1. SCOPE AND OBJECTIVE OF FINANCIAL MANAGEMENT

Q.NO	ABC Analysis	M-06	N-06	M-07	N-07	M-08	N-08	M-09	N-09	M-10	N-10	M-11	N-11	M-12	N-12	M-13	N-13	M-14	N-14	M-15	N-15	M-16	N-16
1	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
2	A	-	4	-	-	-	-	2	-	-	4	-	-	-	4	-	-	-	-	4	-	-	-
3	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
4	A	-	-	-	3	-	-	-	-	-	-	-	-	4	-	-	-	-	-	-	-	-	-
5	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
6	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
7	A	-	-	3	-	-	-	-	-	-	-	-	4		-	-	-	-	-	-	-	-	-
8	A	-	-	-	-	-	-	-	-	3	-	-	-	-	-	-	-	-	-	-	-	-	-
9	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	4	-	-	-	-	4
10	A	-	-	-	-	-	-	-	3	-	-	-	-	-	-	-	-	-	-	-	-	-	-
11	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
12	A	-	-	-	-	-	-	-	2	-	-	-	-	-	-	-	-	-	-	-	-	-	-
13	B	6	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
14	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
15	C	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-

Q.No.1. What are the Objectives of Financial Management? (SM)

Efficient financial management requires the existence of some objectives or goals. Although various objectives are possible but we assume two objectives of financial management for elaborate discussion. These are:

1. **Profit maximisation:**
   - **a)** It has traditionally been argued that the primary objective of a company is to earn profit, hence the objective of financial management is also profit maximisation.
   - **b)** This implies that the finance manager has to make his decisions in a manner so that the profits of the concern are maximised.
   - **c)** However, profit maximisation cannot be the sole objective of a company. It is at best a limited objective. If profit is given undue importance, a number of problems may arise and some of them are:
     - **i)** The term profit is vague. It does not clarify what exactly it means.
     - **ii)** Profit maximisation has to be attempted with a realisation of risks involved.
     - **iii)** Profit maximisation as an objective does not take into account the time pattern of returns.
     - **iv)** Profit maximisation as an objective is too narrow.

2. **Wealth / Value maximization:**
   - **a)** It holds that the primary goal of the firm is to maximize its market value and implies that business decisions should try to increase the net present value of the economic profits of the firm.
   - **b)** It is the duty of the finance manager to see that the shareholders get good returns on the shares. Hence, the value of the share should increase in the share market.

c) Wealth maximization is critical for the very existence of the business enterprise. If this goal is not met, public / institutions would lose confidence in the enterprise and will not invest further in the growth of the organization.

d) Thus, wealth or value maximization is the most important goal of financial management.

Q.No.2. Discuss the conflicts in Profit vs. Wealth maximization principle of the firm. (PM) (M09-2M, N06 - 4M, N10 - 4M)

In a normal organisation management may pursue its own personal goals (profit maximization). But in an organization where there is a significant outside participation (shareholding, lenders etc.), the management may not be able to exclusively pursue its personal goals due to the constant supervision of the various stakeholders of the company - employees, creditors, customers, government, etc.

The wealth maximization objective will be in accordance with the interests of various groups such as owners, employees, creditors and society, and thus, it may be consistent with the management objective of survival.

In today's real world situation, wealth maximization is a better objective.

Below given table highlights some of the advantages and disadvantages of both profit maximization and wealth maximization goals:

Goal	Objective	Advantages	Disadvantages
Profit Maximization	Large amount of profits	• Easy to calculate profits. • Easy to determine the link between financial decisions and profits.	• Emphasizes the short term gains. • Ignores risk or uncertainty. • Ignores the timing of returns. • Requires immediate resources.
Shareholders Wealth Maximisation	Highest market value of shares.	• Emphasizes the long term gains. • Recognises risk or uncertainty. • Recognises the timing of returns. • Considers shareholders' return.	• Offers no clear relationship between financial decisions and share price. • Can lead to management anxiety and frustration.

Q.No.3. Explain as to how the wealth maximisation objective is superior to the profit maximisation objective? (PM)

<u>**A firm's Financial management may often have the following as their objectives:**</u>

a) Profit Maximisation objective:

i) The maximisation of profit is often considered as an <u>implied objective</u> of a firm.

ii) To achieve the aforesaid objective various types of <u>financing decisions</u> may be taken.

iii) The profit of the firm in this case is <u>measured in terms of</u> its total accounting profit available to its shareholders.

b) Value / Wealth Maximisation objective:

i) The value/wealth of a firm is defined as the <u>market price</u> of the firm's stock.

ii) The market price of a firm's stock represents the <u>focal judgment</u> of all market participants as to what the value of the particular firm is.

Superiority of Value maximisation objective:

a) **More wider in nature:** The value maximisation objective of a firm considers all future cash flows, dividends, earning per share, risk of a decision etc. whereas profit maximisation objective does not consider the effect of EPS, dividend paid or any other returns to shareholders or the wealth of the shareholder.

b) **Payment of Dividends:** A firm that wishes to maximise the shareholders wealth may pay regular dividends whereas a firm with the objective of profit maximisation may refrain from dividend payment to its shareholders.

c) **Shareholder's preference:** Shareholders would prefer an increase in the firm's wealth against its generation of increasing flow of profits.

d) **Market Price is more inclusive in nature:** The market price of a share reflects the shareholders expected return, considering the long-term prospects of the firm, reflects the differences in timings of the returns, considers risk and recognises the importance of distribution of returns.

Conclusion: The maximisation of a firm's value as reflected in the market price of a share is viewed as a proper goal of a firm. The profit maximisation can be considered as a part of the wealth maximisation strategy.

Q.No.4. "The Profit maximization is not an operationally feasible criterion." Comment on it. (PM)(M12 - 4M)

Opinion: "The profit maximisation is not an operationally feasible criterion." This statement is true because Profit maximisation can be a short-term objective for any organisation and cannot be its sole objective.

Justification:

1. Profit maximization fails to serve as an operational criterion for maximizing the owner's economic welfare.
2. It fails to provide an operationally feasible measure for ranking alternative courses of action in terms of their economic efficiency.
3. **It suffers from the following limitations:**
   a) **The term profit is vague:** It does not clarify what exactly it means. It conveys a different meaning to different people. For example, profit may be total profit or rate of profit etc.
   b) **Profit maximisation shall consider the risk involved:** Higher the risk, higher is the possibility of profits. If profit maximisation is the only goal, then finance manager may even accept highly risky proposals also, if they give high profits.
   c) **Profit maximisation as an objective does not take into account the time pattern of returns.**
   d) **Profit maximisation as an objective is too narrow:** It fails to take into account the social considerations and obligations to various interests of workers, consumers, society, as well as ethical trade practices. If these factors are ignored, a company cannot survive for long.

Alternative Questions:

1. Write short note on Limitations of Profit Maximisation objective of financial management.

A. Same as above.

Q.No.5. Write a short note on risk-return trade off.

a) The Finance Manager has to strike balance between return he desires and the risk he wants to take.

b) Lower the risk, lower the gain and higher the risk, higher the gain.

c) If Finance Manager takes the projects with higher return involving higher risk then the expected required rate of return shall also be higher.

d) Conversely, in case of projects with lower returns involving lower risks, the expected required rate of return shall be lower.

e) Therefore, Finance Manager has to find that combination of return and risk which shall maximise the present value and that point is called risk-return trade off.

Q.No.6. Discuss the functions of a Chief Financial Officer. (PM)

Functions of a Chief Financial Officer: The twin aspects viz. procurement and effective utilisation of funds are the crucial tasks, which the CFO faces. The Chief Finance Officer is required to look into financial implications of any decision in the firm.

Thus all decisions involving management of funds comes under the purview of finance manager. These are namely:

a) Estimating requirement of funds

b) Decision regarding capital structure

c) Investment decisions

d) Dividend decision

e) Cash management

f) Evaluating financial performance

g) Financial negotiation

h) Keeping touch with stock exchange quotations & behaviour of share prices.

Q.No.7. What are the main responsibilities of a Chief Financial Officer of an organisation? (PM) (M07-3M, N11 - 4M)

Modern Financial Management has come a long way from the traditional corporate finance. As the economy is opening up and global resources are being tapped, the opportunities available to finance managers have becomes numerous.

During the recent years a new era has started for Chief Financial officers. His role assumes significance in the present day context of liberalisation, deregulation and globalisation.

Responsibilities of Chief Financial Officer (CFO): The Chief Financial Officer of an organisation plays an important role in the company's goals, policies and financial success. His main responsibilities include:

a) **Financial analysis and planning:** Determining the proper amount of funds to be employed in the firm.

   a. **decisions:** Efficient allocation of funds to specific assets.

b) **Financial and capital structure decisions:** Rising of funds on favourable terms as possible i.e. determining the composition of liabilities.

c) **Management of financial resources** (such as working capital).

d) **Risk Management:** Protecting assets.

Q.No.8. Role of CFO in today's World vis-a-vis in the past. (SM) (M10-3M)

Today, the role of CFO is no longer confined to accounting, financial reporting and risk management. It's about being a strategic business partner of the chief executive officer or CEO. Some of the key differences that highlight the changing role of a CFO are as follows:-

What a CFO used to do?	What a CFO now does?
Budgeting	Budgeting
Forecasting	Forecasting
Accounting	Managing M&As
Treasury (cash management)	Profitability analysis (for example, by customer or product)
Preparing internal financial reports for Management	Pricing analysis
Preparing quarterly, annual filings for investors	Decisions about outsourcing
Tax filing	Overseeing the IT function
Tracking accounts payable and accounts Receivable	Overseeing the HR function
Travel and entertainment expense Management	Strategic planning (sometimes overseeing this function)
	Regulatory compliance
	Risk management

Alternative Questions:

1. **Write a short note on the Role of Chief Financial Officer.**

A. Same as above.

Q.No.9. Emerging Issues / Priorities Affecting the Future Role of CFO. (SM) (M14,N16 -4M)

a) **Regulation:** Regulation requirements are increasing and CFO's have to see that they are adhered to.

b) **Globalisation:** The challenges of globalisation are creating a need for finance leaders to develop a finance function that works effectively on the global stage and that embraces diversity.

c) **Technology:** Technology is evolving very quickly, providing the potential for CFO's to reconfigure finance processes and drive business insight through 'big data' and analytics.

d) **Risk:** The nature of the risks that organisations face is changing, requiring more effective risk management approaches and increasingly CFO's have a role to play in ensuring an appropriate corporate ethos.

e) **Transformation:** There will be more pressure on CFO's to transform their finance functions to drive a better service to the business at zero cost impact.

f) **Stakeholder Management:** Stakeholder management and relationships will become important as increasingly CFO's become the face of the corporate brand.

g) **Strategy:** There will be a greater role to play in strategy validation and execution, because the environment is more complex and quick changing.

h) **Reporting:** Reporting requirements will broaden and continue to be burdensome for CFO's.

i) **Talent and Capability:** A brighter spotlight will shine on talent, capability and behaviour in the top finance role.

Q.No.10. Explain the two basic functions of Financial Management. (PM) (N09-3M)

The two basic functions of Financial Management are:

1. **Procurement of funds:**

   a) Since funds can be obtained from different sources therefore their procurement is always considered as a complex problem by business concerns.

   b) Funds procured from different sources have different characteristics in terms of risk, cost and control.

   c) The cost of funds should be at the minimum level and for that risk and control factors must be balanced.

   d) Another key consideration in choosing the source of new business finance is to strike a balance between equity and debt.

   e) **Let us discuss some of the sources of funds:**

      i) **Equity:** Equity shares are the best from risk point of view for the firm. However, from the cost point of view, equity capital is usually the most expensive.

      ii) **Debentures:** Debentures are comparatively cheaper because of their tax advantage but they are more risky.

      iii) **Funding from Banks:** Commercial Banks play an important role in funding of the business enterprises.

      iv) **International Funding:** Foreign Direct Investment (FDI) and Foreign Institutional Investors (FII) are two major routes for raising funds from foreign sources besides ADR's (American depository receipts) and GDR's (Global depository receipts).

2. **Effective Utilisation of funds:** Funds shall be invested in such a way that they generate an income higher than the cost of procuring them. Hence, it is crucial to employ the funds properly and profitably. Some of the aspects of funds utilisation are:

   a) **Utilisation for Fixed Assets:** The funds are to be invested in the manner so that the company can produce at its optimum level without endangering its financial solvency. For this, the finance manager has to use the techniques of capital budgeting.

   b) **Utilisation for Working Capital:** While the firms enjoy an optimum level of working capital they do not keep too much funds blocked in inventories, book debts, cash etc. The finance manager must also keep this point in mind.

Q.No.11. Write short notes on the following: (PM)

(a) Inter relationship between Investment, Financing and Dividend decisions.

(b) Finance function.

PART (A)

Inter-relationship between Investment, Financing and Dividend decisions:

a) The finance functions are divided into three major decisions, viz., investment, financing and dividend decisions.

b) These decisions are inter-related because the underlying objective of these three decisions is same i.e. maximisation of shareholders' wealth. So, one has to consider the joint impact of these decisions on the market price of the company's shares.

c) **The interrelationship between these 3 decisions is explained below:**

Investment decision: The investment of long term funds is made after a careful assessment of various projects through capital budgeting and uncertainty analysis. However, we need to invest in only those projects in which the rate of return is more than the cost of capital. This will have an impact on the profitability of the company and ultimately on its wealth.

Financing decision: Funds can be raised from various sources. Each source of funds involves different issues. The finance manager has to maintain a proper balance between long-term and short-term funds. Within the long term funds, he has to ensure a proper mix of loan funds and owner's funds. The optimum financing mix will increase return to equity shareholders and thus maximise their wealth.

Dividend decision: The finance manager assists the top management in deciding as to what portion of the profit should be paid to the shareholders by way of dividends and what portion should be retained in the business. An optimal dividend pay-out ratio maximises shareholder's wealth.

Conclusion: The above discussion makes it clear that investment, financing and dividend decisions are interrelated and are to be taken jointly keeping in view their joint effect on the shareholder's wealth.

PART (B)

Finance function:

a) It is a very important function for all business enterprises.

b) It remains a focus of all activities.

c) It starts with the setting up of an enterprise.

d) It is concerned with raising of funds, deciding the cheapest source of finance, utilisation of funds raised, making provision for refund when money is not required in the business, deciding the most profitable investment, managing the funds raised and paying returns to the providers of funds in proportion to the risks undertaken by them.

Therefore, it aims at acquiring sufficient funds, utilising them properly, increasing the profitability of the organization and maximizing the value of the organization and ultimately the shareholder's wealth.

Q.No.12. Relationship between Financial Management and Financial Accounting. (PM)(N09-2M)

Inter relationship:

a) Input Output relation: Accounting is an important input in financial decision making. In other words, accounting is a necessary input into the financial management function.

b) Provides needed information: The outcome of accounting is the financial statements such as balance sheet, income statement and the statement of changes in financial position. The information contained in these statements and reports helps the financial managers in gauging the past performance and future directions of the organisation.

Differences: Though financial management and accounting are closely related, still they differ in the following aspects:

a) Treatment of Funds: In accounting, the measurement of funds is based on the accrual principle. The accrual based accounting data do not reflect fully the financial conditions of the organisation. An organisation which has earned profit (sales less expenses) may said to be profitable in the accounting sense but it may not be able to meet its current obligations due to uncollectible receivables. Such an organisation will not survive irrespective of its levels of profits.

In financial management the treatment of funds is based on cash flows. The revenues are recognised only when cash is actually received (i.e. cash inflow) and expenses are recognised on actual payment (i.e. cash outflow). Thus, cash flow based returns help financial managers to avoid insolvency and achieve desired financial goals.

b) **Decision – making:** The chief focus of an accountant is to collect data and present the data while the financial manager's primary responsibility relates to financial planning, controlling and decision making.

Thus, in a way it can be stated that financial management begins where accounting ends.

Alternative Questions:

1. Differentiate between Financial Management and Financial Accounting.

A. Same as above.

Q.No.13. "The information age has given a fresh perspective on the role of Financial Management and Finance managers. With the shift in paradigm it is imperative that the role of Chief Financial Officer (CFO) changes from a controller to a facilitator." Can you describe the emergent role which is described by the speaker / author? (PM)

a) The information age has given a fresh perspective on the role of financial management and finance managers. With the shift in paradigm it is imperative that the role of Chief Finance Officer (CFO) changes from a controller to a facilitator.

b) In the emergent role, Chief Finance Officer acts as a catalyst to facilitate changes in an environment where the organization succeeds through self managed teams.

c) The Chief Finance Officer must transform himself to a front-end organiser and leader who spends more time in networking, analzysing the external environment, making strategic decisions, managing and protecting cash flows.

d) In due course, the role of Chief Finance Officer will shift from an operational to a strategic level. Ofcourse, on an operational level the Chief Finance Officer cannot be excused from his backend duties.

e) The knowledge requirements for the evolution of a Chief Finance Officer will extend from being aware about capital productivity and cost of capital to human resources initiatives and competitive environment analysis.

