# CBSE Class 12 Business Studies Question Paper 2022 with Solution PDF-Set 66/4/2

## 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) Questions Number **1 – 4** are of 2 marks. These are Short Answer Type Questions and are to be answered in 30 – 50 words.

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

(iv) Questions Number **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 overall choice in the question paper. However, internal choice has been given in **1** question of 3 marks and **2** questions of 5 marks.

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

**1. Identify and state the step of selection process which helps the Human Resource Manager in eliminating unqualified job seekers on the basis of information supplied in the application form. Also, list the next two steps involved in the process of selection.** [2 marks]

**Solution:**

**Concept:**

- Selection is the process of choosing the most suitable candidate from the applicants for a job. It proceeds through successive steps so that candidates unsuitable for the job can be eliminated.
- Preliminary screening uses the information in an application form to decide whether an applicant meets the basic requirements of the position.

**Step 1:** Identify and state the selection step The step is **preliminary screening**. The clue is the elimination of "unqualified job seekers on the basis of information supplied in the application form". The Human Resource Manager examines the applicants' stated qualifications and experience against the job requirements and rejects those who do not fulfil them. This initial scrutiny reduces the number of applicants who need to undergo the remaining selection procedures.

**Step 2:** List the next two steps in order **Selection tests** follow preliminary screening. These tests assess relevant abilities or characteristics of the shortlisted candidates. The next step is the **employment interview**, in which the employer and applicant interact to assess the applicant's suitability for the job. Thus, the requested sequence is preliminary screening, selection tests, and employment interview.

**Step 3:** Conclusion The identified step is **preliminary screening**: eliminating unqualified applicants using their application forms. The next two steps are **selection tests** and **employment interview**, respectively.

**Quick Tip to Solve:** Match application-form scrutiny with preliminary screening; remember that tests come next and the employment interview follows the tests.

**2. Virat has 2500 shares of Suraj Bulb Ltd. He received an offer from Suraj Bulb Ltd. to purchase two shares for every ten shares held by him.**

**Identify and explain the method of floatation of new issue reflected in the above lines.** [2 marks]

**Solution:**

**Concept:**

- A company can raise fresh share capital in the primary market by offering a new issue to its existing shareholders through a rights issue.
- A rights issue gives existing shareholders the privilege of subscribing to new shares in proportion to their existing shareholding, before those shares are offered to the public.

**Step 1:** Identify the method from the offer The method is a **rights issue**. Virat already owns shares of Suraj Bulb Ltd., and the company offers him "two shares for every ten shares held by him". Both clues matter: the offer is made to an existing shareholder and its size is linked to the number of shares he already holds.

**Step 2:** Explain how a rights issue works Under this method, the company offers new shares first to

its existing shareholders in a specified proportion to their present holdings. The offer gives them a right to subscribe; it does not compel them to purchase the shares. Here, the two-for-ten ratio entitles Virat to subscribe to 500 new shares against his existing 2500 shares. If he accepts the offer, he pays for these new shares and the company receives fresh capital. This is a new issue by the company, rather than a sale of Virat's existing shares to another investor.

**Step 3:** Conclusion Suraj Bulb Ltd. is using a **rights issue**, offering new shares to existing shareholders in proportion to their holdings. The stated offer entitles Virat to subscribe to **500 new shares**.

**Quick Tip to Solve:** An offer to existing shareholders expressed as new shares for a fixed number already held identifies a rights issue.

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**3. 'Staffing is considered as a very important managerial function in all types of organisations.' In the light of the above statement, state any two benefits of staffing.** [2 marks]

**Solution:**

**Concept:**

- Staffing fills and keeps filled the positions in an organisation's structure. It includes finding, selecting, training and developing people for organisational work.
- Its importance follows from matching people's abilities with job requirements and developing their capacity to perform effectively.

**Step 1:** State the benefit of obtaining competent personnel **Obtaining competent personnel:** Staffing helps an organisation discover and obtain competent people for different jobs. Recruitment attracts suitable applicants, while selection identifies those whose knowledge, skills and abilities fit the work. Consequently, the organisation has people capable of carrying out the responsibilities attached to its positions instead of leaving those responsibilities with unsuitable employees.

