MEMBERS AREA

'RC DAILY DOSE'
Volume 13

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PASSAGE – 1

Finance consists of three interrelated areas; (1) money and capital markets, or macro finance, which deals with many of the topics covered in macroeconomics; (2) investments, which focuses on the decisions of individuals and financial institutions as they choose securities for their investment portfolios; and (3) financial management, or "business finance," which involves the management of the firm. Each of these areas interacts with the others, so a corporate financial manager must have a good knowledge of both capital market operations and the way investors appraise securities.

Financial management has undergone significant changes over the years. When it first emerged as a separate field of study in the early 1900s, the emphasis was on the legal aspects of such matters as mergers, consolidations, the formation of new firms, and the various types of securities issued by corporations. Industrialization was sweeping the country, and the critical problem faced by firms such as U.S. Steel and Reynolds Tobacco was in obtaining capital for expansion. The capital markets were relatively primitive, which made transfers of funds from individual savers to businesses difficult. The earnings and asset values reported in accounting statements were unreliable, and stock trading by insiders and manipulators caused prices to fluctuate wildly. Consequently, investors were reluctant to purchase stocks and bonds. As a result of these environmental conditions, finance in the early 1900s focused on legal issues relating to the issuance of securities.

The emphasis remained on securities through the 1920s. However, radical changes occurred during the depression of the 1930s, when an unprecedented number of business failures shifted the focus to bankruptcy and reorganization, to corporate liquidity, and to governmental regulation of securities markets. Finance was still a descriptive, legalistic subject, but the emphasis changed from expansion to survival.

During the 1940s and early 1950s, finance continued to be taught as a descriptive, institutional subject, viewed from the standpoint of an outsider rather than from that of management. However, financial management techniques designed to help firms maximize their profits and stock prices were beginning to receive attention.

A movement towards rigorous analysis developed during the late 1950s. Also, the major emphasis began to shift from the right - hand side of the balance sheet (liabilities and equity) to asset analysis. Computers were beginning to be used, and models were being developed to help manage inventories, cash, accounts receivable, and fixed assets. Increasingly, the focus of finance shifted from the outsider's to the insider's point of view, and financial decisions within the firm came to be recognized as the critical issue in corporate finance. Descriptive, institutional materials on capital markets and financing instruments were still studied, but these topics were considered in terms of their effects on corporate financial decisions.

The 1960s and 1970s witnessed a renewed interest in the liabilities and equity side of the balance sheet, with a focus on (1) the optimal mix of securities and (2) the way in which individual investors make investment decisions, or portfolio theory, and the implications of both topics for corporate finance. Corporate financial management was redesigned to help general management take actions that would maximize the value of the firm and the wealth of its stockholders, giving recognition to the fact that the results of corporate financial decisions depend upon how investors react to them. This recognition produced a blending of investment theory into corporate finance.

In the 1980s, four issues have received emphasis: (1) inflation and its effects on interest rates, (2) deregulation of financial institutions and the accompanying trend away from specialized institutions towards broadly diversified financial service corporations, (3) a dramatic increase in the use of telecommunications for transmitting information and computers for analyzing financial decisions, and (4) new and innovative methods for financing long - term investments. Inflation, including ways to combat it and to deal with it when it heats up, is being worked into the fabric of both financial theories and financial decision processes. New financial institutions and products have been created; for example, money market funds and interest rate futures. Also, older institutions have made major structural changes; so much so that today it is hard to tell a bank from a savings and loan association, or an insurance company from a brokerage firm. For example, Prudential Insurance owns a stock brokerage firm; Merrill Lynch offers checking account services; and Sears, Roebuck is one of the largest U.S. financial institutions, owing such firms as All state Insurance, the Dean Witter brokerage house, and Coldwell Banker, the largest U.S.real estate brokerage company. Technological developments in the computer hardware and telecommunications areas, and the availability of software packages that make otherwise very difficult numerical analyses relatively easy, are bringing about fundamental changes in the way managers manage. Data storage, transmittal, and retrieval techniques are reducing the "judgemental" aspects of management, as financial managers can now obtain relatively precise estimates of the effects of alternative courses of action.