He has to develop general management skills for a wider focus encompassing all aspects of business that depend on or dictate finance.

Alternative Questions:

1. Discuss the changing scenario of financial management in India. (or) The role of CFO changes from controller to facilitator. Comment?

A. Same as above.

Q.No.14. Explain the role of Finance Manager in the changing scenario of financial management in India. (PM)

Role of Finance Manager in the changing scenario of Financial management in India:

a) In the modern enterprise, the finance manager occupies a key position and his role is becoming more and more pervasive and significant in solving the finance problems.

b) The traditional role of the finance manager was confined just to raising of funds from a number of sources, but the recent development in the socio-economic and political scenario throughout the world has placed him in a central position in the business organisation.

c) He is now <u>responsible for shaping the fortunes</u> of the enterprise and is involved in the most vital decision of allocation of capital like mergers, acquisitions, etc.

d) He is working in a <u>challenging environment</u> which changes continuously.

e) <u>Emergence of financial service sector</u> and development of internet in the field of information technology has also brought new challenges.

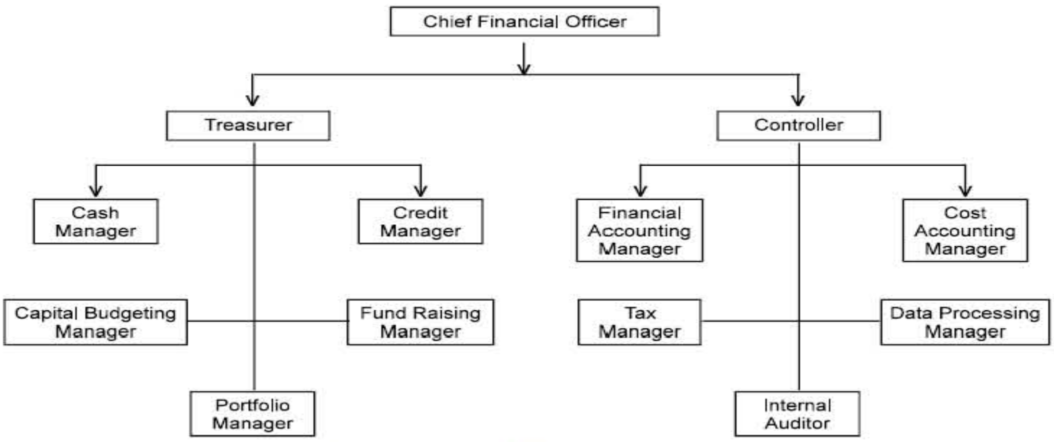
f) <u>Development of new financial tools,</u> techniques, instruments and products and emphasis on public sector undertaking to be self-supporting and their dependence on capital market for fund requirements have all changed the role of a finance manager.

g) <u>His role assumes significance</u> in the present day context of liberalization, deregulation and globalization.

FOR ACADEMIC INTEREST ONLY

Q.No.15. How the finance function in a large organization can be organized?

The figure below shows how the finance function in a large organization may be organized.



Organisation of Finance Function

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Venkanna Sir

Executed By: DhanaLakshmi

THE END

2. TIME VALUE OF MONEY

Q.NO	ABC Analysis	M-06	N-06	M-07	N-07	M-08	N-08	M-09	N-09	M-10	N-10	M-11	N-11	M-12	N-12	M-13	N-13	M-14	N-14	M-15	N-15	M-16	N-16
1	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	4	-	2	-
2	A	-		-	-	-	2	-	-	-	-	-	4	-	-	-	-	-	-	-	-	-	4
3	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	4	-	-	-	-
4	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-

Q.No.1. Define the following terms 1) Time Value of Money, 2) Simple interest, 3) Compound Interest, 4) Present value of a sum of Money, 5) Future Value, 6) Annuity/Perpetuity, 7) Sinking Fund (M16 -2M, M15-4M)

1) **Time Value of Money:** It means money has time value. A rupee today is more valuable than a rupee a year hence. We use rate of interest to express the time value of money.

2) **Simple Interest:** Simple Interest may be defined as Interest that is calculated as a simple percentage of the original principal amount.

   $SI = P_0 (i)(n)$

3) **Compound Interest:** Compound interest is the interest calculated on total of previously earned interest and the original principal.

   $FVn = P_0 (1+i) n$

4) **Present Value of a Sum of Money:** Present value of a sum of money to be received at a future date is determined by discounting the future value at the interest rate that the money could earn over the period.

5) **Future Value:** Future Value is the value at some future time of a present amount of money, or a series of payments, evaluated at a given interest rate.

   $FVn = P0+ SI = P_0 + P_0(i)(n)$ Or, $FV_n = P_0\left(1+\frac{r}{k}\right)^n$

6) **Annuity:** An annuity is a series of equal payments or receipts occurring over a specified number of periods.

   a) **Present Value of an Ordinary Annuity:** Cash flows occur at the end of each period, and present value is calculated as of one period before the first cash flow.

   b) **Present Value of an Annuity Due**: Cash flows occur at the beginning of each period, and present value is calculated as of the first cash flow.

   PVAn = = R (PVIFi,n)

   c) **Future Value of an Ordinary Annuity**: Cash flows occur at the end of each period, and future value is calculated as of the last cash flow.

   d) **Future Value of an Annuity Due:** Cash flows occur at the beginning of each period, and future value is calculated as of one period after the last cash flow.

   FVAn = R (FVIFA i,n)

7) **Sinking Fund:** It is the fund created for a specified purpose by way of sequence of periodic payments over a time period at a specified interest rate.

   FVA=R [FVIFA (i, n)]

Q. No.2. Explain the relevance of Time value of money in financial decisions? (N 16-4M, M 08-2M, N 11 - 4M)

a) It means that worth of a rupee received today is different from the worth of a rupee to be received in future. The preference of money now as compared to future money is known as time preference for money.

b) A rupee today is more valuable than rupee after a year due to several reasons:

i) **Risk** − there is uncertainty about the receipt of money in future.

ii) **Preference for present consumption** − Most of the persons and companies in general, prefer current consumption over future consumption.

iii) **Inflation** − In an inflationary period a rupee today represents a greater real purchasing power than a rupee a year hence.

iv) **Investment opportunities** − Most of the persons and companies have a preference for present money because of availabilities of opportunities of investment for earning additional cash flow.

Many financial problems involve cash flow accruing at different points of time. For evaluating such cash flow an explicit consideration of time value of money is required.

Q.NO.3. Why money in the future is worth less than similar money today? Give the reasons and explain. (N 14- 4M) (SM)

There are three reasons why money can be more valuable today than in the future. Let's discuss them:

a) **Preference for Present Consumption:** Individuals have a preference for current consumption in comparison to future consumption. In order to forego the present consumption for a future one, they need a strong incentive. Say for example, if the individual's present preference is very strong then he has to be offered a very high incentive to forego it like a higher rate of interest and vice versa.

b) **Inflation:** Inflation means when prices of things rise faster than they actually should. When there is inflation, the value of currency decreases over time. If the inflation is more, then the gap between the values of money today to the value of money in future is more. So, greater the inflation, greater is the gap and vice versa.

c) **Risk:** Risk of uncertainty in the future lowers the value of money. Say for example, non receipt of payment, uncertainty of investor's life or any other contingency which may result in non-payment or reduction in payment. Time value of money results from the concept of interest.

Q.No.4. Write short notes on effective rate of interest?

a) Effective rate of interest is the actual Equivalent Annual Rate of interest at which an investment grows in value when interest is credited more often than once in a year.

b) If interest is paid "k" times in a year and "i" is the rate of interest per annum, effective rate of interest (E) is given by the following formula: $E = \left(1+\frac{i}{k}\right)^k - 1$

c) For example, if interest at 10% is payable quarterly on an investment, Effective Rate of Interest (by substituting in the above formula) = **10.38%**

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THE END

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3. CAPITAL BUDGETING/ INVESTMENT DECISIONS

Q.NO	ABC Analysis	M-06	N-06	M-07	N-07	M-08	N-08	M-09	N-09	M-10	N-10	M-11	N-11	M-12	N-12	M-13	N-13	M-14	N-14	M-15	N-15	M-16	N-16
1	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
2	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
3	C	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
4	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
5	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	4	-	-	-	-
6	A	-	-	-	-	-	-	-	-	-	-	-	4	-	-	-	-	-	-	-	4	-	-
7	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
8	A	-	-	2	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
9	A	-	-	-	-	-	3	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
10	B	-	-	-	-	-	-	3	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
11	C	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-

Q.No.1.What is Capital Budgeting? What is the purpose of Capital Budgeting? (SM)

Capital Budgeting: It is the process of evaluating and selecting long term investments that are in line with the goal of investors' wealth maximization.

Example: Setting up of factories, installing a machinery etc.

The Capital Budgeting decisions are important due to following reasons:

a) **Substantial expenditure:** Capital Budgeting decisions involves the investment of substantial amount of funds. It is therefore necessary for a firm to make such decisions after a thoughtful consideration so as to result in the profitable use of its scarce resources.

   The hasty and incorrect decisions would not only result into huge losses but may also account for the failure of the firm.

b) **Long time period:** The capital Budgeting decision has its effect over a long period of time. These decisions not only affect the future benefits and costs of the firm but also influence the rate and direction of growth of the firm.

c) **Irreversibility:** Most of the investment decisions are irreversible. Once they are taken, the firm may not be in a position to reverse them back. This is because, as it is difficult to find a buyer for the second-hand capital items.

d) **Complex decision:** The capital investment decision involves an assessment of future events, which in fact is difficult to predict. Further it is quite difficult to estimate in quantitative terms all the benefits or the costs relating to a particular investment decision.

Alternative Questions:

1. **"Capital Budgeting decisions are important, crucial and critical business decisions due to various reasons". Comment.**

A. Same as above.

Q.No.2. What are the basic financial factors used in project evaluation?

a) **Initial Investment:** This is equal to the cash outflow at the initial stage, net of salvage value of old asset, if any. Hence Initial Investment = Cost of New Asset purchased less Sale value of old assets, if any.

b) **Cash Flow after Taxes:** (CFAT): This is equal to the cash inflows generated by the projects at various points of time. Generally CFAT = PAT + Depreciation and other amortizations.

c) **Project Life:** The time within which the project generates positive CFAT is called project life.

d) **Discount Rate:** It represents the cut- off rate for capital investment evaluation. A project which does not earn at least the cut- off rate should not be accepted. Generally, the rate used for discounting is the Weighted Average Cost of Capital of the enterprise.

PV Factor and Annuity Factor Tables: For the purpose of discounting future cash flows, the PV factor and Annuity Factor tables are used.

Q.No.3. What do you understand by payback period? (PM)

Payback Period:

a) It represents the length of time period required for complete recovery of the initial investment in the project.

b) It is the period within which the total cash inflows from the project will be equal to the cost of the project.

c) The lower the payback, the better it is, initial investment will be recouped faster.

Merits:

a) It is easy to understand and calculate.

b) It emphasizes liquidity by stressing earlier cash inflows.

c) It uses the cash flows rather than accounting data.

d) It enables the management to cope with the risk associated with the project by having a shorter payback period.

e) The reciprocal of the payback is a close approximation of the internal rate of return if the life of the project is atleast twice the payback period and the project generates equal annual cash inflows.

Demerits:

a) It ignores the time value of money.

b) It ignores the cash flows occurring after the payback period.

c) There is no objective way to determine the maximum acceptable payback period.

d) It is not a measure of profitability since the cash flows occurring after the payback period are ignored.

e) It does not necessarily maximize the wealth of the shareholders.

Q.No.4. Write short note on Net Present Value method (NPV)?

The Net Present Value:

a) **It** is the sum of the present values of all future cash inflows less the sum of present values of all cash outflows associated with the proposal.

b) It uses a specified discount rate to bring all subsequent net cash inflows aftger the initial investment to their present value.

c) Thus: **NPV** = Discounted Cash Inflows less Discounted Cash Outflows.

Merits:

a) NPV method takes into account the time value of money.

b) The whole stream of cash flows is considered.

c) The net present value can be seen as the addition to the wealth of share holders. The criterion of NPV is thus in conformity with basic financial objectives.

d) The NPV uses the discounted cash flows i.e. expresses cash flows in terms of current rupees. The NPV's of different projects therefore can be compared. It implies that each project can be evaluated independent of others on its own merit.

Demerits:

a) It involves difficult calculations.

b) The application of this method necessitates forecasting cash flows and the discount rate. Thus accuracy of NPV depends on accurate estimation of these two factors which may be quite difficult in practice.

b) The decision under NPV method is based on absolute measure. It ignores the difference in initial outflows, size of different proposals etc. while evaluating mutually exclusive projects.

Q.No.5. Write short notes on internal rate of return (IRR) or Project IRR? (N 14-4M) (PM)

Internal Rate of Return (IRR):

a) Internal Rate of Return techniques are one of the discounted cash flow techniques which takes into account the time value of money.

b) Internal Rate of Return refers to the rate, which equates the present value of all cash inflows with the present value of all cash outflows associated with the project.

c) The Internal Rate of Return is the rate at which NPV is Zero.

d) It is called an internal rate because it depends solely upto the cash inflows and the cash outflows associated with the project and not on any rate determined outside project.

e) This rate is to be found by trial and error method. It also be stated as the discounting ate at which the ratio of present value of Cash inflows and Present value of cash outflows is equal to 1.

$$\text{IRR: } \frac{\text{Present value of Cash Inflows}}{\text{Present value of Cash Outflows}} = 1$$

f) In evaluating investment proposals, internal rate of return is compared with a required rate of return, known as cut-off rate. If it is more than cut-off rate the project is treated as acceptable otherwise project is rejected.

Merits:

a) It considers the time value of money.

b) It considers entire cash flows over entire life of the project.

c) It is consistent with the objective of maximising the wealth of owners.

d) It is a measure of profitability since entire cash flows over entire life of the project are considered.

e) Unlike the NPV, cost of capital is not assumed to be known.

Demerits:

a) It requires the estimation of cash inflows and cash outflows, which is a difficult task.

b) It assumes that intermediate cash inflows are reinvested at IRR.

c) It may yield negative rates under certain circumstances. (e.g. when Cash Outflows are more than Cash Inflows).

d) It may yield multiple rates under certain circumstances (e.g. when cash flows reverse their signs during the project).

e) It is relatively difficult to compute.

Q.No.6. Distinguish between Net Present Value and Internal Rate of Return. (N11-4M, N15-4M) (PM)

NPV versus IRR: NPV and IRR methods differ in the sense that the results regarding the choice of an asset under certain circumstances are mutually contradictory under two methods.

a) In case of mutually exclusive investment projects, in certain situations, they may give contradictory results such that if the NPV method finds one proposal acceptable, IRR favors another.

b) The different rankings given by the NPV and IRR methods could be due to size disparity problem, time disparity problem and unequal expected lives.

c) The NPV is expressed in financial values whereas IRR is expressed in percentage terms.

d) In the NPV, cash flows are assumed to be re-invested at cost of capital rate. In IRR reinvestment is assumed to be made at IRR rates.

Q.No.7. Do the Profitability index and the NPV criterion of evaluating investment proposals lead to the same acceptance-rejection and ranking decisions? In what situations will they give conflicting results? (PM)

a) In most of the situations the Net Present Value Method (NPV) and Profitability Index (PI) yield same accept or reject decision.

b) In general items, under PI method a project is acceptable if Profitability index value is greater than 1 and rejected if it less than 1.

c) Under NPV method a project is acceptable if Net present value of a project is positive and rejected if it is negative.

d) Clearly a project offering a profitability index greater than 1 must also offer a net present value which is positive. But a conflict may arise between two methods if a choice between mutually exclusive projects has to be made.