**Step 2:** State the benefit of higher performance **Higher performance:** Staffing helps achieve higher performance by putting the right person on the right job. When an employee's abilities match the demands of the position, the employee can carry out the work more effectively. Training and development further improve the skills needed for the job. Better individual performance supports the achievement of the organisation's objectives.

**Step 3:** Conclusion Two benefits of staffing are **obtaining competent personnel for different jobs** and **achieving higher performance by placing the right person on the right job**.

**Quick Tip to Solve:** For two benefits, use two distinct NCERT headings and explain each: obtaining competent personnel and achieving higher performance.

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**4. 'Analysing deviations' and 'taking corrective actions' are the steps in the process of one of the significant functions of management. Identify the function and list the first three steps of the process of the function identified.** [2 marks]

**Solution:**

**Concept:**

- Controlling means comparing actual performance with predetermined standards and taking corrective action so that organisational activities produce the desired results.
- The controlling process follows a sequence: standards are set before performance can be measured and compared; deviations are then analysed and corrected.

**Step 1:** Identify the function from the given steps The function is **controlling**. The expressions "analysing deviations" and "taking corrective actions" refer to its final two steps: finding why actual results differ from the standards and removing the causes of significant differences.

**Step 2:** List the first three steps in order

1. **Setting performance standards:** Establish the criteria against which actual performance will be assessed.
2. **Measurement of actual performance:** Measure the results actually achieved, using suitable and reliable methods.
3. **Comparison of actual performance with standards:** Compare the measured results with the predetermined standards to identify deviations.

**Step 3:** Conclusion The identified function is **controlling**; its first three steps are setting performance standards, measurement of actual performance, and comparison of actual performance with standards.

**Quick Tip to Solve:** Remember the controlling sequence as set, measure, compare, analyse and correct. The two steps named in this question come after the first three.

**5(a). State any three features of motivation.** [3 marks]

**Solution:**

**Concept:**

- Motivation is the process of stimulating people to action to accomplish desired goals. It connects an individual's needs with the effort directed towards satisfying them.
- Features of motivation describe its nature. They explain where the urge to act originates, how it shapes behaviour and why the same incentive may affect people differently.

**Step 1:** State the internal and behavioural features

1. **Motivation is an internal feeling:** The urge to act arises within a person from needs, desires, aspirations or feelings. A manager may provide incentives or a supportive environment, but the employee must feel the desire to respond. For example, a desire for recognition can create an internal drive to perform well.
2. **Motivation produces goal-directed behaviour:** A motivated person acts towards a particular goal that promises to satisfy a need. Thus motivation gives direction to effort instead of

producing aimless activity. An employee seeking promotion may work more carefully and improve performance to achieve that goal.

**Step 2:** Explain why motivation is complex

3. **Motivation is a complex process:** Individuals differ in their needs, expectations and reactions. A particular incentive, such as an increase in pay, may motivate one employee strongly while another values recognition or responsibility more. Therefore, a manager cannot assume that one type of motivation will work equally well for everyone.

**Step 3:** Conclusion Three features of motivation are that it is an **internal feeling**, it produces **goal-directed behaviour**, and it is a **complex process** because individual needs and responses differ.

**Quick Tip to Solve:** State each feature as a clear heading and explain its meaning. Keep features such as internal feeling separate from benefits such as improved performance.

OR

**5(b). Identify the function of management which is concerned with instructing, guiding, counselling, motivating and leading people in the organisation to achieve its objectives. Also, state any two features of the identified function of management.** [3 marks]

**Solution:**

**Concept:**

- Directing is the management function concerned with instructing, guiding, counselling, motivating and leading people to achieve organisational objectives.
- Its features describe how it operates in an organisation; these are different from its elements, such as supervision, motivation, leadership and communication.

**Step 1:** Identify the function from the activities given The function is **Directing**. The words "instructing, guiding, counselling, motivating and leading people" describe a manager's efforts to influence employees and help them perform their work. These activities put plans into action by getting people to contribute to the organisation's objectives.

**Step 2:** State the first feature **Directing initiates action:** Planning determines what is to be done, organising arranges the work and resources, and staffing provides the people. Directing begins the actual performance of work by giving employees instructions and guidance. It therefore translates these preparations into purposeful action towards organisational goals.