Several innovative financing techniques have emerged in the current era in response to changing economic conditions. For example, a market for high - risk, high - yield bonds known as junk bonds was developed to finance mergers and management buyouts of their own firms. Floating rate debt, in which the interest rate is changed periodically to reflect current market conditions, was introduced in the early 1980s to protect investors from the adverse effects of high inflation and fluctuating interest rates.

1. *All of the following are false, as per the passage, except that :*
   (1) corporate financial management hindered the general management of the unit.
   (2) financial decisions within the firm are matters of critical issues and are shaped more by an insider's viewpoint than by those of an outsider.
   (3) technological developments in the computer hardware and telecommunications area have complicated numerical analyses.
   (4) floating rate debt plunged the investors in harsher, inflationary and adverse circumstances.

2. *As per the passage, floating rate debt was meant :*
   (1) to speculate favourably so that the basis for an investor to formulate a decision is sound.
   (2) to augment the capital build-up of an upcoming unit.
   (3) to protect investors from the adverse effects of high inflation and fluctuating interest rates.
   (4) to help firms maximise their profits.

3. *Which of the following is true with respect to the passage ?*
   (1) A corporate financial manager must have a good knowledge of both capital market operations and the way investors appraise securities.
   (2) A corporate financial manager must be stern with the manpower and be able to extract work from them.
   (3) Information on capital markets and financial instruments had no effect on and relevance to corporate financial decisions.
   (4) All of the above.

4. *Junk bonds, as per the passage :*
   (1) was a stop-gap arrangement for a sick company to extricate itself from the morass.
   (2) was an idea mooted by Coldwell Banker, the largest U.S. real estate brokerage company.
   (3) was developed to finance mergers and management buyouts of their own firms.
   (4) None of the above.

5. *The early part of the twentieth century, as the passage makes out, had finance :*
   (1) confined to buying and selling.
   (2) confined to transfer of funds from individual savers to businesses.
   (3) restricted to documentation as the centre of activity, in the event of partnership and consortium arrangements coming to the fore.
   (4) was focussed on legal issues relating to mergers, consolidations, formation of new firms and various types of securities issued by corporations.

6. *A suitable title for the passage could be :*
   (1) Investment Theory And Corporation Finance.
   (2) Capital Markets And Financial Decisions.
   (3) Changes In Financial Management Over The Years.
   (4) Corporate Sickness And Their Rehabilitation.

7. *The change in the approach of financial management in the decades of the sixties and seventies, as per the passage, was manifest in the focus on :*
   (1) the optional mix of securities.
   (2) portfolio theory.
   (3) equity side of the balance sheet.
   (4) All of the above.

8. *According to the passage, the floating rate debt is :*
   (1) a soft loan meant to assist the unit to surmount the distress and meet its contingent liabilities.
   (2) a bridge loan given by the financial institutions for the company to set right its account with them.
   (3) one in which the interest rate is changed periodically to reflect current market conditions.
   (4) a short term finance meant to help investors buy the best shares and keep the share market buzzing.

9. *Which of the following best represents the feature of financial management in the current era ?*
   (1) The 'judgemental' aspects of management have been reduced on account of easy availability of the relatively precise estimates of the effects of alternative courses of action.
   (2) Management has become more complicated owing to dependence on computers.
   (3) 'Management By Coercion' is the in-thing in today's corporate world.
   (4) Legal Aspect of Management has scored over the financial aspect.

10. *As per the passage, financial management is :*
   (1) restrictive, being supervisory in nature.
   (2) all encompassing, necessitating a knowledge of several things.
   (3) amenable to change and innovation in response to change in economic conditions.
   (4) All expect (1).