Q. No.8. Define Modified Internal Rate of Return method. (M 07 - 2M)

Modified Internal Rate of Return (MIRR):

a) There are several limitations attached with the concept of the conventional Internal Rate of Return. The MIRR addresses some of these deficiencies.

b) For example, it eliminates multiple IRR rates, it addresses the reinvestment rate issue and produces results, which are consistent with the Net Present Value method.

c) Under this method, all cash flows, apart from the initial investment, are brought to the terminal value using an appropriate discount rate (usually the cost of capital).

d) This results in a single stream of cash inflow in the terminal year. The MIRR is obtained by assuming a single outflow in the zeroth year and the terminal cash inflow as mentioned above.

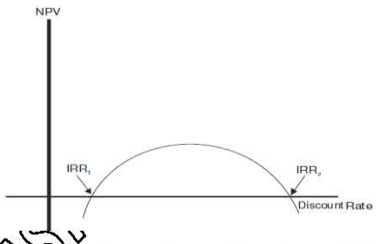
e) The discount rate which equates the present value of the terminal cash in flow to the zeroth year outflow is called the MIRR.

Q. No.9. Define Multiple Internal Rate of Return (MIRR). (N 08 - 3M)

<u>Multiple Internal Rate of Return (MIRR):</u>

a) In cases where project cash flows change signs or reverse during the life of a project for example, an initial cash outflow is followed by cash inflows and subsequently followed by a major cash outflow, there may be more than one internal rate of return (IRR).

b) The following graph of discount rates versus Net Present Value (NPV) may be used as an illustration:



c) In such situations if the cost of capital is less than the two IRR's, a decision can be made easily, however, otherwise the IRR decision rule may turn out to be misleading as the project should only be invested if the cost of capital is between IRR_1 and IRR_2.

d) To understand the concept of multiple IRR's it is necessary to understand the implicit re-investment assumption in both NPV and IRR techniques.

- **i)** **<u>NPV</u>** - Interim cash inflows at the end of each year are assumed to be reinvested at cost of capital.
- **ii)** **<u>IRR</u>** -Interim cash inflows at the end of each year are assumed to be reinvested at IRR.

Q.No.10. Explain the concept of Discounted Payback Period? (M 09 - 3M)

<u>Discounted Payback Period:</u>

a) Payback Period is <u>time taken to recover the original investment</u> from project cash flows. It is also termed as break even period.

b) The focus of the analysis is on liquidity aspect and it suffers from the <u>limitation of ignoring time value of money and profitability</u>.

c) <u>Discounted payback period considers present value of cash flows</u>, discounted at company's cost of capital to estimate breakeven period i.e. it is that period in which future discounted cash flows equal the initial outflow.

d) The shorter the period, better it is.

e) It also ignores post Discounted Payback Period cash flows.

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Q.No 11. Write short notes Capital Budgeting Process? (SM)

a) **Planning:** The capital Budgeting Process begins with the identification of potential investment opportunities. The opportunity then enters the planning phase when the potential effect on the firm's fortunes is assessed and the ability of the management of the firm to exploit the opportunity is determined. Opportunities having little merit are rejected and promising opportunities are advanced in the form of a proposal to enter the evaluation phase.

b) **Evaluation:** This phase involves the determination of proposal and its investments, inflows and outflows. Investment appraisal techniques, ranging from the simple payback method and accounting rate of return to the more sophisticated discounted cash flow techniques, are used to appraise the proposals. The technique selected should be the one that enables the manager to make the best decision in the light of prevailing circumstances.

c) **Selection:** Considering the returns and risks associated with the individual projects as well as the cost of capital to the organisation, the organisation will choose among projects so as to maximise shareholders' wealth.

d) **Implementation:** When the final selection has been made, the firm must acquire the necessary funds, purchase the assets, and begin the implementation of the project.

e) **Control:** The progress of the project is monitored with the aid of feedback reports. These reports will include capital expenditure progress reports, performance reports comparing actual performance against plans set and post completion audits.

f) **Review:** When a project terminates, or even before, the organisation should review the entire project to explain its success or failure. This phase may have implication for firms planning and evaluation procedures. Further, the review may produce ideas for new proposals to be undertaken in the future.

TWO MARKS QUESTIONS

1. **Cut - off Rate:** It is the minimum rate which the management wishes to have from any project. Usually this is based upon the cost of capital. The management gains only if a project gives return of more than the cut - off rate. Therefore, the cut - off rate can be used as the discount rate or the opportunity cost rate. **(PM)**

2. **Desirability Factor / Profitability Index: (RTP - N14, N09 - 1.5M) (PM)**

In certain cases we have to compare a number of proposals each involving different amount of cash inflows. One of the methods of comparing such proposals is to work out what is known as the 'Desirability factor' or 'Profitability index'. In general terms, a project is acceptable if its profitability index value is greater than 1.
Mathematically, the desirability factor is calculated as below:

$$\frac{\text{Sum of Discounted Cash inflows}}{\text{Initital Cash outlay or Total Discounted Cash outflow (as the case may be)}}$$

3. Capital Rationing: **(PM)**

Capital Rationing is a process whereby the limited funds available are allocated amongst the financially viable projects which are not mutually exclusive under consideration so as to maximise the wealth of the shareholders. Thus capital rationing is said to exist if:

a) Limited funds are available for investment.

b) More than one financially viable project which are not mutually exclusive under consideration.

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4. COST OF CAPITAL

Q.NO	ABC Analysis	M-06	N-06	M-07	N-07	M-08	N-08	M-09	N-09	M-10 TO N-15	M-16	N-16
1	A	-	-	-	-	-	-	-	-	-	-	-
2	B	-	-	-	-	-	-	-	-	-	-	-
3	A	-	-	-	-	-	-	-	3	-	-	-
4	A	-	2	-	-	-	-	-	-	-	-	-
5	A	-	-	-	-	-	-	-	-	-	-	-
6	B	-	-	-	-	-	-	-	-	-	-	-

Q.No1. Define the following terms (a) Cost of Capital (b) Components of Cost of Capital (c) Marginal Cost of Capital

a) **Cost of Capital:**

i) It is the minimum rate of return that a firm must earn on its investment which will maintain the market value of share at its current level.

ii) It can also be stated as the opportunity cost of an investment, i.e. the rate of return that a company would otherwise be able to earn at the same risk level as the investment that has been selected

b) **Components of Cost of Capital:** The cost of capital can be either explicit or implicit.

i) **Explicit Cost:** The discount rate that equals that present value of the cash inflows that are incremental to the taking of financing opportunity with the present value of its incremental cash outflows.

ii) **Implicit Cost:** It is the rate of return associated with the best investment opportunity for the firm and its shareholders that will be foregone if the project presently under consideration by the firm was accepted.

c) **Marginal Cost of Capital:** It may be defined as “the cost of raising an additional rupee of capital”. To calculate the marginal cost of capital, the intended financing proportion should be applied as weights to marginal component costs. The marginal cost of capital should, therefore, be calculated in the composite sense. The marginal weights represent the proportion of funds the firm intends to employ.

Q.NO.2. What is the significance of Cost of capital (SM)

a) **Evaluation of Investment options:** The estimated benefits (future cash flows) from available investment opportunities (business or project) are converted into the present value of benefits by discounting them with the relevant cost of capital. Here it is pertinent to mention that every investment option may have different cost of capital hence it is very important to use the cost of capital which is relevant to the options available. Here Internal Rate of Return (IRR) is treated as cost of capital for evaluation of two options (projects).

b) **Performance Appraisal:** Cost of capital is used to appraise the performance of a particulars project or business. The performance of a project or business in compared against the cost of capital which is known here as cut-off rate or hurdle rate.

c) **Designing of Optimum credit policy:** While appraising the credit period to be allowed to the customers, the cost of allowing credit period is compared against the benefit/ profit earned by providing credit to customer of segment of customers. Here cost of capital is used to arrive at the present value of cost and benefits received.

Q.No.3. What is meant by Weighted Average Cost of Capital? (PM) (N09-3M)

Meaning of Weighted Average Cost of Capital (WACC): The composite or overall cost of capital of a firm is the weighted average of the costs of the various sources of funds.

a) Weights are taken to be in the proportion of each source of fund in the capital structure.

b) While making financial decisions this overall or weighted cost is used.

c) Each investment is financed from a pool of funds which represents the various sources from which funds have been raised.

d) Any decision of investment, therefore, has to be made with reference to the overall cost of capital and not with reference to the cost of a specific source of fund used in the investment decision.

The Weighted Average Cost of Capital is calculated by:

a) Calculating the cost of specific source of fund e.g. cost of debt, equity etc,

b) Multiplying the cost of each source by its proportion in capital structure, and

c) Adding the weighted component cost to get the firm's WACC represented by k_0.

$$k_0 = k_1 w_1 + k_2 w_2 + \ldots\ldots\ldots\ldots$$

Where, k_1, k_2 are component costs and w_0, w_2 are weights.

Q.No.4. Discuss the Dividend-price approach and Earnings price approach to estimate cost of equity capital. (PM) (N06-2M)

Dividend-price approach:

a) In dividend price approach, cost of equity capital is computed by dividing the current dividend by average market price per share.

b) This ratio expresses the cost of equity capital in relation to what yield the company should pay to attract investors.

c) It is computed as: $K_e = \frac{D_1}{P_0}$

Where,

D_1 = Dividend per share in period 1.

P_0 = Market price per share today.

Earnings price approach:

a) The advocates of earnings price approach co-relate the earnings of the company with the market price of its share.

b) Accordingly, the cost of ordinary share capital would be based upon the expected rate of earnings of a company.

c) This approach is similar to dividend price approach, only it seeks to nullify the effect of changes in dividend policy.

Q.No.5. Write a short note on Capital Asset Pricing Model (CAPM).

1. CAPM was developed by sharp Mossin and Linter in 1960.

2. CAPM model describes the risk-return trade-off for securities. It describes the linear relationship between risk and return for securities.

3. The risks, to which a security is exposed, can be classified into two groups:

a) **Unsystematic Risk:** This is also called company specific risk as the risk is related with the company's performance. This type of risk can be reduced or eliminated by diversification of the securities portfolio. This is also known as diversifiable risk.

b) **Systematic Risk:** It is the macro- economic or market specific risk under which a company operates. This type of risk cannot be eliminated by the diversification hence, it is non-diversifiable. The examples are inflation, Government policy, interest rate etc.

4. As diversifiable risk can be eliminated by an investor through diversification, the non diversifiable risk is the risk which cannot be eliminated; therefore a business should be concerned as per CAPM method, solely with non-diversifiable risk.

5. The non-diversifiable risks are assessed in terms of beta coefficient (b or β) through fitting regression equation between return of a security and the return on a market portfolio.

Thus, the cost of equity capital can be calculated under this approach as:

$K_e = R_f + ß\,(R_m - R_f)$

Where,

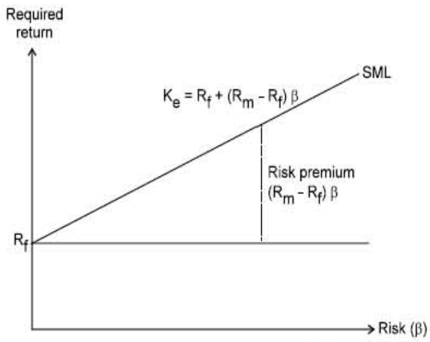
K_e = Cost of equity capital

R_f = Rate of return on security

ß = Beta coefficient

R_m = Rate of return on market portfolio

$(R_m - R_f)$ = Market premium



Cost of Equity under CAPM

Q.NO.6. If a company finds that its cost of capital has changed does this affect the Profitability of the company? (M 15-RTP)

a) The answer depends on how the company has been financed.

b) If the company is financed mainly from short-term sources, it cannot ignore an increase in interest rates and may choose to switch to long-term financing. This will be at a higher rate and profitability will be diminished.

c) If the company is financed mainly from long-term sources, an increase in interest rates will not affect its profits directly.

d) However, higher interest rates may depress economic activity and its profits may fall accordingly.

e) If the company is financed mainly from retained earnings or equity, an increase in the required return of shareholders will lead to pressure for higher dividends.

f) The company may have insufficient funds to meet such demands.

TWO MARKS QUESTIONS

1. **Optimum Capital Structure:** The capital structure is said to be optimum when the firm has selected such a combination of equity and debt so that the wealth of firm is maximum. At this capital structure, the cost of capital is minimum and the market price per share is maximum.

2. **Disadvantages of debt financing:**

   a) **Risk & Return:** The higher the risk, the higher the return expectations. Lenders / Debenture holders have prior claim on interest and principal repayment, whereas Equity Shareholders are entitled to Residual Earnings only. Hence, the expectations of Equity Shareholders are higher than that of Debt holders and Preference Shareholders.

   b) **Tax Effect:** Interest on Debt can be deducted for computing the taxable income. Hence, use of debt reduces the corporate tax payment. Thus, Debt is cheaper than Equity, due to the Tax – Shield.

   c) **Issue Costs:** Issuing and Transaction costs associated with raising and servicing Debts are generally less than that of equity shares.

3. **Realised Yield Approach:** According to this approach, the average rate of return realized in the past few years is historically regarded as 'expected return' in the future. It computes cost of equity based on the past records of dividends actually realised by the equity shareholders. The yield of equity for the year is:

$$Y_t = \frac{D_t - P_{t-1}}{P_{t-1}}$$

Where,

Y_t = Yield for the year t,

D_t = Dividend per share at the end of the year t,

P_t = Price per share at the end of the year t,

$P_t - 1$ = Price per share at the beginning and at the end of the year t.

Q.NO.4. "The overall Cost of Capital can be reduced by increasing the debt portion in the Capital Structure." (RTP N14)

In a zero-tax environment, MM Hypothesis has proved that the overall cost of capital is independent of the amount of leverage in the capital structure. However, when companies are subject to tax, the overall cost of capital will be reduced due to the tax shield provided by debt.

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5. CAPITAL STRUCTURE DECISIONS

Q.NO	ABC Analysis	M-06	N-06	M-07	N-07	M-08	N-08	M-09	N-09	M-10	N-10	M-11	N-11	M-12	N-12	M-13	N-13	M-14	N-14	M-15	N-15	M-16	N-16
1	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	4	-	-	-	-	-	-
2	A	6	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
3	A	-	-	-	-	-	-	-	-	-	-	-	-	-	4	-	-	-	-	-	-	4	-
4	B	-	-	-	-	-	-	2	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
5	A	-	-	-	-	-	-	-	-	-	4	-	-	-	-	-	-	-	-	-	-	-	-
6	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
7	A	-	-	-	3	-	-	-	-	-	-	-	-	4	-	-	-	-	-	-	-	-	-
8	A	-	-	2	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	4	-	-	-
9	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	4	-	-	-	-	-	-
10	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
11	C	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-

1. MEANING AND CONCEPT OF CAPITAL STRUCTURE

Q. No.1. What do you mean by Capital Structure? State its significance in Financing decision? (N13 - 4M) (PM)

Capital Structure:

Capital structure refers to the mix of a firm's capitalisation i.e. mix of long-term sources of funds such as debentures, preference share capital, equity share capital and retained earnings for meeting its total capital requirement.

Significance in Financing Decision:

a) The capital structure decisions are very important in financial management as they influence debt – equity mix which ultimately affects shareholders return and risk.

b) These decisions help in deciding the forms of financing (which sources to be tapped), their actual requirements (amount to be funded) and their relative proportions (mix) in total capitalisation. Therefore, such a pattern of capital structure must be chosen which minimises cost of capital and maximises the owners' return.

Q.No.2. Discuss the major considerations in Capital Structure planning. (PM)(M06-6M, M15-MTP1)

Major considerations in Capital Structure planning: There are three major considerations, i.e. risk, cost of capital and control, which help the finance manager in determining the proportion in which he can raise funds from various sources at a given point of time.

1. **Risk / Risk Principle:**

   a) The finance manager attempts to design the capital structure in such a manner, so that risk and cost are the least and the control of the existing management is diluted to the least extent.

   b) Risk is of two kinds, i.e. financial risk and Business risk. Here, we are concerned primarily with the financial risk.

c) Financial risk also is of two types:

i) Risk of cash insolvency,

ii) Risk of variation in the expected earnings available to equity share-holders.

2. **Cost of Capital / Cost Principle:**

a) Cost is an important consideration in capital structure decisions. It is obvious that a business should be at least capable of earning enough revenue to meet its cost of capital and finance its growth.

b) Hence, along with a risk as a factor, the finance manager has to consider the cost aspect carefully while determining the capital structure.