**Step 3:** State the second feature **Directing is a continuous process:** A manager's work of instructing, guiding, motivating and leading does not end after an initial instruction. Employees need support and direction throughout the life of the organisation, so directing continues as long as people are working towards its objectives.

**Step 4:** Conclusion The identified function is **Directing**. Two of its features are that it **initiates action** and is a **continuous process**.

**Quick Tip to Solve:** Use the verbs in the question to identify directing, then give features of the function rather than merely listing its elements.

**6. Explain any two factors affecting the 'Dividend Decision' of a company.** [3 marks]

**Solution:**

**Concept:**

- The dividend decision concerns how much of the profit earned by a company should be distributed to shareholders and how much should be retained in the business.
- A company must consider both its earnings and the availability of cash: earning a profit and having cash available for its distribution are related but different matters.

**Step 1:** Explain the effect of the amount of earnings **Amount of earnings:** Dividends are paid out of current and past earnings. Therefore, the amount of earnings available is a major determinant of the dividend decision. Other things remaining the same, a company with higher earnings has greater scope to declare a higher dividend. If earnings are low or inadequate, the amount available for distribution is smaller and the company may pay a lower dividend or retain the available earnings. Thus, a larger pool of distributable earnings increases the company's capacity to reward shareholders.

**Step 2:** Explain the effect of cash flow position **Cash flow position:** Payment of a cash dividend involves an outflow of cash. A company therefore needs sufficient cash to pay dividends while meeting its other cash requirements. A sound cash flow position makes it easier to declare and pay a higher dividend. A shortage of cash can restrict the dividend even when the company reports a substantial profit, because part of that profit may be tied up in receivables or other assets rather than being immediately available as cash.

**Step 3:** Conclusion Two factors affecting the dividend decision are **amount of earnings** and **cash flow position**. Higher earnings provide a greater basis for distribution, while adequate cash enables the company to make the actual dividend payment.

**Quick Tip to Solve:** Separate the profit available for distribution from the cash needed for payment; a profitable company can still have a cash shortage.

**7. GDFS Limited are the manufacturers of consumer goods. The demand for their products was continuously declining after the outbreak of COVID-19. In spite of fall in demand, the company assured its employees that no worker will be retrenched from the job. Name the category of incentive and the incentive offered to the employees. Also explain any two more incentives of the same category.** [3 marks]

**Solution:**

**Concept:**

- Non-financial incentives motivate employees by satisfying psychological, social and emotional needs, such as security, recognition and personal growth, rather than by directly offering money.
- Job security is a non-financial incentive: the assurance of continuity of employment reduces the employee's fear of losing the job and income.

**Step 1:** Identify the category and the incentive from the assurance The category is **non-financial incentives**, and the particular incentive is **job security**. The decisive case line is that the company

assured its employees that "no worker will be retrenched from the job." Although demand declined after COVID-19, employees were assured of continued employment. This satisfies their need for security and encourages commitment; the case does not describe a bonus or an increase in salary.

**Step 2:** Explain employee recognition programmes **Employee recognition programmes:** Recognition means acknowledging and appreciating an employee's good performance. For example, an organisation may congratulate a worker publicly, display an achievement on its notice board or award a certificate for excellent performance. Such appreciation makes the employee feel valued and satisfies the need for esteem, encouraging the employee to maintain or improve performance.

**Step 3:** Explain career advancement opportunity **Career advancement opportunity:** Employees are motivated when an organisation provides opportunities to improve their skills and progress to higher-level jobs. Appropriate training, development and a sound promotion policy help employees see a future for themselves in the organisation. The prospect of growth and greater responsibility satisfies their desire for advancement and encourages better work. This is another possible incentive of the same category; it is not an additional action stated in the case.

**Step 4:** Conclusion GDFS Limited offers the non-financial incentive of **job security**. Two other non-financial incentives are employee recognition programmes and career advancement opportunity.

**Quick Tip to Solve:** Match "no retrenchment" with job security; for other non-financial incentives, choose benefits that satisfy esteem or growth needs and explain how each motivates.

**8. Abhishek Limited is engaged in manufacturing of Air Purifiers. The target production is 500 Air Purifiers in a week. Over the last few months, it has been observed by the Production Manager that the weekly production target was not achieved.**

**Identify the function and explain any two points of its importance.** [3 marks]

**Solution:**

**Concept:**

- Controlling is the management function of measuring actual performance, comparing it with predetermined standards, analysing deviations and taking corrective action to ensure achievement of objectives.
- A production target is a performance standard. When actual output falls short of the standard, control helps management discover the reasons and bring performance back towards the plan.