PASSAGE – 2

Financial ratio analysis is especially useful for small businesses. Readily available sources of key financial ratios provide comparative data by size, with the class size varying down to some very small firms. For example, Robert Morris Associates provides comparative ratios for a number of small - firm classes, including the size range of zero to $250,000 in annual sales. Nevertheless, the financial analysis of small firms presents some unique problems that are related to risks and to depth and quality of management. We examine here some of those problems from the standpoint of a bank loan officer, one of the most frequent users of ratio analysis.

When examining a small - business credit prospect, a banker is essentially making a prediction about the ability of the company to repay its debt if the bank extends credit. In making this prediction, the banker will especially be concerned about indicators of liquidity and about continuing prospects for profitability. The banker will elect to do business with a new customer if it appears that loans will be paid off on a timely basis and that the company will remain in business and therefore be a customer of the bank for years to come. Thus, both short-run and long - run viability are of interest to the banker. On the other hand, the banker's perceptions about the business are important to the owner-manager, because the bank may become a vital source of funds as the firm's needs increase in the future.

The first problem the banker is likely to encounter is that, unlike the bank's bigger customers, the small firm may not have audited financial statements. Furthermore, the statements that are available may have been produced on an irregular basis (for example, in some months or quarters but not in others). If the firm is young, it may have historical financial statements for only one year, or perhaps it has none at all. Also, the banker will probably require that periodic financial statements be produced by a reputable accounting firm, not by the owner's brother-in-law.

The quality of its financial data may therefore be a problem for a small business that is attempting to establish a banking relationship. This may keep the firm from getting credit even though it is really on solid financial ground. Therefore, it is in the owner's interest to make sure that the firm's financial data are credible, even if it is more expensive to do so. Furthermore, if the banker is uncomfortable with the data, the firm's management should also be uncomfortable: Because many managerial decisions depend on the number in the firm's accounting statements, those numbers should be as accurate as possible.

For a given set of financial ratios, a small firm may be riskier than a larger one. Often small firms produce a single product or else rely heavily on a single customer, or both. For example, several years ago a company called Yard Man, Inc., manufactured and sold lawn equipment. Most of Yard Man's sales were to Sears, so most of Yard Man's revenues and profits were due to the Sears account. When Sears decided to drop Yard Man as a supplier, the company was left without its most important customer. Yard Man is no longer in business. Because large firms typically have a broad customer base, they are not as susceptible to a loss of such a large portion of their business.

A similar danger applies to a single - product company. Just as the loss of a key customer can be disastrous for a small business, so can a shift in the tides of consumer interest in a particular fad. For example, Coleco manufactured and sold the extremely popular Cabbage patch dolls. The phenomenal popularity of the dolls was a great boom for Coleco, but the public is fickle. One can never predict when such a fad will die out, leaving the company with a great deal of capacity to make a product that no one will buy and with a large amount of overvalued inventory. Exactly this situation hit Coleco, and it was forced into bankruptcy in 1988.

The extension of credit to a small company, and especially a small owner-managed company, often involves yet another risk that is less of a problem for larger firms - namely, dependence on the leadership of a single key individual whose unexpected death could cause the company to fail. Similarly, if the company is family owned and managed, there is typically one key decision maker, although perhaps several other family members are involved in helping to manage the company. In the case of the family business, the loss of the top person may not wipe out the company, but it may create the equally serious problem of who will assume the leadership role. The loss of a key family member is often a highly emotional event, and it is not at all unusual for it to be followed by an ugly and prolonged struggle for control of the business. It is in the family's interest, and certainly in the creditors' interests, to see that a plan of management succession is clearly specified before trouble arises. If no good plan can be worked out, perhaps the firm should be forced to carry "key person insurance," payable to the bank and used to retire the loan in the event of the key person's death.

In summary, to determine the credit-worthiness of a small firm, the financial analyst must look beyond the basic financial ratios and analyze the viability of the firm's products, customers, management, and market. It is not an easy task, but it must be done. Ratio analysis is only the starting point.