3. **Control / Control Principle:**

a) Along with cost and risk factors, the control aspect is also an important consideration in planning the capital structure.

b) When a company issues further equity shares, it automatically dilutes the controlling interest of the present owners.

c) Similarly, preference shareholders can have voting rights and thereby affect the composition of the Board of Directors,. Hence, when the management agrees to raise loans from financial institutions, by implication it agrees to forego a part of its control over the company.

Alternative Questions:

1. **"Risk, Cost of Capital and Control are the Major considerations in Capital Structure planning." Comment on it.**

A. Same as above.

Q. No.3. List the fundamental principles governing Capital Structure.
(PM) (M16 -4M ,N 12-4M)

The fundamental principles are:

a) **Cost Principle:** According to this principle, an ideal pattern or capital structure is one that minimises cost of capital structure and maximises earnings per share (EPS).

b) **Risk Principle:** According to this principle, reliance is placed more on common equity for financing capital requirements than excessive use of debt. Use of more and more debt means higher commitment in form of interest payout. This would lead to erosion of shareholders value in unfavorable business situation.

c) **Control Principle:** While designing a capital structure, the finance manager may also keep in mind that existing management control and ownership remains undisturbed.

d) **Flexibility Principle:** It means that the management chooses such a combination of sources of financing which it finds easier to adjust according to changes in need of funds in future too.

e) **Other Considerations:** Besides above principles, other factors such as nature of industry, timing of issue and competition in the industry should also be considered.

3. EBIT-EPS ANALYSIS / INDIFFERENCE POINT ANALYSIS

Q.No.4. Discuss the concept of Debt-Equity or EBIT-EPS Indifference point / Equivalency point, while determining the capital structure of a company. (PM) (M 09-2M)

a) The determination of optimum level of debt in the capital structure of a company is a formidable task and is a major policy decision.

b) It ensures that the firm is able to service its debt as well as contain its interest cost.

c) Determination of optimum level of debt involves equalizing between return and risk.

d) EBIT – EPS analysis is a widely used tool to determine level of debt in a firm.

e) Through this analysis, a comparison can be drawn for various methods of financing by obtaining indifference point.

f) It is a point to the EBIT level at which EPS remains unchanged irrespective of debt-equity mix.

g) The indifference point for the capital mix (equity share capital and debt) can be determined as follows:

$$\frac{(EBIT - I_1)(1 - T)}{E_1} = \frac{(EBIT - I_2)(1 - T)}{E_2}$$

Q. No.5. Discuss Financial Break-even and EBIT-EPS Indifference analysis. (PM) (N 10-4M)

a) Financial break-even point is the minimum level of EBIT needed to satisfy all the fixed financial charges i.e. interest and preference dividend.

b) It denotes the level of EBIT for which firm's EPS equals zero.

c) If the EBIT is less than the financial breakeven point, then the EPS will be negative but if the expected level of EBIT is more than the breakeven point, then more fixed costs financing instruments can be taken in the capital structure, otherwise, equity would be preferred.

d) EBIT-EPS analysis is a vital tool for designing the optimal capital structure of a firm.

e) The objective of this analysis is to find the EBIT level that will equate EPS regardless of the financing plan chosen.

$$\frac{(EBIT - I_1)(1 - T)}{E_1} = \frac{(EBIT - I_2)(1 - T)}{E_2}$$

Where,

EBIT = Indifference point,

E_1 = Number of equity shares in Alternative 1,

E_2 = Number of equity shares in Alternative 2,

I_1 = Interest charges in Alternative 1,

I_2 = Interest charges in Alternative 2,

T = Tax-rate.

Alternative 1= All equity finance,

Alternative 2= Debt-equity finance.

4. CAPITAL STRUCTURE THEORIES

Q.No.6. What is Net Income (NI) theory of Capital Structure? (SM)

Net Income (NI) Approach:

a) According to this approach, capital structure decision is relevant to the value of the firm.

b) An increase in financial leverage will lead to decline in the Weighted Average Cost of Capital (WACC), while the value of the firm as well as market price of ordinary share will increase.

c) Conversely, a decrease in the leverage will cause an increase in the overall cost of capital and a consequent decline in the value as well as market price of equity shares.

Assumptions of NI Approach:

a) $K_d < K_e$: The debt capitalisation rate (K_d) is less than the equity capitalisation rate (K_e).

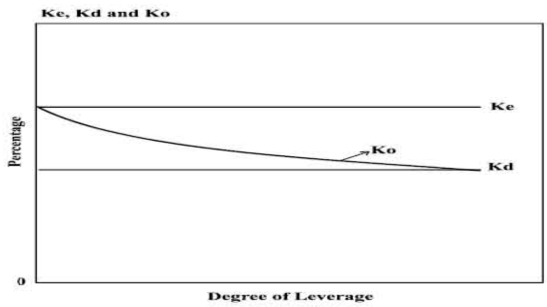
b) **No Change in risk:** The use of debt content does not change the risk perception of investors. As a result, both debt capitalisation rate (K_d) and equity capitalisation rate (K_e) remains constant.

c) **No Taxes:** The corporate income taxes do not exist.

Graphical Presentation of the effect of change in leverage on the WACC under NI approach

From the below diagram, K_e and K_d are assumed not to change with leverage. As debt increases, it causes Weighted Average Cost of Capital (WACC) to decrease.

The value of the firm on the basis of Net Income Approach can be ascertained as follows:



V = S + D

Where,

V = Value of the firm

S = Market value of equity

D = Market value of debt

Market value of equity (S) = $\frac{NI}{K_e}$

Where,

N_I = Earnings available for equity shareholders

K_e = Equity Capitalisation rate

Under, NI approach, the value of the firm will be maximum at a point where weighted average cost of capital (WACC) is minimum.

Conclusion:

a) This theory suggests total or maximum possible debt financing for minimising the cost of capital. The overall cost of capital under this approach is:

b) Overall cost of capital = $\frac{\text{EBIT}}{\text{Value of the firm}}$

c) Thus the firm can increase its total value by decreasing its overall cost of capital through increasing the degree of leverage. The significant conclusion of this approach is that it pleads for the firm to employ as much debt as possible to maximise its value.

Q.No.7. What is Net Operating Income (NOI) theory of Capital Structure? Explain the assumptions of Net Operating Income approach theory of Capital Structure. (PM) (N 07-3M, M 12-4M)

Introduction:

a) As per this approach, an increase in the use of debt which is apparently cheaper is offset by an increase in the equity capitalisation rate. This happens because equity investors seek higher compensation as they are opposed to greater risk due to the existence of fixed return securities in the capital structure.

b) This theory believes that, leverage has no effect at all on the overall Cost of Capital and the value of the firm.

Assumptions of NOI Approach:

a) The corporate income taxes do not exist.

b) The market capitalizes the value of the firm as whole. Thus the split between debt and equity is not important.

c) The increase in proportion of debt in capital structure leads to change in risk perception of the shareholders.

d) The overall cost of capital (K_O) remains constant for all degrees of debt equity mix.

Graphical Presentation of the effect of change in leverage on K_e & WACC under NOI approach

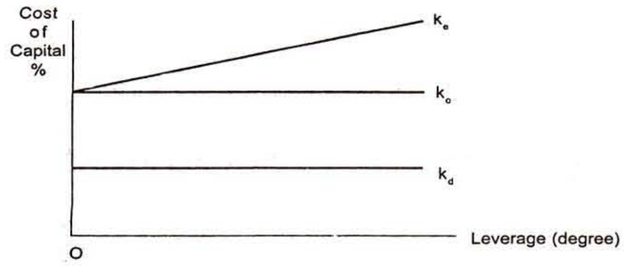
It means Cost of Equity Capital (Ke) is equal to:

$$K_e = (K_O - K_d)\ D/E$$

Where, Ke = Cost of Equity Capital,

K_O = Average Cost of Capital,

K_d = Cost of Debt.



Conclusion: According to this approach, the overall Capitalisation Rate and the Cost of Debt remain constant for all degrees of leverage. Hence, every capital structure is optimal.

Q.No.8. Explain, briefly, Modigliani and Miller approach on Cost of Capital. (or) Explain in brief the assumptions of Modigliani-Miller theory? (PM) (M07 - 2M, M15 - 4M)

Modigliani and Miller approach to Cost of Capital:

a) Modigliani and Miller's argue that the total cost of capital of a particular corporation is independent of its methods and level of financing.

b) According to them a change in the debt equity ratio does not affect the cost of capital. This is because a change in the debt equity ratio changes the risk element of the company which in turn changes the expectations of the shareholders from the particular shares of the company.

c) Hence they contend that leverages have little effect on the overall cost of capital or on the market price.

Assumptions:

a) Capital markets are perfect. Information is costless and readily available to all investors, there are no transaction costs, and all securities are infinitely divisible.

b) Investors are assumed to be rational and to behave accordingly.

c) Firms can be categorised into "equivalent return" classes. All firms within a class have the same degree of business risk.

d) The absence of corporate income taxes is assumed.

Their three Basic Propositions are:

a) The total market value of the firm and its cost of capital are independent of its capital structure. The total market value of a firm is given by capitalising the expected stream of operating earnings at a discount rate appropriate for its risk class.

b) The expected yield of a share of stock, K_e is equal to the capitalisation rate of a pure equity stream, plus a premium for financial risk equal to the difference between the pure equity capitalization rate and K_g times the ratio B/S. In other words, K_e increases in a manner to exactly offset the use of cheaper debt funds.

c) The cut-off rate for investment purposes is completely independent of the way in which an investment is financed. This proposition along with the first implies a complete separation of the investment and financing decisions of the firm.

Conclusion: The theory propounded by them is based on the prevalence of perfect market conditions which are rare to find. Corporate taxes and personal taxes are a reality and they exert appreciable influence over decision making whether to have debt or equity.

Alternative Questions:

1. **Discuss the Propositions made in Modigliani and Miller approach in Capital Structure theory.**

A. Same as above.

5. OVER & UNDER - CAPITALISATION

Q.No.9. What is Over Capitalisation? State its causes and consequences.(PM) (N 13-4M)

Overcapitalization and its Causes and Consequences:

It is a situation where a firm has more capital than it needs or in other words assets are worth less than its issued share capital, and earnings are insufficient to pay dividend and interest.

Causes of Over Capitalization: Over-capitalisation arises due to following reasons

a) Raising more money through issue of shares or debentures than company can employ profitably.

b) Borrowing huge amount at higher rate than rate at which company can earn.

c) Excessive payment for the acquisition of fictitious assets such as goodwill etc.

d) Improper provision for depreciation, replacement of assets and distribution of dividends at a higher rate.

e) Wrong estimation of earnings and capitalization.

Consequences of Over-Capitalisation: Over-capitalisation results in the following consequences:

a) Considerable reduction in the rate of dividend and interest payments.
b) Reduction in the market price of shares.
c) Resorting to "window dressing".
d) Some companies may opt for reorganization. However, sometimes the matter gets worse and the company may go into liquidation.

Q.NO.10. What is Under capitalisation? State its causes and consequences. (SM)

Under Capitalisation: It is just reverse of over-capitalisation. It is a state, when its actual capitalisation is lower than its proper capitalisation as warranted by its earning capacity. This situation normally happens with companies which have insufficient capital but large secret reserves in the form of considerable appreciation in the values of the fixed assets not brought into the books.

Consequences of Under-Capitalisation: Under-capitalisation results in the following consequences

a) The dividend rate will be higher in comparison to similarly situated companies.
b) Market value of shares will be higher than value of shares of other similar companies because their earning rate being considerably more than the prevailing rate on such securities.
c) Real value of shares will be higher than their book value.

Effects of Under-Capitalisation: Under-capitalisation has the following effects

a) It encourages acute competition. High profitability encourages new entrepreneurs to come into same type of business.
b) High rate of dividend encourages the workers' union to demand high wages.
c) Normally common people (consumers) start feeling that they are being exploited.
d) Management may resort to manipulation of share values.
e) Invite more government control and regulation on the company and higher taxation also.

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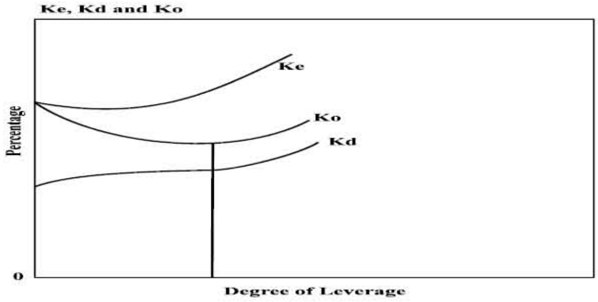
Q.No.11. What is Traditional theory of Capital Structure? (SM)

Traditional Approach:

a) This approach favors that as a result of financial leverage up to some point, cost of capital comes down and value of firm increases. However, beyond that point, reverse trends emerge.
b) The principle implication of this approach is that the cost of capital is dependent on the capital structure and there is an optimal capital structure which minimises cost of capital.
c) At the optimal capital structure, the real marginal cost of debt and equity is the same. Before the optimal point, the real marginal cost of debt is less than real marginal cost of equity and beyond this optimal point the real marginal cost of debt is more than real marginal cost of equity.

Graphical Presentation of the effect of change in leverage on K_e, K_d & WACC under Traditional approach

The above diagram suggests that cost of capital is a function of leverage. It declines with K_d (debt) and starts rising. This means that there is a range of capital structure in which cost of capital is minimised.



Conclusion:

Optimum capital structure occurs at the point where value of the firm is highest and the cost of capital is the lowest.

According to Net Operating Income approach, capital structure decisions are totally irrelevant. Modigliani-Miller supports the net operating income approach but provides behavioral justification. The traditional approach strikes a balance between these extremes.

TWO MARKS QUESTIONS

1. **Optimum Capital Structure:** **(PM) (N 07-2M, N 08-2M)**

   a) Optimum capital structure deals with the issue of right mix of debt and equity in the long-term capital structure of a firm.
   b) According to this, if a company takes on debt, the value of the firm increases upto a certain point. Beyond that value of the firm will start to decrease.
   c) If the company is unable to pay the debt within the specified period then it will affect the goodwill of the company in the market.

   Therefore, company should select its appropriate capital structure with due consideration of all factors.

Q.No.2. How does Capital Structure differ from Financial Structure? (PM) (M 10-2M)

Capital Structure:

a) Capital Structure refers to the combination of debt and equity which a company uses to finance its long-term operations.
b) It is the permanent financing of the company representing long-term sources of capital i.e. owner's equity and long-term debts but excludes current liabilities.

Financial Structure:

a) It is the entire left-hand side of the balance sheet which represents all the long-term and short-term sources of capital.
b) Thus, capital structure is only a part of financial structure.

Q.No.3. Discuss the relationship between the financial leverage and firm's required rate of return to equity shareholders as per Modigliani and Miller Proposition II. (PM)

Modigliani and Miller argue that the Cost of Equity (K_e) is equal to the Capitalisation Rate of pure equity stream plus a premium for financial risk. The financial risk increases with more debt content in the Capital Structure. As a result, K_e increases in a manner to offset exactly the use of less expensive sources of debt funds. Hence, overall Cost of Capital is constant.

Relationship between the financial leverage and firm's required rate of return to equity shareholders with corporate taxes is given by the following relation

$$r_E = r_0 + \frac{D}{E}(1 - T_C)(r_O - r_B)$$

Where,

r_E = required rate of return to equity shareholders,

r_0 = required rate of return for an all equity firm,

D = Debt amount in capital structure,

E = Equity amount in capital structure,

T_C = Corporate tax rate,

r_B = required rate of return to lenders.

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THE END

6. LEVERAGE (BUSINESS RISK AND FINANCIAL RISK)

Q.NO	ABC Analysis	M-06	N-06	M-07	N-07	M-08	N-08	M-09	N-09	M-10	N-10	M-11	N-11	M-12	N-12	M-13	N-13	M-14	N-14	M-15	N-15	M-16	N-16
1	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
2	A	-	-	3	-	-	-	-	2	-	-	-	-	-	4	-	-	-	4	-	-	2	-
3	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	4	-	-	-	-	-	-	-
4	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
5	C	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-

Q.No.1. Explain the Meaning and types of Leverages? (SM)

Meaning of Leverage:

a) Leverage refers to the ability of a firm in employing long term funds having a fixed cost, to enhance returns to the owners.

b) In other words, leverage is the amount of debt that a firm uses to finance its assets. A firm with a lot of debt in its capital structure is said to be highly levered. A firm with no debt is said to be unlevered.

c) In financial analysis it represents the influence of one financial variable over some other related financial variable. These financial variables may be costs, output, sales revenue, Earnings before Interest and Tax (EBIT), Earning per share (EPS) etc.