**Step 1:** Identify controlling from the production comparison The function is **controlling**. The case sets the standard as "500 Air Purifiers in a week" and states that "the weekly production target was not achieved." Observing the shortfall compares actual production with the predetermined target and reveals a deviation. Controlling requires the manager to analyse the causes and take suitable corrective action; the case does not state that those corrective steps have already been taken.

**Step 2:** Explain how controlling accomplishes organisational goals **Accomplishing organisational goals:** Controlling measures progress towards planned goals and brings deviations to light. This allows management to guide activities back towards the desired results. For Abhishek Limited, analysing the repeated production shortfall and correcting its causes would help the factory work

towards its weekly target of 500 air purifiers. Thus control makes performance conform more closely to the organisation's plans.

**Step 3:** Explain how controlling uses resources efficiently **Making efficient use of resources:** By checking work against prescribed standards, controlling reduces wastage and spoilage and helps resources be used effectively. Employees carry out activities according to the standards, while managers identify and correct inefficient operations. In a manufacturing unit, such checks can improve the use of materials, machinery and labour. These are possible benefits of control; no particular cause of this company's shortfall can be assumed from the case.

**Step 4:** Conclusion The function is **controlling**. Two points of its importance are accomplishing organisational goals and making efficient use of resources.

**Quick Tip to Solve:** A target compared with actual performance signals controlling. Explain its importance as benefits, and keep those benefits distinct from the steps of the control process.

**9. State any three protective and any two regulatory functions of the Securities and Exchange Board of India.** [5 marks]

**Solution:**

**Concept:**

- The Securities and Exchange Board of India (SEBI) protects investors' interests and regulates the securities market. Its protective functions safeguard investors from exploitation and unfair practices.
- Its regulatory functions establish and enforce rules for market participants and market operations. The required functions are classified below under these two headings.

**Step 1:** State the first protective function **Prohibit fraudulent and unfair trade practices:** SEBI prohibits practices such as misleading statements and price manipulation that deceive investors or create an artificial market in securities. This protects investors from being induced to buy or sell on a false impression of a security's value.

**Step 2:** State the second protective function **Control insider trading:** SEBI controls trading based on unpublished price-sensitive information available to company insiders. Such information may concern matters affecting the company's share price. Preventing insiders from exploiting it protects ordinary investors, who do not possess that information, from an unfair disadvantage.

**Step 3:** State the third protective function **Undertake investor education:** SEBI educates investors about the securities market, the risks involved and their rights. Better-informed investors can assess investment proposals, recognise misleading claims and make more careful decisions instead of relying blindly on rumours or promises of returns.

**Step 4:** State the first regulatory function **Register brokers, sub-brokers and other market participants:** SEBI registers intermediaries operating in the securities market. Registration brings these participants within the regulatory framework and enables supervision of their conduct, helping ensure that market services are provided according to prescribed requirements.

**Step 5:** State the second regulatory function **Regulate the takeover of companies:** SEBI regulates

substantial acquisition of shares and company takeovers. By prescribing and enforcing procedures for these transactions, it ensures that changes in ownership and control take place within an orderly regulatory framework.

**Step 6:** Conclusion The three protective functions are prohibiting fraudulent and unfair trade practices, controlling insider trading and undertaking investor education. The two regulatory functions are registering market intermediaries and regulating company takeovers.

**Quick Tip to Solve:** Remember protection through fraud prevention, insider-trading control and investor education; remember regulation through registration of intermediaries and rules for takeovers.

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

**(i) Right to be Heard**

**(ii) Right to be Informed** [5 marks]

**Solution:**

**Concept:**

- The Consumer Protection Act, 2019 recognises consumer rights to protect buyers against exploitation and to ensure fair treatment in the market.
- The right to be heard gives consumers a voice when their interests are affected, while the right to be informed gives them the product information needed for an informed buying decision.

**Step 1:** Explain the right to be heard **Meaning:** A consumer has the right to be heard and to be assured that the consumer's interests will receive due consideration at appropriate forums. A grievance about a defective product, deficient service or unfair trade practice must have an opportunity to be presented and considered.

