capital budgeting. These decisions usually involve a large commitment of funds and are difficult or costly to reverse, so careful evaluation is essential.

Step 2: State the three factors affecting the decision **(b) The three factors are:**

- **Cash flows of the project:** An investment involves cash outflows and cash inflows over its life. Their amounts and timing must be assessed and analysed carefully before the investment decision is made. For the proposed channel, the company must evaluate the outflows for acquiring and operating the assets against the cash inflows expected from their use.
- **Rate of return:** The return expected from each investment proposal must be estimated. The expected return and the risk involved in the proposals should be considered when comparing them. Other things being equal, a proposal with a higher expected rate of return is preferable. The company should therefore assess how the assets would contribute to the returns from the channel.
- **Investment criteria involved:** Investment proposals must be evaluated using appropriate capital budgeting techniques. These criteria consider the investment required, the cash flows, the rate of return and the associated risk. Applying suitable techniques allows the company to compare proposals systematically and select those that are financially worthwhile.

Step 3: Conclusion The case describes a **long-term investment or capital budgeting decision**. The three factors affecting it are the **cash flows of the project**, its expected **rate of return**, and the **investment criteria involved**.

Quick Tip to Solve: When a case stresses buying assets for long-term earning capacity, identify capital budgeting. For its factors, recall cash flows, return and investment criteria; financing factors concern the sources of funds instead.

OR

12(b). 'Reliable Labs Ltd.' is a trusted name in diagnostic services with seven branches spread across the city of Pune. The directors of this company have projected that with the rise in health consciousness in the society and the rising burden of chronic diseases, the demand for diagnostic tests is expected to grow in future. Considering this, they decided to open branches of their diagnostic labs in Ahmedabad.

It was estimated that it will require ₹ 100 crore of additional funds. The directors have to take the decision about how much funds should be raised from equity capital and how much from debt. It will affect the overall cost of capital and the financial risk of the company.

(a) Identify and state the financial decision discussed in the above paragraph.

(b) State any three factors that should be kept in mind by the Board of Directors of 'Reliable Labs Ltd.', while taking the decision identified in (a) above. [5 marks]

Solution:

Concept:

- Financial Management: the financing decision concerns the amount of finance to be raised from different long-term sources, especially the choice between shareholders' funds and borrowed funds.
- The debt-equity mix affects the cost of capital and financial risk. Debt creates fixed interest and repayment commitments, whereas equity does not require a fixed payment to shareholders.

Step 1: Identify and state the decision in part (a) The decision is the **financing decision**. It is the decision regarding the quantum of finance to be raised from various long-term sources, including equity share capital and debt. Reliable Labs Ltd. must decide how to finance its additional requirement of Rs 100 crore. The words "how much funds should be raised from equity capital and how much from debt" identify the choice of sources of finance. The decision concerns obtaining funds for expansion; it is different from selecting the assets in which those funds will be invested.

Step 2: State three factors for part (b)

- **Cost:** The cost of raising finance from different sources differs. The directors should compare the cost of debt with the cost of equity and choose an appropriate combination that keeps the overall cost of capital as low as practicable. Debt is generally cheaper, partly because interest is a tax-deductible expense, but cost alone cannot determine the mix.
- **Risk:** Debt involves a fixed obligation to pay interest and repay the principal, irrespective of the company's earnings. Greater use of debt therefore increases financial risk. Equity carries no comparable compulsory fixed payment. The directors should choose a mix consistent with the level of financial risk the company can bear.
- **Cash flow position:** A stronger cash flow position permits greater use of debt because interest and principal must be paid when due. The directors should assess whether expected cash receipts from the diagnostic business can meet these commitments. If cash flows are weak or uncertain, greater reliance on equity is more suitable.

Step 3: Conclusion Reliable Labs Ltd. is taking a **financing decision** about the long-term sources for its Rs 100 crore requirement. Three relevant factors are the **cost of finance, financial risk and cash flow position**.

Quick Tip to Solve: In a case, the choice between equity and debt identifies financing. Link cost to the price of funds, risk to fixed commitments, and cash flow to the ability to meet them.