Types of Leverages:

a) **Operating Leverage:**

i) It exists when a firm has a fixed cost that must be defrayed regardless of volume of business.

ii) It is the firm's ability to use fixed operating costs to magnify the effects of changes in sales on its earnings before interest and taxes.

iii) Degree of operating leverage (DOL) is equal to the percentage increase in the net operating income to the percentage increase in the output.

$$\text{Degree of Operating Leverage} = \frac{\text{Contribution}}{\text{EBIT}}$$

b) **Financial Leverage:**

i) It involves the use fixed cost of financing and refers to mix of debt and equity in the capitalisation of a firm.

ii) Degree of financial leverage (DFL) is the ratio of the percentage increase in earnings per share (EPS) to the percentage increase in earnings before interest and taxes (EBIT).

$$\text{Degree of Financial Leverage} = \frac{\text{EBIT}}{\text{EBT}}$$

c) **Combined Leverage:**

i) It is the potential use of fixed costs, both operating and financial, which magnifies the effect of sales volume change on the earning per share of the firm.

ii) Degree of combined leverage (DCL) is the ratio of percentage change in earning per share to the percentage change in sales. It indicates the effect the sales changes will have on EPS.

iii) Degree of Combined Leverage = DOL× DFL

Q.No.2. Differentiate between Business risk and Financial risk. (M16-2M, M07-3M, N09-2M, N12-4M, N14-4M) (PM)

Business Risk:

a) It refers to the risk associated with the firm's operations.

b) It is an unavoidable risk because of the environment in which the firm has to operate and the business risk is represented by the variability of Earnings before Interest and Tax (EBIT).

c) The variability in turn is influenced by revenues and expenses. Revenues and expenses are affected by demand of firm's products, variations in prices and proportion of fixed cost in total cost. If there is no fixed cost, there would be no operating risk.

Financial Risk:

a) It refers to the additional risk placed on firm's shareholders as a result of debt and preference shares used in the capital structure of the concern.

b) Companies that issue more debt instruments would have higher financial risk than companies financed mostly by equity.

c) It can be measured by ratios such as firm's financial leverage multiplier, total debt to assets ratio etc.

Q.No.3. "Operating risk is associated with Cost structure, whereas Financial risk is associated with Capital structure of a business concern." Critically examine this statement. (PM)(M13 - 4M)

Opinion: "Operating risk is associated with Cost structure, whereas Financial risk is associated with Capital structure of a business concern."

Justification:

a) Operating risk refers to the risk associated with the firm's operations. It is represented by the variability of Earnings before Interest and Tax (EBIT). The variability in turn is influenced by revenues and expenses, which are affected by demand of firm's products, variations in prices and proportion of fixed cost in total cost. If there is no fixed cost, there would be no operating risk.

b) Whereas financial risk refers to the additional risk placed on firm's shareholders as a result of debt and preference shares used in the capital structure of the concern. Companies that issue more debt instruments would have higher financial risk than companies financed mostly by equity.

Q.NO.4. "Financial Leverage is a Double edge Sword." Comment. (SM)(N15 - RTP)

Opinion: Financial Leverage is a 'Double edged Sword':

Justification:

a) On one hand when cost of 'fixed cost fund' is less than the return on investment financial leverage will help to increase return on equity and EPS. The firm will be more than the return it will affect return of equity and EPS unfavorably and as a result firm can be under financial distress. This is why financial leverage is known as "double edged sword".

b) **Effect on EPS and ROE:**

When, ROI > Interest – Favorable – Advantage.

When, ROI < Interest – Unfavorable – Disadvantage.

When, ROI = Interest – Neutral – Neither advantage nor disadvantage.

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Q.No.5. Discuss the impact of financial leverage on shareholders wealth by using Return-On-Assets (ROA) and Return-On-Equity (ROE) analytical framework?

The impact of financial leverage of ROE is positive, if cost of debt (after – tax) is less than ROA. But it is double edged sword.

1. ROA or ROCE = Profitability Ratio × Turnover Ratio

   So, ROA or ROCE = $\frac{\text{EBIT Less Tax}}{\text{Sales}} \times \frac{\text{Sales}}{\text{Capital Employed}}$

   (This is post-tax ROCE / ROA / ROI)

2. ROE (Return on Equity) = $\frac{\text{Earnings available for Equity Shareholders}}{\text{Equity Funds Employed}}$

3. ROE can also be computed as under

   a) ROE (when there is no tax) = ROA + $\frac{\text{Debt}}{\text{Equity}}$ [ROA –Interest]

   b) ROE (post-tax) = ROA (100%-Tax Rate) + $\frac{\text{Debt}}{\text{Equity}}$ [ROA – Interest (100%-Tax Rate)]

4. When ROA is high, the ROE is also higher and financial leverage is favourable. However, when the after tax cost of debt is higher than ROA or ROCE, financial leverage works in the reverse manner and consequently ROE will be affected.

5. Hence, Equity Shareholders stand to gain with use of debt-funds, only if ROA

   (i.e. ROCE or ROI) is higher than the after-tax cost of debt.

   Note: [Interest (100%-Tax Rate)] is the Cost of Debt denoted by k_d.

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THE END

7. MANAGEMENT OF WORKING CAPITAL

Q.NO	ABC Analysis	M-06	N-06	M-07	N-07	M-08	N-08	M-09	N-09	M-10	N-10	M-11	N-11	M-12	N-12	M-13	N-13	M-14	N-14	M-15	N-15	M-16	N-16
1	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
2	A	-	-	-	-	-	-	-	-	-	4	-	-	-	-	-	-	-	-	-	-	-	-
3	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
4	A	-	-	-	-	-	-	-	-	2	-	-	-	-	4	-	-	-	-	-	-	-	-
5	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
6	A	-	-	-	-	-	-	-	-	-	4	-	-	-	-	-	-	-	-	-	-	-	-
7	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
8	A	-	-	-	-	3	-	2	-	-	-	-	-	-	-	-	-	-	-	-	-	-	4
9	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
10	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	4	-	-
11	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
12	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
13	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	4	-	-	-	-	-
14	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	4	-	-	-	-
15	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	4	-
16	A	-	-	-	-	-	-	-	-	-	-	-	4	-	-	-	-	-	-	4	-	-	-
17	A	-	-	-	-	-	-	-	-	-	-	4	-	-	-	-	-	-	-	-	-	-	-
18	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	4	-	-	-	-	-	-	-
19	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	4	-	-	-	-	-	-
20	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
21	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
22	B	-	-	-	-	-	-	-	-	2	-	-	-	-	-	-	-	-	-	-	-	-	-
23	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
24	A	-	-	-	-	-	-	-	-	-	-	5	-	-	-	-	-	-	-	-	-	-	-
25	A	-	-	-	-	-	-	-	2	-	-	-	-	-	-	4	-	-	-	4	-	-	-
26	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
27	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
28	C	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
29	C	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
30	C	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
31	C	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-

1. MEANING, CONCEPTS AND POLICIES OF WORKING CAPITAL MANAGEMENT

Q.No.1. What is Working Capital Management? What are the aspects of Working Capital Management? (SM)

Working Capital Management:

a) Working Capital Management involves managing the balance between firm's short-term assets and its short-term liabilities.

b) The goal of working capital management is to ensure that the firm is able to continue its operations and that it has sufficient cash flow to satisfy both maturing short-term debt and upcoming operational expenses.

c) The interaction between current assets and current liabilities is, therefore, the main theme of the theory of working capital management.

Aspects of Working Capital Management:

a) **Time:** Working capital management requires much of the finance manager's time.

b) **Investment:** Working capital represents a large portion of the total investment in assets.

c) **Credibility:** Working capital management has great significance for all firms but it is very critical for small firms.

d) **Growth:** The need for working capital is directly related to the firm's growth.

Q.No.2. Discuss the liquidity vs. Profitability issue in Management of Working Capital. (PM) (N10 - 4M)

Liquidity versus Profitability Issue in Management of Working Capital:

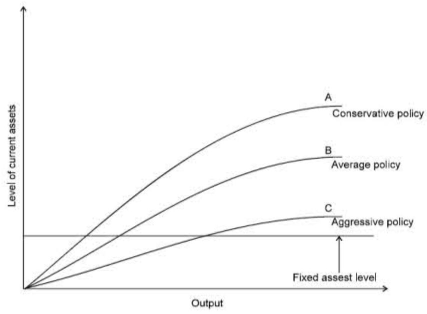
a) Working capital management entails the control and monitoring of all components of working capital i.e. cash, marketable securities, debtors, creditors etc.

b) Finance manager has to pay particular attention to the levels of current assets and their financing.

c) To decide the level of financing of current assets, the risk return trade off must be taken into account.

d) The level of current assets can be measured by creating a relationship between current assets and fixed assets.

e) A firm may follow a conservative, aggressive or moderate policy.



f) A conservative policy means lower return and risk while an aggressive policy produces higher return and risk. The two important aims of the working capital management are profitability and solvency. A liquid firm has less risk of insolvency i.e. it will hardly experience a cash shortage or a stock out situation. However, there is a cost associated with maintaining a sound liquidity position. So, to have a higher profitability the firm may have to sacrifice solvency and maintain a relatively low level of current assets.

Q.No.3. What are the methods of estimating Working Capital Needs? (PM)

Estimating Working Capital Needs: Operating cycle is one of the most reliable methods of Computation of Working Capital.

However, other methods like ratio of sales and ratio of fixed investment may also be used to determine the Working Capital requirements. These methods are briefly explained as follows:

a) **Current Assets Holding Period:** To estimate working capital needs based on the average holding period of current assets and relating them to costs based on the company's experience in the previous year. This method is essentially based on the Operating Cycle Concept.

b) **Ratio of Sales:** To estimate working capital needs as a ratio of sales on the assumption that current assets change with changes in sales.

c) **Ratio of Fixed Investments:** To estimate Working Capital requirements as a percentage of fixed investments.

A number of factors will, however, be impacting the choice of method of estimating Working Capital. Factors such as seasonal fluctuations, accurate sales forecast, investment cost and variability in sales price would generally be considered. The production cycle and credit and collection policies of the firm will have an impact on Working Capital requirements. Therefore, they should be given due weightage in projecting Working Capital requirements.

Alternative Questions:

1. Brief out various methods of estimating Working Capital Needs

A. Same as above.

Q.No.4. Enumerate the various forms of bank credit in financing the working capital of a business organization. (PM) (M 10 - 2M, N 12 - 4M, M15 - MTP2)

Forms of Bank Credit: Some of the forms of bank credit are

a) **Short Term Loans:** In a loan account, the entire advance is disbursed at one time either in cash or by transfer to the current account of the borrower. It is a single advance and given against securities like shares, government securities, life insurance policies and fixed deposit receipts, etc.

b) **Overdraft:** Under this facility, customers are allowed to withdraw in excess of credit balance standing in their Current Account. A fixed limit is therefore granted to the borrower within which the borrower is allowed to overdraw his account.

c) **Clean Overdrafts:** Request for clean advances are entertained only from parties which are financially sound and reputed for their integrity. The bank has to rely upon the personal security of the borrowers.

d) **Cash Credits:** Cash Credit is an arrangement under which a customer is allowed an advance up to certain limit against credit granted by bank. Interest is not charged on the full amount of the advance but on the amount actually availed of by him.

e) **Advances against goods:** Goods are charged to the bank either by way of pledge or by way of hypothecation. Goods include all forms of movables which are offered to the bank as security.

f) **Bills Purchased / Discounted:** These advances are allowed against the security of bills which may be clean or documentary. Usance bills maturing at a future date or sight are discounted by the banks for approved parties. The borrower is paid the present worth and the bank collects the full amount on maturity.

g) **Advance against documents of title to goods:** A document becomes a document of title to goods when its possession is recognised by law or business custom as possession of the goods like bill of lading, dock warehouse keeper's certificate, railway receipt, etc. An advance against the pledge of such documents is an advance against the pledge of goods themselves.

h) **Advance against supply of bills:** Advances against bills for supply of goods to government or semi-government departments against firm orders after acceptance of tender fall under this category. It is this debt that is assigned to the bank by endorsement of supply bills and executing irrevocable power of attorney in favour of the banks for receiving the amount of supply bills from the Government departments

(**Note:** Students may answer any four of the above forms of bank credit.)

Alternative Questions:

1. What are the forms of Bank Credit?

A. Same as above.

Q.No.5. Explain the importance of trade credit and accruals as source of working capital. What is the cost of these sources? (PM)

Trade credit and accruals:

a) Trade credit and accruals as source of working capital refers to credit facility given by suppliers of goods during the normal course of trade.

b) It is a short term source of finance. SSI firms in particular are heavily dependent on this source for financing their working capital needs.

c) The major advantages of trade credit are − easy availability, flexibility and informality.

d) It involves implicit cost. The supplier extending trade credit incurs cost in the form of opportunity cost of funds invested in trade receivables.

e) Generally, the supplier passes on these costs to the buyer by increasing the price of the goods or alternatively by not extending cash discount facility.

1.A. OPERATING CYCLE

Q.No.6. Discuss the estimation of Working Capital needs based on Operating Cycle process. (PM) (N10-4M)

Estimation of Working Capital need based on Operating Cycle: One of the methods for forecasting working capital requirement is based on the concept of operating cycle.

a) The determination of operating capital cycle helps in the forecast, control and management of working capital.

b) The length of operating cycle is the indicator of performance of management.

c) The net operating cycle represents the time interval for which the firm has to negotiate for Working Capital from its Bankers.

d) It enables to determine accurately the amount of working capital needed for the continuous operation of business activities.

e) The duration of working capital cycle may vary depending on the nature of the business.

In the form of an equation, the operating cycle process can be expressed as follows:

Operating Cycle = R + W + F +D – C

Where,

R = Raw material storage period.

W = Work-in-progress holding period.

F = Finished goods storage period.

D = Debtors collection period.

C = Credit period availed.

Alternative Questions:

1. How could you estimate Working Capital needs based on Operating Cycle?

A. Same as above.

2. TREASURY AND CASH MANAGEMENT

Q.No.7. What is the meaning of Treasury Management? (SM)

1) **Treasury Management:**
   a) It is concerned about the efficient management of liquidity and financial risk in business.
   b) It is defined as 'the corporate handling of all financial matters, the generation of external and internal funds for business, the management of currencies and cash flows and the complex, strategies, policies and procedures of corporate finance.'
2) **The Treasury Management mainly deals with:**
   a) Working capital management, and
   b) Financial risk management (It includes forex and interest rate management).
3) **The key goals of Treasury Management are:**
   a) Maximize the return on the available cash,
   b) Minimize interest cost on borrowings,
   c) Mobilise as much cash as possible for corporate ventures (in case of need), and
   d) Effective dealing in forex, money and commodity markets to reduce risks arising because of fluctuating exchange rates, interest rates and prices which can affect the profitability of the organization.

Alternative Questions:

1. Write short note on Treasury Management?

A. Same as above.

Q.No.8. Define Treasury Management? What are the functions of Treasury Management? (SM) (N16 - 4M M09 - 2M,)

Treasury Management: It is defined as 'the corporate handling of all financial matters, the generation of external and internal funds for business, the management of currencies and cash flows and the complex, strategies, policies and procedures of corporate finance.'

Functions of Treasury Management:

a) **Cash Management:** The efficient collection and payment of cash both inside the organization and to third parties is the function of treasury department. Treasury normally manages surplus funds in an investment portfolio.
b) **Currency Management:** The treasury department manages the foreign currency risk exposure of the company. It advises on the currency to be used when invoicing overseas sales. It also manages any net exchange exposures in accordance with the company policy.
c) **Fund Management:** Treasury department is responsible for planning and sourcing the company's short, medium and long-term cash needs. It also participates in the decision on capital structure and forecasts future interest and foreign currency rates.
d) **Banking:** Since short-term finance can come in the form of bank loans or through the sale of commercial paper in the money market, therefore, treasury department carries out negotiations with bankers and acts as the initial point of contact with them.

e) **Corporate Finance:** Treasury department is involved with both acquisition and disinvestment activities within the group. In addition, it is often responsible for investor relations.

Alternative Questions:

1. **Write short note on functions of Treasury Management.**

A. Same as above.

2. **Explain briefly the functions of Treasury Management**

A. Same as above.

Q.No.9. What is Cash Management? What are the objectives of Cash Management? (SM)

Cash Management: It is an important function of the finance manager. It is concerned with the managing of:

a) Cash flows into and out of the firm,
b) Cash flows within the firm, and
c) Cash balances held by the firm at a point of time by financing deficit or investing surplus cash.