11. *As per the passage, ratio analysis :*
    (1) is the starting point to determine the credit-worthiness of a small firm.
    (2) throws light on the risks and quality of management to be adopted to surmount them.
    (3) provides a comparative data by size, with the class varying down to very small firms.
    (4) All of the above.

12. *All of the following are true in relation to the passage, except that :*
    (1) short-run and long-run viability are of interest to the banker.
    (2) bank's perceptions about the business are important to the owner-manager.
    (3) ratio analysis is frequently used by a bank officer to process loans and make an appraisal of the credit needs of the borrower unit.
    (4) the quality of the financial data is not a problem for small business attempting to seek a banking relationship.

13. *A banker, according to the passage, while appraising the credit needs of a firm :*
    (1) makes a market survey of the reputation of the firm.
    (2) predicts about the ability of the firm to repay its debt if the bank extends credit.
    (3) is concerned about the prospects for profitability and is on the lookout for indicators of liquidity.
    (4) All except (1).

14. *The dangers that lie in front of a single product company are in the instance of :*
    (1) a shift in the tides of consumer interest in a particular fad.
    (2) a fall in market demand for the particular product.
    (3) the sales tax regulations becoming stringent.
    (4) the raw material and other ingredients towards making that product, suddenly becoming unavailable.

15. *The problem relating to the small firm, from the viewpoint of a banker, as made out by the passage, is :*
    (1) the shortage of the required work force, making the running of the unit difficult.
    (2) the quality of its financial data, posing a question on the firm's credibility.
    (3) the outlet market for the products manufactured.
    (4) None of the above.

16. *The author avers that for a given set of financial ratios, small firms carry more risk than large ones as :*
    (1) large firms are more efficiently managed than small firms.
    (2) loss of workers would severely affect the working of small firms than large ones.
    (3) small firms produce a single product or rely heavily on a single customer.
    (4) there is no scope for outperforming in competition, due to lack of upgradation and improvement.

17. *The credit extended to small company, that is owner managed, is fraught with risks as :*
    (1) a dispute might arise among the members constituting the family owning the business, regarding the loan availment.
    (2) the terms and conditions of the conduct of the business might not be properly spelt out.
    (3) the conduct of the business may be unethical and violatory of certain ground ethics.
    (4) the company is heavily dependent on the leadership of a single key individual whose decision is the final word and is irrevocable.

18. *The author has handled the passage in a manner which is :*
    (1) based on assumptions
    (2) illogical
    (2) imaginary
    (4) analytical

19. *A suitable tile for the passage could be :*
    (1) Ratio Analysis–An Index Of Credit–Worthiness.
    (2) Risks And Problems In Small Business.
    (3) The Importance Of Financial Data.
    (4) Product And Customer Management.

20. *The passage is least likely to have been extracted from :*
    (1) an article highlighting finances for small business units.
    (2) the deliberations during the Banker's meet to discuss the problem of financing.
    (3) a chapter on 'Finance', for students of High School classes.
    (4) A handbook on 'Credit Lending', for use by bankers.