**Complaint and representation:** The consumer can raise a complaint when dissatisfied with a good or service. Many business firms establish consumer service and grievance cells for this purpose. Consumer organisations also help consumers represent their interests and put forward complaints before the appropriate authorities.

**Practical significance:** This right prevents consumers' concerns from being ignored simply because an individual buyer has little bargaining power. For example, a buyer whose appliance repeatedly fails can put the complaint before the firm's grievance cell and seek consideration of the problem. The central idea is an opportunity to express the grievance and have it considered.

**Step 2:** Explain the right to be informed **Meaning and scope:** A consumer has the right to obtain complete information about the goods or services being purchased, including their quality, quantity, potency, purity, standard and price. Such information protects the buyer against unfair trade practices and enables a reasoned comparison of alternatives.

**Product particulars:** In the case of a packaged product, its label should provide relevant particulars such as the ingredients, net weight or quantity, manufacturing date, expiry date where applicable, maximum retail price and directions or precautions for use. These details help the consumer judge suitability and value before purchasing.

**Practical significance:** An informed consumer can check whether the product meets a need, compare

its price with other products and avoid misleading claims or unsafe use. For example, checking a food packet's ingredients and expiry date helps the consumer decide whether to buy it. The information must be available before the buying decision, rather than only after a problem arises.

**Step 3:** Conclusion The **right to be heard** ensures that consumers can present grievances and that their interests receive due consideration. The **right to be informed** ensures access to complete and relevant product or service information so that consumers can make informed choices and protect themselves against exploitation.

**Quick Tip to Solve:** Link "heard" with a complaint or representation, and "informed" with product details on the label. Explain the meaning and practical use of each right separately.

OR

**10(b). State any five responsibilities of a consumer as per The Consumer Protection Act, 2019.**

[5 marks]

**Solution:**

**Concept:**

- Consumer protection is effective when consumers exercise their rights and also act responsibly before, during and after purchasing goods or services.
- An informed consumer checks quality and product information, insists on proof of purchase and takes action against an unfair trade practice instead of remaining silent.

**Step 1:** Be aware of available goods and services **Be an informed consumer:** Be aware of the different goods and services available in the market so that an intelligent and well-informed choice can be made. Compare their quality, features and prices rather than buying solely because of an attractive advertisement or a seller's persuasion. This awareness helps the consumer select a product suited to the actual need.

**Step 2:** Buy standardised goods **Look for quality certification:** Buy standardised goods, as they provide an assurance of quality. Look for appropriate quality marks, such as ISI on electrical goods, AGMARK on agricultural products and Hallmark on jewellery. The consumer should check that the certification is relevant to the product being purchased.

**Step 3:** Read labels carefully **Check the product information:** Read labels to obtain information about the price, net weight, manufacturing and expiry dates, ingredients and instructions for use. Such checks help the consumer avoid expired or unsuitable products and use the goods safely. Instructions and warnings should be followed rather than ignored after purchase.

**Step 4:** Insist on a cash memo **Obtain proof of purchase:** Ask for a cash memo or bill whenever goods or services are purchased, and retain it safely. It records the transaction and serves as evidence of purchase. This proof becomes especially useful when the consumer has to establish a claim concerning defective goods, deficient services or an incorrect charge.

**Step 5:** File a complaint when necessary **Seek redressal for genuine grievances:** File a complaint with the appropriate consumer forum or commission if there is a shortcoming in the quality of goods

purchased or services availed. Do not overlook an unfair practice merely because the amount involved is small. Provide the relevant purchase documents and truthful details so that the grievance can be examined.

**Step 6:** Conclusion Five responsibilities are to remain informed about market offerings, buy standardised goods, read labels carefully, insist on a cash memo and file a complaint for a genuine grievance. Responsible action helps consumers obtain value for their money and makes consumer protection more effective.

**Quick Tip to Solve:** Remember the purchase sequence: compare, check the quality mark, read the label, keep the bill and complain if necessary.