Objectives of Cash Management:

a) Provide adequate cash to each of its units,
b) No funds are blocked in idle cash, and
c) The surplus cash (if any) should be invested in order to maximize returns for the business.

A cash management scheme therefore, is a delicate balance between the twin objectives of liquidity and costs.

Q.No.10. What is Cash Budget? What are the various purposes of Cash Budgets? (SM)(N15 - 4M)

Cash Budget: It is the most significant device to plan for and control cash receipts and payments. This represents cash requirements of business during the budget period.

Purposes of Cash Budgets are:

a) It coordinate the timings of cash needs and identifies the period(s) when there might either be a shortage of cash or an abnormally large cash requirement,
b) It also helps to pinpoint period(s) when there is likely to be excess cash,
c) It enables firm which has sufficient cash to take advantage like cash discounts on its accounts payable,
d) It helps to plan/arrange adequately needed funds (avoiding excess/shortage of cash) on favorable terms.

On the basis of cash budget, the firm can decide to invest surplus cash in marketable securities and earn profits.

Alternative Questions:

1. **Evaluate the role of cash budget in effective cash management system.**

A. Same as above.

Q.No.11. What are the main components involved in preparation of Cash budget? (SM)

Main Components involves in Preparation of Cash budget:

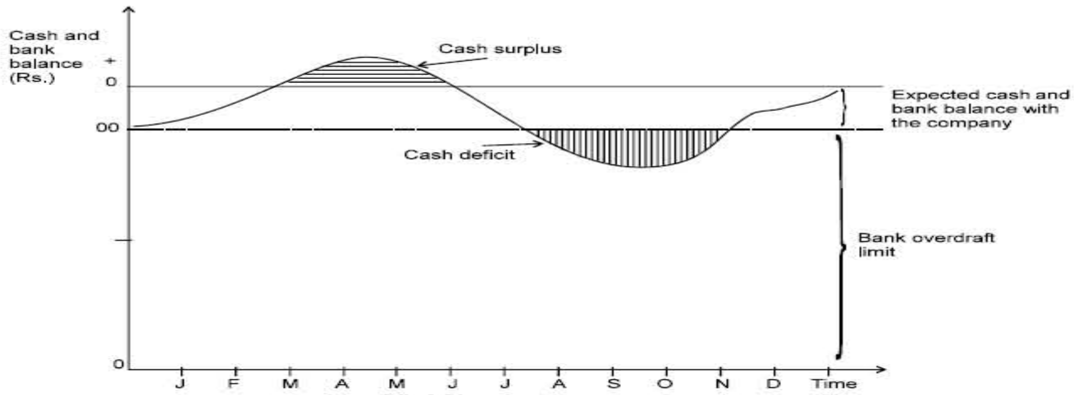
a) Selection of the period of time to be covered by the budget. It is also defining the planning horizon.

b) Selection of factors that have a bearing on cash flows. The factors that generate cash flows are generally divided into following two categories:

   i) Operating (cash flows generated by operations of the firm), and

   ii) Financial (cash flows generated by financial activities of the firm).

The following figure highlights the cash surplus and cash shortage position over the period of cash budget for preplanning to take corrective and necessary steps.



Q.No.12. What are the methods used for preparation of Cash Budgets? (SM)

a) **Receipts and Payments Method:** In this method all the expected receipts and payments for budget period are considered. This method is commonly used in business organizations.

b) **Adjusted Income Method:** In this method the annual cash flows are calculated by adjusting the sales revenues and cost figures for delays in receipts and payments (change in debtors and creditors) and eliminating non-cash items such as depreciation.

c) **Adjusted Balance Sheet Method:** In this method, the budgeted balance sheet is predicted by expressing each type of asset and short-term liabilities as percentage of the expected sales. The profit is also calculated as a percentage of sales, so that the increase in owner's equity can be forecasted. Known adjustments, may be made to longterm liabilities and the balance sheet will then show if additional finance is needed.

Alternative Questions:

1. **Name out various methods used for estimation of Cash Budget.**

A. Same as above.

3. MANAGING CASH COLECTIONS

Q.No.13. Explain the following 1. Concentration Banking 2. Lock Box System. (M14-4M) (SM)

1. **Concentration Banking:**
   a) In concentration banking the company establishes a number of strategic collection centers in different regions instead of a single collection centre at the head office.
   b) This system reduces the period between the time a customer mails in his remittances and the time when they become spendable funds with the company.
   c) Payments received by the different collection centers are deposited with their respective local banks which in turn transfer all surplus funds to the concentration bank of head office. The concentration bank with which the company has its major bank account is generally located at the headquarters.
   d) Concentration banking is one important and popular way of reducing the size of the float.
2. **Lock Box System:**
   a) A lock box arrangement usually is on regional basis which a company chooses according to its billing patterns.
   b) Under this arrangement, the company rents the local post-office box and authorizes its bank at each of the locations to pick up remittances in the boxes.
   c) Customers are billed with instructions to mail their remittances to the lock boxes.
   d) The bank picks up the mail several times a day and deposits the cheques in the company's account.
   e) The cheques may be micro-filmed for record purposes and cleared for collection. The company receives a deposit slip and lists all payments together with any other material in the envelope. This procedure frees the company from handling and depositing the cheques.

Alternative Questions:

1. **What are the various localised cash collection systems?**

A. Same as above.

Q.No.14. Write short note on Different kinds of float with reference to management of cash. (PM) (N14 - 4M)

Different Kinds of Float with Reference to Management of Cash: The term float is used to refer to the periods that affect cash as it moves through the different stages of the collection process. Four kinds of float can be identified.

a) **Billing Float:** An invoice is the formal document that a seller prepares and sends to the purchaser as the payment request for goods sold or services provided. The time between the sale and the mailing of the invoice is the billing float.

b) **Mail Float:** This is the time when a cheque is being processed by post office, messenger service or other means of delivery.

c) **Cheque processing float:** This is the time required for the seller to sort, record and deposit the cheque after it has been received by the company.

d) **Bank processing float:** This is the time from the deposit of the cheque to the crediting of funds in the seller's account.

Alternative Questions:

1. **What are the various types of float?**

A. Same as above.

4. CASH MANAGEMENT MODELS

Q.No.15. Explain Baumol's Model of Cash Management? (PM) (M 16 4M)

Baumol's Model of Cash Management:

a) William J. Baumol developed a model for optimum cash balance which is normally used in inventory management.

b) The optimum cash balance is the trade-off between cost of holding cash (opportunity cost of cash held) and the transaction cost (i.e. cost of converting marketable securities in to cash).

c) Optimum cash balance is reached at a point where the two opposing costs are equal and where the total cost is minimum.

The formula for determining optimum cash balance is:

$$C = \sqrt{\frac{2U \times P}{S}}$$

Where, C = Optimum cash balance

U = Annual (or monthly) cash disbursement

P = Fixed cost per transaction.

S = Opportunity cost of one rupee p.a. (or p.m.)

H = Opportunity cost one rupee per annum (Holding cost)

Assumptions of the model:

a) Cash needs of the firm are known with certainty.

b) The cash is used uniformly over a period of time and it is also known with certainty.

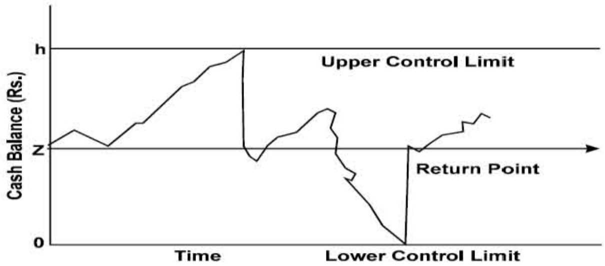
c) The holding cost is known and it is constant.

d) The transaction cost also remains constant.

Q.No.16. Discuss Miller-Orr Cash Management model. (PM) (N 05-3M, M11 - 4M, M15 - 4)

Miller – Orr Cash Management Model:

1. According to this model the net cash flow is completely stochastic. When changes in cash balance occur randomly, the application of control theory serves a useful purpose.
2. The Miller – Orr model is one of such control limit models. This model is designed to determine the time and size of transfers between an investment account and cash account.
3. In this model control limits are set for cash balances. These limits may consist of ‘h’ as upper limit, ‘z’ as the return point and zero as the lower limit.



MILLER-ORR CASH MANAGEMENT MODEL

4. When the cash balance reaches the upper limit, the transfer of cash equal to ‘h – z’ is invested in marketable securities account.
5. When it touches the lower limit, a transfer from marketable securities account to cash account is made.
6. During the period when cash balance stays between (h, z) and (z, 0) i.e. high and low limits, no transactions between cash and marketable securities account is made. The high and low limits of cash balance are set up on the basis of fixed cost associated with the securities transaction, the opportunities cost of holding cash and degree of likely fluctuations in cash balances.
7. These limits satisfy the demands for cash at the lowest possible total costs.

   The formula for calculation of the spread between the control limits is:

$$\text{Spread} = 3\left(\frac{3/4 \text{ x Transaction Cost x Variance of outflows}}{\text{Interest rate}}\right)^{1/3}$$

And, the return point can be calculated using the formula:

$$\text{Return point} = \text{Lower limit} + \frac{\text{Spread}}{3}$$

Q.No.17. Write short note on William J. Baumal vs. Miller-Orr Cash Management Model. (PM) (M11 - 4M)

William J. Baumal vs. Miller- Orr Cash Management Model:

Particulars	Baumol’s model	Miller Orr model
a) Developed	William J. Baumol developed in 1952	Merton Miller & Daniel Orr model developed in 1966
b) Application	It helps to determining the optimum cash balance when the demand for cash is certain. It is also called Inventory model	It helps to determining the optimum cash balance when the demand for cash is uncertain. It is also called Stochastic model.
c) Optimum Cash Balance	According to this model optimum cash level is that level of cash	This model is designed to determine the time and size of transfers

	where the carrying costs and transactions costs are the minimum. The carrying costs refer to the cost of holding cash, namely, the interest foregone on marketable securities. The transaction cost refers to the cost involved in getting the marketable securities converted into cash. This happens when the firm falls short of cash and has to sell the securities resulting in clerical, brokerage, registration and other costs.	between an investment account and cash account. In this model control limits are set for cash balances. These limits may consist of 1. H as upper limit 2. z as the return point 3. zero as the lower limit
d) Mathematical equations	The formula for determining optimum cash balance is: $C = \sqrt{\frac{2U \times P}{S}}$, Where, C = Optimum cash balance U= Annual (monthly) cash disbursements P = Fixed cost per transaction S = Opportunity cost of one rupee p.a. (or p.m)	1. $Z = \sqrt[3]{\frac{3TV}{4i}}$ 2. Upper limit = 3Z + L 3. Return level R= L+Z 4. Spread = H-L 5. Average Cash Balance = $\frac{4R - L}{3}$
e) Assumption	Cash needs of the firm are known with certainty	Cash needs of the firm are not known with certainty

4. RECENT DEVELOPMENTS IN CASH MANAGEMENT

Q.No.18. State the advantage of Electronic Cash Management System. (PM) (M 13-4M)

Electronic Cash Management System:

a) Most of the cash management systems now-a-days are electronically based, since 'speed' is the essence of any cash management system. Electronically, transfer of data as well as funds play a key role in any cash management system.

b) Various elements in the process of cash management are linked through a satellite.

c) Various places that are interlinked may be the place where the instrument is collected, the place where cash is to be transferred in company's account, the place where the payment is to be transferred etc.

d) This system may also provide a limited access to third parties like parties having very regular dealings of receipts and payments with the company etc.

Advantages of Electronic Cash Management System:

a) Significant saving in time.

b) Decrease in interest costs.

c) Less paper work.

d) Greater accounting accuracy.

e) More control over time and funds.

f) Supports electronic payments.

g) Faster transfer of funds from one location to another, where required.

h) Speedy conversion of various instruments into cash.

i) Making available funds wherever required, whenever required.

j) Reduction in the amount of 'idle float' to the maximum possible extent.

k) Ensures no idle funds are placed at any place in the organization.

l) It makes inter-bank balancing of funds much easier.

m) It is a true form of centralised 'Cash Management'.

n) Produces faster electronic reconciliation.

o) Allows for detection of book-keeping errors.

p) Reduces the number of cheques issued.

q) Earns interest income or reduce interest expense.

Alternative Questions:

1. Explain importance of Electronic Cash Management System?

A. Same as above.

Q.No.19. What is Virtual Banking? State its advantages. (PM) (N 13 - 4M, N15 - MTP2)

Virtual banking:

a) Virtual banking refers to the provision of banking and related services through the use of information technology without direct recourse to the bank by the customer.

b) It denotes the provision of banking and related services through extensive use of information technology without direct recourse to the bank by the customer.

c) The Reserve Bank of India has been taking a number of initiatives, which will facilitate the active involvement of commercial banks in the sophisticated cash management system which ensure faster and reliable mobility of funds in a country is to have an efficient payment system.

Developments in Virtual banking:

a) Introduction of computerized settlement of clearing transactions,

b) Use of Magnetic Ink Character Recognition (MICR) technology,

c) Provision of inter-city clearing facilities and high value clearing facilities,

d) Electronic Clearing Service Scheme (ECSS),

e) Electronic Funds Transfer (EFT) scheme,

f) Delivery vs. Payment (DVP) for Government securities transactions,

g) Setting up of Indian Financial Network (INFINET).

Introduction of Centralised Funds Management System (CFMS), Securities Services System (SSS), Real Time Gross Settlement System (RTGS) and Structured Financial Messaging System (SFMS) are the other top priority items on the agenda to transform the existing system into a state-of-the art payment infrastructure in India.

Advantages of Virtual banking:

a) Lower cost of handling a transaction.

b) The increased speed of response to customer requirements.

c) The lower cost of operating branch network along with reduced staff costs leads to cost efficiency.

d) Virtual banking allows the possibility of improved and a range of services being made available to the customer rapidly, accurately and at his convenience.

Alternative Questions:

1. **"Sophisticated cash management system can be achieved through Virtual banking." Discuss.**

A. Same as above.

4. MANAGEMENT OF RECIEVABLES

Q.No.20. What are the factors for determining the credit policy? (SM)

Factors for determining the credit policy:

a) The effect of credit on the volume of sales,

b) Credit terms,

c) Cash discount,

d) Policies and practices of the firm for selecting credit customers,

e) Paying practices and habits of the customers,

f) The firm's policy and practice of collection, and

g) The degree of operating efficiency in the billing, record keeping and adjustment function, other costs such as interest, collection costs and bad debts etc.,

The firm may follow a lenient or a stringent credit policy. The firm which follows a lenient credit policy sells on credit to customers on very liberal terms and standards. On the contrary a firm following a stringent credit policy sells on credit on a highly selective basis only to those customers who have proper credit worthiness and who are financially sound.

Q.No.21. What are the various Receivables Collection Practices? (SM)

Receivable Collection Practices:

a) The aim of debtors' collection should be to reduce, monitor and control the accounts receivable at the same time maintain customer goodwill.

b) The fundamental rule of sound receivable management should be to reduce the time lag between the sale and collection.

c) Any delays that lengthen this span causes receivables to unnecessary build up and increase the risk of bad debts.

d) This is equally true for the delays caused by billing and collection procedures as it is for delays caused by the customer.

The following are major receivable collection procedures and practices:

a) Issue of Invoice.

b) Open account or open-end credit.

c) Credit terms or time limits.

d) Periodic statements.

e) Use of payment incentives and penalties.

f) Record keeping and Continuous Audit.

g) Export Factoring: Factors provide comprehensive credit management, loss protection collection services and provision of working capital to the firms exporting internationally.

h) Business Process Outsourcing: This refers to a strategic business tool whereby an outside agency takes over the entire responsibility for managing a business process.

Q.No.22. Explain briefly the accounts receivable systems? (PM) (M 10-2M)

Accounts Receivable Systems:

a) Manual systems of recording the transactions and managing receivables are cumbersome and costly.

b) The automated receivable management systems automatically update all the accounting records affected by a transaction.

c) This system allows the application and tracking of receivables and collections to store important information for an unlimited number of customers and transactions, and accommodate efficient processing of customer payments and adjustments.

Q.No.23. Explain the 'Aging Schedule' in the context of monitoring of receivables. (PM)

Ageing Schedule: An important means to get an insight into collection pattern of debtors is the preparation of their 'Ageing Schedule'.

a) Receivables are classified according to their age from the date of invoicing

e.g. 0 – 30 days, 31 – 60 days, 61 – 90 days, 91 – 120 days and more.

b) The ageing schedule can be compared with earlier month's figures or the corresponding month of the earlier year.

c) This classification helps the firm in its collection efforts and enables management to have a close control over the quality of individual accounts.

d) The ageing schedule can be compared with other firms also.