Detailed Solutions

1. **Ans.(2).** Each of the options (1), (3) and (4) are false, as the passage does not state them. Option (2) is in place and is endorsed by the fifth paragraph. The focus of finance shifted from the point of view of an outsider to that of an insider. Hence the option to be ticked is (2).
2. **Ans.(3).** The last paragraph of the passage is about the floating rate debt. It was meant to protect investors from the adverse effects of high inflation and fluctuating interest rates. Option (3) best represents this and is the sought one. The remaining options are not true.
3. **Ans.(1).** The opening paragraph has spelt out the essentialities of a corporate financial manager. Option (1) best depicts this. The remaining options are not the contents or representations of the passage and can be ignored.
4. **Ans.(3).** The last paragraph of the passage states the purpose behind the floating of junk bounds. Option (3) best synchronises with this and is the correct one. The remaining options are not correct and can be ignored.
5. **Ans.(4).** The second paragraph is about the role of finance in the early part of the twentieth century. It was confined to legal issues as investors fought shy to purchase stocks and bonds. Option (4) best denotes this and is the appropriate one. The remaining options are not correct.
6. **Ans.(3).** The passage explains financial management and its evolution over the years. Priority areas have been spelt out, relevant to the respective times and appropriate techniques have been evolved. Option (3) best represents this and is the suitable title for the passage. The remaining options are not representative of the contents of the passage and pass off as unsuitable titles.
7. **Ans.(4).** The sixth paragraph gives a fair idea of the mindset influencing financial decision making. Each of the options (1), (2) and (3) are the areas of focus and clearly reflect the said change. Hence options (1), (2) and (3) are intact, however, option (4), their combination deserves the tick.
8. **Ans.(3).** The last line of the passage defines the floating rate debt. Option (3) best depicts this and is the correct one. The remaining options are incorrect.
9. **Ans.(1).** The penultimate paragraph states that in the current era, a manager tends to be less 'judgemental', since there are available, relatively precise estimates of the effects of the alternative courses of action. Option (1) best synchronises with this and is to be ticked. The remaining options are not appropriate, as they find no place in the passage.
10. **Ans.(4).** Options (2) and (3) are upheld in the passage. Option (2) is a general deduction whereas option (3) is stated in the opening line of the last paragraph. Option (1) has no place in the passage. However, option (4), a combination of options (2) and (3), is the correct pick.
11. **Ans.(4).** Each of the options (1), (2) and (3) find a place in the passage. The last line of the passage and the opening paragraph uphold them. Hence options (1), (2) and (3) are validated, leading to option (4), their combination, as the best one.
12. **Ans.(4).** Options (1), (2) and (3) find their place in the passage and are mentioned in the second and the first paragraphs respectively. Option (4) finds no place in the passage, as the fourth paragraph refutes it. Hence the sought option is (4).
13. **Ans.(4).** Option (1) is rejected, as the passage nowhere has stated or implied it. Options (2) and (3) find a place in the passage in the second paragraph. However option (4), a combination of options (2) and (3), is the best pick.
14. **Ans.(1).** The sixth paragraph elaborates on the dangers facing a single product company. Option (1) best depicts this and is the appropriate one. The remaining options are not the viewpoints expressed in the passage and can be bypassed.
15. **Ans.(2).** The fourth paragraph comes out with the problem, a banker is likely to face when dealing with a small firm. The lack of adequate financial data, necessary for the bank to work out the feasibility of the scheme, viability of the unit and repayment ability will create a serious problem. Option (2) best matches and is the appropriate one. The remaining options are not correct, as they find no place in the passage.
16. **Ans.(3).** The fifth paragraph of the passage comes out with the idea that for a given set of financial ratios, the risk faced by a small firm is larger than that faced by a bigger firm. Option (3) best matches and is the correct one. The remaining options are not appropriate and can be sidelined.
17. **Ans.(4).** Options (1), (2) and (3) are not validated. Option (4) finds a mention in the penultimate paragraph of the passage. It is the correct one.
18. **Ans.(4).** Option (4) is the exact one, for the passage uses the method of analysis to drive home certain concepts. The remaining options are absurd and can be safely ignored.
19. **Ans.(2).** The passage is essentially about small businesses. Financial data, ratio analysis and risks involved are specific to small business unit. Options (1) and (3) are partially correct and pale out before option (2), which is the suitable title for the passage. Option (4) is incorrect, as it is irrelevant to the passage.
20. **Ans.(3).** Options (1), (2) and (4) are quite likely the sources from where the passage could have been extracted. Option (3) falls out as the passage is too high a stuff meant for students of High School classes. Hence option (3) is the sought one.

Answer Keys

1.(2)	2.(3)	3.(1)	4.(3)	5.(4)	6.(3)	7.(4)	8.(3)	9.(1)	10.(4)
11.(4)	12.(4)	13.(4)	14.(1)	15.(2)	16.(3)	17.(4)	18.(4)	19.(2)	20.(3)