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**11. After the outbreak of pandemic COVID-19, Yash Publishing Limited is planning to go digital as the teachers and students are now more interested in E-content. After due consultation with the top management, the company decided to publish E-books. For the same, they hired a recruitment agency to tap the right talent for the job.**

**The company also approached a well-established university in the city of Indore to recruit qualified personnel for various managerial positions. For the post of E-content writer the company is using shine.com and monster.com.**

**(a) Identify and explain the function of management highlighted above.**

**(b) Quoting lines from the above, explain the types of external sources of recruitment discussed in the para.**

**(c) State any two advantages of external sources of recruitment.** [5 marks]

**Solution:**

**Concept:**

- Staffing is the management function concerned with obtaining and developing suitable people for organisational positions. Recruitment is its step of searching for prospective employees and encouraging them to apply.
- External recruitment brings candidates from outside the organisation. Placement agencies, campus recruitment and web publishing are distinct external sources.

**Step 1:** Identify and explain the management function in part (a) The function is **staffing**. The clue is that the company "hired a recruitment agency to tap the right talent for the job." Staffing means finding the right people for the right jobs and developing them so that organisational work is performed effectively. It includes estimating manpower requirements, recruitment, selection, placement and orientation, training and development, performance appraisal, promotion and career planning, and compensation. Here the shift to E-books creates a need for suitable personnel, and the company searches for them through recruitment, a part of staffing.

**Step 2:** Link each external source to its case evidence in part (b) **Placement agencies and management consultants:** The line "they hired a recruitment agency to tap the right talent for the job" identifies this source. Such agencies maintain information about job-seekers and their qualifications and help employers obtain candidates suited to their requirements, usually for a fee. Management

consultants are particularly useful in finding suitable managerial personnel.

**Campus recruitment:** The company "approached a well-established university in the city of Indore to recruit qualified personnel for various managerial positions." Through campus recruitment, business organisations approach universities, colleges and professional institutions to recruit qualified students for suitable jobs. The institution provides access to prospective candidates with the required education and training.

**Web publishing:** The line "For the post of E-content writer the company is using shine.com and monster.com" identifies recruitment through the Internet. Specialised job websites display vacancies and allow candidates to submit their qualifications or resumes, bringing employers and applicants together. The sites named in the case are the evidence for this source.

**Step 3:** State two advantages of external recruitment in part (c) **Wider choice:** Recruitment outside the existing workforce gives the organisation access to a large pool of applicants. It can compare their qualifications and experience and select people who best meet the job requirements.

**Fresh talent:** New recruits bring fresh ideas, skills and perspectives into the organisation. This can improve existing practices and help the business respond to new requirements such as digital publishing.

**Step 4:** Conclusion The management function is staffing. The external recruitment sources are placement agencies and management consultants, campus recruitment, and web publishing. Two advantages are wider choice of candidates and the introduction of fresh talent.

**Quick Tip to Solve:** In a recruitment case, match the channel to the source: an agency means placement services, a university means campus recruitment, and a job portal means web publishing.

**12(a). 'Technology upgradation' and 'Level of collaboration' affect one of the types of capital requirements of the company. Identify the type of capital requirement affected with reference to the above statement. Also, explain any other two factors, apart from the ones stated above affecting the type of capital requirement identified.** [5 marks]

**Solution:**

**Concept:**

- Fixed capital refers to the funds invested in fixed assets such as land, buildings, plant and machinery. These assets serve the business for a long period rather than being used up in its daily operations.
- The amount of fixed capital required depends on the business's long-term asset needs. Nature of business and scale of operations are two determinants, apart from technology upgradation and level of collaboration.

**Step 1:** Identify the capital requirement The type identified is **fixed capital requirement**. The statement mentions "Technology upgradation" and "Level of collaboration", both of which affect the investment a company needs in long-term assets. Upgrading technology can require replacing machinery before its physical life ends, while collaboration may allow firms to share facilities instead of buying them separately. The reference is therefore to investment in fixed assets, rather than funds required for everyday expenses.

**Step 2:** Explain nature of business **Nature of business:** A manufacturing concern normally requires more fixed capital than a trading concern. A manufacturer must invest in production facilities such as factory buildings, plant and machinery to convert raw materials into finished products. In contrast, a trading concern buys and sells finished goods and therefore does not ordinarily need manufacturing machinery. Consequently, its investment in fixed assets is relatively lower, other things remaining the same.