Q.No.24. Write short note on Factoring? Enumerate the main advantages of factoring. (PM) (M 11-5M)

Factoring:

a) It is a new financial service that is presently being developed in India.

b) Factoring involves provision of specialised services relating to credit investigation, sales ledger management, purchase and collection of debts, credit protection as well as provision of finance against receivables and risk bearing.

c) In factoring, accounts receivables are generally sold to a financial institution (a subsidiary of commercial bank-called "Factor"), who charges commission and bears the credit risks associated with the accounts receivables purchased by it.

d) Its operation is very simple. Clients enter into an agreement with the "factor" working out a factoring arrangement according to his requirements.

e) The factor then takes the responsibility of monitoring, follow-up, collection and risk-taking and provision of advance.

f) The factor generally fixes up a limit customer-wise for the client (seller).

Advantages of Factoring:

a) The firm can convert accounts receivables into cash without bothering about repayment.

b) Factoring ensures a definite pattern of cash inflows.

c) It is an useful short-term funds requirement of business enterprises

d) Unlike an unsecured loan, compensating balances are not required in this case.

e) Another advantage consists of relieving the borrowing firm of substantially credit and collection costs and to a degree from a considerable part of cash management.

However, factoring as a means of financing is comparatively costly source of financing since its cost of financing is higher than the normal lending rates.

Alternative Questions:

1. "Factoring is a new financial service." Comment on it.

A. Same as above.

Q.No.25. Distinguish Factoring and Bill Discounting? (N09 - 2M, M13 - 4M, M15 - 4M, M15 - MPT2)

a) Factoring is called as "Invoice Factoring' whereas Bills discounting is known as 'Invoice discounting'.

b) In factoring, the parties are known as the Client, Factor and Debtor whereas in bills discounting, they are known as Drawer, Drawee and Payee.

c) Factoring is a sort of management of book debts whereas bills discounting is a sort of borrowing from commercial banks.

d) For factoring there is no specific Act, whereas in case of bills discounting, the Negotiable Instruments Act is applicable.

Q.No.26. Factoring Vs. Debt securitization.

Factoring:

a) It is a new financial service that is presently being developed in India.

b) It is a fee based service for managing receivables. In factoring, accounts receivables are generally sold to a financial institution (a subsidiary of commercial bank called 'Factor') that charges commission and bears the credit risk associated with account receivables purchased by it.

c) It also involves provision of specialized services relating to credit investigation, sales ledger management, purchase and collection of debts, Credit protection as well as provision of finance against receivables and risk bearing.

Debt securitization:

a) It is a method of recycling funds. It is especially beneficial to financial intermediaries to support lending volumes.

b) The process of securitization is generally without recourse i.e. the investor bears credit risk or risk default and the issuer is under an obligation to pay to investors only if Cash flows are received by him from the collateral. However, the issuer has a right to legal recourse in the event of default. The risk run by the investor can be further reduced through credit enhancement facilities like insurance, Letter of credit and guarantees.

c) For the investors, securitization opens up new investment avenues, though the investor bears the credit risk. The securities are tied up to definite assets.

Q.No.27. Suggest ways in which companies can exercise control over their levels of working capital (RTP M 15)

Companies can exercise control over the levels of their working capital by formulating and implementing policies concerning inventory, debtors, cash and creditors. Such policies will take account of the factors that influence these components of working capital, as follows:

a) **Debtors:** Credit period allowed by a company and its competitors, speed of invoicing and other aspects of administrative efficiency, the use of discounts for early settlement, debtor collection methods, the forecast volume of sales.

b) **Stock:** The length of the production process, the rate of turnover of raw materials, the turnover period of finished goods, delivery lead time, the budgeted and actual volumes of output and sales.

c) **Creditors:** The extent to which a company can delay payments to suppliers,the volume of purchases, and the availability of cash discounts for early payment.

d) **Cash:** Interest rates and available short-term investments, the availability of credit, the ease with which a company can access funds.

Q.No.28. Explain the Determinants of Working Capital? (SM)

The factors which need to be considered while planning for Working Capital requirement are:

a) **Cash:** Identify the cash balance which allows for the business to meet day-to-day expenses, but reduces cash holding costs.

b) **Inventory:** Identify the level of inventory which allows for uninterrupted production but reduces the investment in raw materials and hence increases cash flow, the techniques like Just in Time (JIT) and Economic order quantity (EOQ) are used for this.

c) **Debtors:** Identify the appropriate credit policy, i.e. credit terms which will attract customers, such that any impact on cash flows and the cash conversion cycle will be offset by increased revenue and hence Return on Capital (or vice versa). The tools like Discounts and allowances are used for this.

d) **Short-term Financing Options:** Inventory is ideally financed by credit granted by the supplier, dependent on the cash conversion cycle, it may however, be necessary to utilize a bank loan (or overdraft), or to "convert debtors to cash" through "factoring" in order to finance working capital requirements.

e) **Nature of Business:** For e.g. in a business of restaurant, most of the sales are in Cash. Therefore need for working capital is very less.

f) **Market and Demand Conditions:** For e.g. if an item's demand far exceeds its production, the working capital requirement would be less as investment in finished good inventory would be very less.

g) **Technology and Manufacturing Policies:** For e.g. in some businesses the demand for goods is seasonal, in that case a business may follow a policy for steady production through out over the whole year or instead may choose policy of production only during the demand season.

h) **Operating Efficiency:** A company can reduce the working capital requirement by eliminating waste, improving coordination etc.

i) **Price Level Changes:** For e.g. rising prices necessitate the use of more funds for maintaining an existing level of activity. For the same level of current assets, higher cash outlays are required. Therefore the effect of rising prices is that a higher amount of working capital is required.

Q.No.29. Write short note on Working Capital Finance from Banks. (SM)

Working Capital Finance from Banks: Banks in India today constitute the major suppliers of working capital credit to any business activity. Recently, some term lending financial institutions have also announced schemes for working capital financing. The two committees viz., Tandon Committee and Chore Committee have evolved definite guidelines and parameters in working capital financing, which have laid the foundations for development and innovation in the area.

Instructions of RBI on assessment of Working Capital finance by Banks:

a) Reserve Bank of India has withdrawn the prescription, in regard to assessment of working capital needs, based on the concept of Maximum Permissible Bank Finance, in April 1997. Banks are now free to evolve, with the approval of their Boards, methods for assessing the working capital requirements of borrowers, within the prudential guidelines and exposure norms prescribed. Banks, however, have to take into account Reserve Bank's instructions relating to directed credit (such as priority sector, export, etc.), and prohibition of credit (such as bridge finance, rediscounting of bills earlier discounted by NBFC's) while formulating their lending policies.

b) With the above liberalizations, all the instructions relating to MPBF issued by RBI from time to time stand withdrawn. Further, various instructions/guidelines issued to banks with objective of ensuring lending discipline in appraisal, sanction, monitoring and utilization of bank finance cease to be mandatory. However, banks have the option of incorporating such of the instructions/guidelines as are considered necessary in their lending policies/procedures.

Q.No.30. Write a short note on Management of Marketable Securities? (SM)

Management of marketable securities:

It is an integral part of investment of cash as this may serve both the purposes of liquidity and cash, provided choice of investment is made correctly.

As the working capital needs are fluctuating, it is possible to park excess funds in some short term securities, which can be liquidated when need for cash is felt.

Principles relating to selection of Marketable securities:

a) **Safety:** Return and risks go hand in hand. As the objective in this investment is ensuring liquidity, minimum risk is the criterion of selection.

b) **Maturity:** Matching of maturity and forecasted cash needs is essential. Prices of long term securities fluctuate more with changes in interest rates and are therefore, more risky.

c) **Marketability:** It refers to the convenience, speed and cost at which a security can be converted into cash. If the security can be sold quickly without loss of time and price it is highly liquid or marketable.

The choice of marketable securities is mainly limited to Government treasury bills, Deposits with banks and Inter-corporate deposits. Units of Unit Trust of India and commercial papers of corporates are other attractive means of parking surplus funds for companies along with deposits with sister concerns or associate companies. Money Market Mutual Funds (MMMFs) have also emerged as one of the avenues of short-term investment.

Q.No.31. Brief out Cost and Benefits of Trade Credit?

<u>**Cost and Benefits of Trade Credit:**</u>

1. **Cost of Availing Trade Credit:** Normally it is considered that the trade credit does not carry any cost. However, it carries the following costs:
   a) **Price:** There is often a discount on the price that the firm undergoes when it uses trade credit, since it can take advantage of the discount only if it pays immediately. This discount can translate into a high implicit cost.
   b) **Loss of goodwill:** If the credit is overstepped, suppliers may discriminate against delinquent customers if supplies become short. As with the effect of any loss of goodwill, it depends very much on the relative market strengths of the parties involved.
   c) **Cost of managing:** Management of creditors involves administrative and accounting costs that would otherwise be incurred.
   d) **Conditions:** Sometimes most of the suppliers insist that for availing the credit facility the order should be of some minimum size or even on regular basis.
2. **Cost of Not Taking Trade Credit:** On the other hand the costs of not availing credit facilities are as under:
   a) **Impact of Inflation:** If inflation persists then the borrowers are favoured over the lenders with the levels of interest rates not seeming totally to redress the balance.
   b) **Interest:** Trade credit is a type of interest free loan, therefore failure to avail this facility has an interest cost. This cost is further increased if interest rates are higher.
   c) **Inconvenience:** Sometimes it may also cause inconvenience to the supplier if the supplier is geared to the deferred payment.

TWO MARKS QUESTIONS

1. **Optimum Working Capital:**
   a) The amount of the working capital shall be maintained at such level, which is adequate for business to run its business operations, neither excessive nor inadequate. This level of working capital is called as the “Optimum Working Capital”.
   b) It can be determined only with reference to the particular circumstances of a specific situation.

c) In nutshell, a firm should have adequate working capital to run its business operations. Both excessive as well as inadequate working capital positions are dangerous.

2. **Effect of Double Shift Working on Working Capital Requirements:**

a) It is obvious that in double shift working, an increase in stocks will be required as the production rises. However, it is quite possible that the increase may not be proportionate to the rise in production since the minimum level of stocks may not be very much higher. Thus, it is quite likely that the level of stocks may not be required to be doubled as the production goes up two-fold.

b) The amount of materials in process will not change due to double shift working since work started in the first shift will be completed in the second; hence, capital tied up in materials in process will be the same as with single shift working. As such the cost of work-in-process will not change unless the second shift's workers are paid at a higher rate.

3. **The Need for Cash:**

a) **Transaction need:** Cash facilitates the meeting of the day-to-day expenses and other debt payments. Normally, inflows of cash from operations should be sufficient for this purpose. But sometimes this inflow may be temporarily blocked. In such cases, it is only the reserve cash balance that can enable the firm to make its payments in time.

b) **Speculative needs:** Cash may be held in order to take advantage of profitable opportunities that may present themselves and which may be lost for want of ready cash/settlement.

c) **Precautionary needs:** Cash may be held to act as for providing safety against unexpected events. Safety as is explained by the saying that a man has only three friends an old wife, an old dog and money at bank.

4. **Cash Planning:**

a) Cash Planning is a technique to plan and control the use of cash. This protects the financial conditions of the firm by developing a projected cash statement from a forecast of expected cash inflows and outflows for a given period. This may be done periodically either on daily, weekly or monthly basis.

b) The period and frequency of cash planning generally depends upon the size of the firm and philosophy of management.

5. **Inventory Management:** Inventory management covers a large number of problems including fixation of minimum and maximum levels, determining the size of inventory to be carried, deciding about the issues, receipts and inspection procedures, determining the economic order quantity, proper storage facilities, keeping check over obsolescence and ensuring control over movement of inventories.

6. **Three Principles Relating to Selection of Marketable Securities: (PM)**

a) **Safety:** Return and risk go hand-in-hand. As the objective in this investment is ensuring liquidity, minimum risk is the criterion of selection.

b) **Maturity:** Matching of maturity and forecasted cash needs is essential. Prices of longterm securities fluctuate more with changes in interest rates and are, therefore, riskier.

c) **Marketability:** It refers to the convenience, speed and cost at which a security can be converted into cash. If the security can be sold quickly without loss of time and price, it is highly liquid or marketable.

7. **Electronic Fund Transfer:** With the developments which took place in the Information technology, the present banking system is switching over to the computerisation of banks branches to offer efficient banking services and cash management services to their customers. The network will be linked to the different branches, banks. This will help the customers in the following ways:
   a) Instant updation of accounts.
   b) The quick transfer of funds.
   c) Instant information about foreign exchange rates.
8. **Zero Balance Account:** For efficient cash management some firms employ an extensive policy of substituting marketable securities for cash by the use of zero balance accounts. Every day the firm totals the cheques presented for payment against the account. The firm transfers the balance amount of cash in the account if any, for buying marketable securities. In case of shortage of cash the firm sells the marketable securities.
9. **Trading on Equity:** The term 'equity refers to the ownership or 'stock' of a company and 'trading' means 'taking advantage of'. Hence, the term trading on equity' means taking advantage of equity share capital to borrow funds in reasonable basis. If refers to the additional profits which equity shares make at the expense of there forms to securities. This concept is based on the theory that there is a difference among the rates of return on the various types of securities issued by the company. **(M08 - 2M)**

Q.No.9. Is it worth offering discounts to debtors to encourage prompt payment? (RTP M 15)

a) Proposed changes to credit policy should be evaluated in the light of the additional costs and benefits that will result from their being undertaken.
b) For example, the cost of the introduction of cash discounts can be compared with the benefits of faster settlement of accounts in terms of reduced interest charges, and possibly also the additional business that may result. The change should only be undertaken if the marginal benefits arising from the new policy exceed its marginal costs.

Q.No.10. 'Management of marketable securities is an integral part of investment of cash.' Comment. (PM) (N 13 - 4M)

Opinion: "Management of Marketable Securities is an Integral Part of Investment of Cash."

Justification:

a) Management of marketable securities is an integral part of investment of cash as it serves both the purposes of liquidity and cash, provided choice of investment is made correctly.
b) As the working capital needs are fluctuating, it is possible to invest excess funds in some short term securities, which can be liquidated when need for cash is felt.
c) The selection of securities should be guided by three principles namely safety, maturity and marketability.

Verified By: T. Bala Subramanyam Sir
Venkanna Sir

Executed By: Dhanalakshmi

THE END

8. FINANCIAL ANALYSIS & PLANNING

TOPIC WISE ANALYSIS OF PAST EXAM PAPERS OF IPCC

No.	ABC	M-09	N-09	M-10	N-10	M-11	N-11	M-12	N-12	M-13	N-13	M-14	N-14	M-15	N-15	M-16	N-16
1.	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
2.	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
3.	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
4.	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
5.	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
6.	A	2	-	-	-	-	-	-	-	-	-	4	-	-	-	-	-
7.	C	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
8.	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
9.	C	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
10.	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
11.	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
12.	A	-	-	-	-	4	-	-	-	-	-	-	-	-	-	-	-
13.	A	-	2	-	-	-	-	-	-	-	-	-	-	-	-	-	-
14.	B	-	-	-	-	-	-	4	-	-	-	-	-	-	-	-	-
15.	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
16.	C	3	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
17.	C	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-

DEFINITION AND IMPORTANCE

Q.No.1. WHAT DO YOU MEAN BY RATIO ANALYSIS.DISCUSS ITS SIGNIFICANCE? (PM)

<u>MEANING:</u> Ratio Analysis is comparison of different numbers from the Balance Sheet, income statement, and cash flow statement against the figures of previous years, other companies, the industry, or even the economy in general for the purpose of financial analysis.

<u>TYPES OF RATIOS:</u>

a) **Liquidity Ratios:** Liquidity or short term solvency means ability of the business to pay its short - term liabilities.

b) **Capital Structure / Leverage Ratios:** These ratios provide an insight into the financing techniques used by a business and focus, as a consequence, on the long term solvency position.

c) **Coverage Ratios:** The coverage ratios measure the firm's ability to service the fixed liabilities.

d) **Activity Ratios:** These ratios are employed to evaluate the efficiency with which the firm manages and utilize its assets.

e) **Profitability ratios:** The Profitability ratios measure the profitability or the operational efficiency of the firm. These ratios reflect the final results of business operations.