**Step 3:** Explain scale of operations **Scale of operations:** A business operating on a larger scale requires more fixed capital than one operating on a smaller scale. Larger operations need greater production capacity and a bigger organisation, involving more machinery, larger premises and additional equipment. A small-scale undertaking can work with fewer machines and smaller facilities, so its fixed-asset investment is lower. Thus, an increase in the scale of operations generally raises fixed capital requirements.

**Step 4:** Conclusion The statement concerns **fixed capital requirements**. Two other factors are **nature of business** and **scale of operations**: manufacturing and larger-scale operations generally require a greater investment in fixed assets than trading and smaller-scale operations respectively.

**Quick Tip to Solve:** For each fixed-capital factor, state which situation needs more long-term assets and explain why. Here, use two factors other than technology upgradation and collaboration.

OR

**12(b). When the 'Return on Investment' of the company is higher than 'Interest Rate on debt', it can use more debt in the capital structure of the company in order to increase its 'Earning Per Share'. Explain the given situation with the help of a suitable example.** [5 marks]

**Solution:**

**Concept:**

- **Trading on equity** means increasing the earnings available per equity share by using fixed financial charge funds, such as debt, in the capital structure. Debt carries interest, whereas equity shareholders receive the residual earnings.
- When the return on investment exceeds the interest rate on debt, the company earns more on borrowed funds than it pays as interest. The resulting surplus can increase earnings per share (EPS), provided the other conditions in the comparison remain the same.

**Step 1:** Identify why borrowing can benefit equity shareholders The case states that the company's "Return on Investment" is higher than the "Interest Rate on debt". This is a favourable situation for **trading on equity**. After paying the fixed interest charge, part of the earnings generated by the borrowed funds remains for the equity shareholders. Raising part of the capital through debt also avoids issuing as many new equity shares, so the residual profit is divided among fewer shares.

**Step 2:** Set up two comparable financing plans Suppose a company needs total capital of Rs 10,00,000 and earns a return on investment of 20%, giving annual earnings before interest and tax (EBIT) of Rs 2,00,000. Compare an all-equity plan with a plan using Rs 5,00,000 equity and Rs 5,00,000 debt. Assume equity shares of Rs 10 each, debt interest of 10% per annum and a tax rate of 30%. Total

investment and EBIT are identical in both plans; only the financing mix changes.

**Step 3:** Compare earnings per share under the two plans

| Particulars | All equity | Equity and debt |
|---|---|---|
| Equity capital (Rs) | 10,00,000 | 5,00,000 |
| Debt (Rs) | Nil | 5,00,000 |
| Total capital (Rs) | 10,00,000 | 10,00,000 |
| EBIT (Rs) | 2,00,000 | 2,00,000 |
| Interest at 10% (Rs) | Nil | 50,000 |
| Earnings before tax (Rs) | 2,00,000 | 1,50,000 |
| Tax at 30% (Rs) | 60,000 | 45,000 |
| Earnings after tax (Rs) | 1,40,000 | 1,05,000 |
| Number of equity shares | 1,00,000 | 50,000 |
| EPS (Rs) | 1.40 | 2.10 |

In the all-equity plan, Rs 1,40,000 is divided among 1,00,000 shares, giving Rs 1.40 per share. Under the debt plan, Rs 1,05,000 is divided among 50,000 shares, giving Rs 2.10 per share. Thus, even though total earnings after tax are lower after paying interest, earnings *per equity share* are higher.

**Step 4:** Explain the gain and recognise the financial risk The borrowed Rs 5,00,000 earns Rs 1,00,000 at the assumed 20% return, but its interest cost is only Rs 50,000. The Rs 50,000 excess before tax contributes to the equity shareholders' earnings. This favourable difference explains the increase in EPS from Rs 1.40 to Rs 2.10. However, interest and repayment are fixed obligations: if operating returns fall, debt may reduce EPS and increase financial risk. A company must therefore also assess cash flows and its capacity to service debt before increasing borrowing.

**Step 5:** Conclusion The situation illustrates **trading on equity through favourable financial leverage**. With a return on investment of 20% exceeding the debt interest rate of 10%, the example shows that replacing part of equity with debt raises EPS from Rs 1.40 to Rs 2.10, while increasing the company's financial risk.

**Quick Tip to Solve:** In a trading-on-equity example, keep total capital and operating earnings unchanged; subtract interest and tax before dividing the remaining earnings by the number of equity shares.