IMPORTANCE OF RATIO ANALYSIS: The Importance of ratio analysis lies in the fact that it presents facts on a comparative basis and enables drawing of inferences regarding the performance of a firm. It is relevant in assessing the performance of a firm in respect of the following aspects.

- Liquidity Position
- Long term solvency
- Operating Efficiency
- Overall Profitability
- Inter-Firm Comparison
- Financial ratios for Supporting Budgeting.

LIQUIDITY RATIOS

Q. No.2. DISCUSS LIQUIDITY RATIOS. (SM)

LIQUIDITY RATIOS:

1. The term 'Liquidity' and 'Short term' solvency are used synonymously.
2. Liquidity or Short term solvency means ability of the business to pay its short term liabilities. Inability to pay off short term liabilities affects its credibility as well as credit rating.
3. Continuous default on the part of the business leads to commercial bankruptcy.
4. Eventually such commercial bankruptcy may lead to its sickness and dissolution.
5. Short term lenders and creditors of a business are very much interested to know its state of liquidity because of their financial stake.
6. Both lack of sufficient liquidity and excess liquidity is bad for the organization.

VARIOUS LIQUIDITY RATIOS ARE:

RATIO	FORMULAE	COMMENTS
Current Ratio	$\frac{\text{Current Assets}}{\text{Current Liabilities}}$	A simple measure that estimates whether the business can pay short term debts. Ideal Ratio is 2:1
Quick Ratio	$\frac{\text{Quick Assets}}{\text{Current Liabilities}}$	It measures the ability to meet current debt immediately. Ideal Ratio is 1:1
Cash Ratio	$\frac{\text{Cash \& Bank Balances} + \text{Marketable securities}}{\text{Current Liabilities}}$	It measures absolute liquidity of the business.
Basic Defense Interval Ratio	$\frac{\text{Cash \& Bank Balances} + \text{Marketable securities}}{\text{operating expenses / No of days}}$	It measures the ability of the business to meet regular cash expenditures.
Net Working Capital Ratio	Current Assets – Current Liabilities	It is a measure of cash flow to determine the ability of business to survive financial crisis.

Q. No.3 WHAT IS QUICK RATIO? WHAT DOES IT SIGNIFY? (PM) (N 08- 2M)

It is a much more exacting measure than the current ratio. It adjusts the current ratio to eliminate all assets that are not already in cash (or near cash form). A ratio less than one indicates low liquidity and hence is a danger sign.

$$\text{Quick Ratio} = \frac{\text{Quick Assets}}{\text{Current Liabilities}}$$ Where, Quick Assets = Current Assets – Inventory

LEVERAGE RATIOS

Q. No.4. DISCUSS CAPITAL STRUCTURE RATIOS. (SM)

1. These ratios provide an insight into the financing techniques used by a business and focus, as a consequence, on the long-term solvency position.
2. From the balance sheet one can get only the absolute fund employed and its sources, but only Capital structure ratios show the relative weight of different sources.

VARIOUS CAPITAL STRUCTURE RATIOS ARE:

RATIO	FORMULAE	COMMENTS
Equity Ratio	$\frac{\text{Share holders Equity}}{\text{Capital employed}}$	It indicates owner's fund in companies to total fund invested.
Debt Ratio	$\frac{\text{Total Outside liabilities}}{\text{Total debt} + \text{Networth}}$	It is an indicator of use of outside funds.
Debt to Equity Ratio	$\frac{\text{Total Outside liabilities}}{\text{Share Holders Equity}}$	It indicates the composition of capital structure in terms of debt and equity.
Debt to Total Assets ratio	$\frac{\text{Total Outside liabilities}}{\text{Total Assets}}$	It indicates how much of total assets are financed by debt.
Capital Gearing ratio	$\frac{\text{Borrowings (all long term debts including normal overdraft)}}{\text{Net Assets or Shareholders' Funds}}$	It shows the proportion of fixed interest bearing capital to equity shareholders' fund. It also signifies the advantage of financial leverage to the equity shareholder.
Proprietary Ratio	$\frac{\text{Proprietary Fund}}{\text{Total Assets}}$	It measures the proportion of total assets financed by shareholders.

Q. No.5. DISCUSS COVERAGE RATIOS. (SM)

1. The coverage ratios measure the firm's ability to service the fixed liabilities.
2. These ratios establish the relationship between fixed claims and what is normally available out of which these claims are to be paid.
3. The fixed claims consist of:

a) Interest on loans

b) Preference dividend

c) Amortization of principal or repayment of the instalment of loans or redemption of preference capital on maturity.

VARIOUS COVERAGE RATIOS ARE:

RATIO	FORMULAE	COMMENTS
Debt Service Coverage Ratio (DSCR)	$\frac{\text{Earnings available for debt service}}{\text{Interest} + \text{Instalments}}$	It measures the ability to meet the commitment of various debt services like interest, instalment etc. Ideal ratio is 2.
Interest Coverage Ratio	$\frac{\text{EBIT}}{\text{Interest}}$	It measures the ability of the business to meet interest. Ideal ratio is > 1.
Preference Dividend Coverage Ratio	$\frac{\text{Net Profit / Earnings After Tax}}{\text{Preference Dividend Liability}}$	It measures the ability to pay the preference Shareholders dividend. Ideal ratio is > 1
Fixed Charges Coverage Ratio	$\frac{\text{EBIT} + \text{Depreciation}}{\text{Interest} + \text{Repayment of Loan}/(1 - \text{Tax rate})}$	This ratio shows how many times the cash flow before interest and taxes covers all fixed financing charges. The ideal ratio is > 1.

Q.No.6. HOW IS DEBT SERVICE COVERAGE RATIO CALCULATED? WHAT IS ITS SIGNIFICANCE? (M14 - 4M) (M 07- 2M) (N 14 MTP II – 3M) (PM)

Lenders are interested in this ratio to judge the firm's ability to pay off current interest and installments.

CALCULATION OF DEBT SERVICE COVERAGE RATIO (DSCR): The debt service coverage ratio can be calculated as under:

$$\text{Debt Service Coverage ratio} = \frac{\text{Earnings available for debt service}}{\text{Interest} + \text{Installments}}$$

Earning available for debt service = Net profit + Non-cash operating expenses like depreciation & other amortizations + Non-operating adjustments like loss on sale of fixed assets + Interest on Debt Fund.

SIGNIFICANCE:

1. Debt service coverage ratio indicates the capacity of a firm to service a particular level of debt i.e. repayment of principal and interest.

2. High credit rating firms target DSCR to be greater than 2 in its entire loan life. High DSCR facilitates the firm to borrow at the most competitive rates.

ACTIVITY/EFFICIENCY RATIOS

Q. No.7. DISCUSS ACTIVITY RATIOS/EFFICIENCY/PERFORMANCE/TURNOVER RATIOS. (SM)

1. These ratios are employed to evaluate the efficiency with which the firm manages and utilizes its assets. For this reason, they are often called as "Asset Management Ratios".
2. These ratios usually indicate the frequency of sales with respect to its assets. These assets may be capital assets or working capital or average inventory.

VARIOUS ACTIVITY RATIOS ARE:

RATIO	FORMULAE	COMMENTS
Total Asset Turnover ratio	$\frac{\text{Sales / Cost of Goods sold}}{\text{Average Total Assets}}$	A measure of total asset utilisation. It helps to answer the question - What sales are being generated by each rupee's worth of assets invested in the business?
Fixed Assets Turnover Ratio	$\frac{\text{Sales / Cost of Goods sold}}{\text{Fixed Assets}}$	This ratio is about fixed asset capacity. A reducing sales or profit being generated from each rupee invested in fixed assets may indicate overcapacity or poorer-performing equipment.
Capital Turnover Ratio	$\frac{\text{Sales / Cost of Goods sold}}{\text{Net Assets}}$	This indicates the firm's ability to generate sales per rupee of long term Investment.
Working Capital Turnover Ratio	$\frac{\text{Sales / Cost of Goods sold}}{\text{Working Capital}}$	It measures the efficiency of the firm to use working capital.
Inventory Turnover Ratio	$\frac{\text{Sales / Cost of Goods sold}}{\text{Average Inventory}}$	It measures the efficiency of the firm to manage its inventory.
Debtors Turnover Ratio	$\frac{\text{Credit Sales}}{\text{Average Accounts Receivable}}$	It measures the efficiency at which firm is managing its receivables.
Receivables (Debtors) Velocity	$\frac{\text{Average Accounts Receivables}}{\text{Average Daily credit Sales}}$	It measures the velocity of collection of receivables.
Payables turnover Ratio	$\frac{\text{Annual Net Credit Purchases}}{\text{Average Accounts Payables}}$	It measures the velocity of payables payment.

Q. No.8 WHAT DO YOU MEAN BY STOCK TURNOVER RATIO AND GEARING RATIO? (PM) (N 08 - 3M)

STOCK TURNOVER RATIO

1. Stock Turnover Ratio helps to find out if there is too much inventory build-up.

2. An increasing stock turnover figure or one which is much larger than the "average" for an industry may indicate poor stock management. The formula for the Stock Turnover Ratio is as follows:

$$\text{Stock Turnover ratio} = \frac{\text{Cost of Sales}}{\text{Average inventory}} \text{ or } \frac{\text{Turnover}}{\text{Average inventory}}$$

GEARING RATIO

1. Gearing Ratio indicates how much of the business is funded by borrowing.
2. In theory, the higher the level of borrowing (gearing), the higher are the risks to a business, since the payment of interest and repayment of debts are not "optional" in the same way as dividends.
3. However, gearing can be a financially sound part of a business's capital structure particularly if the business has strong, predictable cash flows.

The formula for the Gearing Ratio is as follows:

$$\text{Gearing Ratio} = \frac{\text{Borrowings (all long term debts including normal overdraft)}}{\text{Net Assets or Shareholders' Funds}}$$

Q. No.9 DISCUSS ANY THREE RATIOS COMPUTED FOR INVESTMENT ANALYSIS. (PM)

Three ratios computed for investment analysis are as follows:

i) $\text{Earnings per share} = \frac{\text{Profit after tax}}{\text{Number of equity shares outstanding}}$

ii) $\text{Dividend yield ratio} = \frac{\text{Equity dividend per share} \times 100}{\text{Market price per share}}$

iii) $\text{Return on capital employed} = \frac{\text{Net Profit before interest and tax} \times 100}{\text{Capital employed}}$

Q.No.10 HOW RETURN ON CAPITAL EMPLOYED IS CALCULATED? WHAT IS ITS SIGNIFICANCE? (PM) (N 08- 2M)

1. It is another variation of ROI. It is the most important ratio of all.
2. It is the percentage of return on funds invested in the business by its owners.
3. In short, it indicates what returns management has made on the resources made available to them before making any distribution of those returns.

Return on Capital Employed = $\frac{\text{EBIT}}{\text{Capital Employed}} \times 100$ Where,

Capital Employed = Equity Share Capital
+ Reserve and Surplus
+ Pref. Share Capital
+ Debentures and other long term loan
– Misc. expenditure and losses
– Non-trade Investments.

Intangible assets (assets which have no physical existence like goodwill, patents and trademarks) should be included in the capital employed. But no fictitious asset should be included within capital employed.

Q.No.11. DISCUSS HOW FINANCIAL RATIOS HELP IN EVALUATING COMPANY PERFORMANCE ON OPERATING EFFICIENCY AND LIQUIDITY POSITION ASPECTS. (PM) (N 06 - 4M)

OPERATING EFFICIENCY:

1. Ratio analysis throws light on the degree of efficiency in the management and utilization of its assets. The various activity ratios (such as turnover ratios) measure this kind of operational efficiency.
2. These ratios are employed to evaluate the efficiency with which the firm manages and utilises its assets.
3. These ratios usually indicate the frequency of sales with respect to its assets.
4. These assets may be capital assets or working capital or average inventory. In fact, the solvency of a firm is, in the ultimate analysis, dependent upon the sales revenues generated by use of its assets – total as well as its components.

LIQUIDITY POSITION:

1. With the help of ratio analysis, one can draw conclusions regarding liquidity position of a firm.
2. The liquidity position of a firm would be satisfactory, if it is able to meet its current obligations when they become due.
3. Inability to pay-off short-term liabilities affects its credibility as well as its credit rating.
4. Continuous default on the part of the business leads to commercial bankruptcy.
5. Eventually such commercial bankruptcy may lead to its sickness and dissolution.
6. Liquidity ratios are current ratio, liquid ratio and cash to current liability ratio.
7. These ratios are particularly useful in credit analysis by banks and other suppliers of short-term loans.

Q. No.12 EXPLAIN THE FOLLOWING RATIOS: (M 11- 4M) (PM)

i) CONCEPT OF OPERATING RATIO:

$$\text{Operating ratio} = \frac{\text{Cost of goods sold} + \text{operating expenses}}{\text{Net sales}} \times 100$$

This is the test of the operational efficiency with which the business is being carried; the operating ratio should be low enough to leave a portion of sales to give a fair return to the investors.

ii) CONCEPT OF PRICE-EARNINGS RATIO:

$$\text{Price Earnings Ratio} = \frac{\text{Market price per equity share}}{\text{Earning per share}}$$

This ratio indicates the number of times the earnings per share is covered by its market price. It indicates the expectation of equity investors about the earnings of the firm.

LIMITATIONS OF FINANCIAL RA

Q. No.13 EXPLAIN BRIEFLY THE LIMITATIONS OF FINANCIAL RATIOS. (N 09-2M) (PM)

The limitations of financial ratios are listed below:

1) **Diversified product lines:** Many businesses operate a large number of divisions in quite different industries. In such cases, ratios calculated on the basis of aggregate data cannot be used for inter-firm comparisons.
2) **Financial data are badly distorted by inflation:** Historical cost values may be substantially different from true values. Such distortions of financial data are also carried in the financial ratios.
3) Seasonal factors may also influence financial data.
4) **To give a good shape to the popularly used financial ratios (like current ratio, debt-equity ratios, etc.):** The business may make some year-end adjustments. Such window dressing can change the character of financial ratios which would be different had there been no such change.
5) **Differences in accounting policies and accounting period:** It can make the accounting data of two firms non-comparable as also the accounting ratios.
6) **There is no standard set of ratios against which a firm's ratios can be compared:** Sometimes a firm's ratios are compared with the industry average. But if a firm desires to be above the average, then industry average becomes a low standard. On the other hand, for a below average firm, industry averages become too high a standard to achieve.

Q.No.14 EXPLAIN THE IMPORTANT RATIOS THAT WOULD BE USED IN EACH OF THE FOLLOWING SITUATIONS: (M 12 – 4M) (PM)

1) A bank is approached by a company for a loan of Rs. 50 lakhs for working capital purposes.
   a) **Liquidity Ratios-** Here Liquidity or short-term solvency ratios would be used by the bank to check the ability of the company to pay its short-term liabilities. A bank may use Current ratio and Quick ratio to judge short terms solvency of the firm.
2) A long term creditor interested in determining whether his claim is adequately secured.
   a) **Capital Structure/Leverage Ratios-** Here the long-term creditor would use the capital structure/leverage ratios to ensure the long term stability and structure of the firm. A long term creditors interested in the determining whether his claim is adequately secured may use Debt-service coverage and interest coverage ratio.
3) A shareholder who is examining his portfolio and who is to decide whether he should hold or sell his holding in the company.
   a) **Profitability Ratios-** The shareholder would use the profitability ratios to measure the profitability or the operational efficiency of the firm to see the final results of business operations. A shareholder may use return on equity, earning per share and dividend per share.

4) A finance manager interested to know the effectiveness with which a firm uses its available resources

a) **Activity Ratios-** The finance manager would use these ratios to evaluate the efficiency with which the firm manages and utilizes its assets. Some important ratios are (a) Capital turnover ratio (b) Current and fixed assets turnover ratio (c) Stock, Debtors and Creditors turnover ratio.

Q.No.15. RATIO ANALYSIS CAN BE USED TO STUDY LIQUIDITY, TURNOVER, PROFITABILITY, ETC. OF A FIRM. WHAT DOES DEBT-EQUITY RATIO HELP TO STUDY? (MTP MAY15 II - 4M)

Debt –Equity Ratio is an indicator of leverage of a firm. A high ratio means less protection for creditors while a low ratio indicates a wider safety cushion.

$$\text{Debt Equity Ratio} = \frac{\text{Total Liabilities}}{\text{Share holders equity}}$$

<u>**Note:**</u> Sometimes only interest bearing, long term debt is used instead of total liabilities.

1. A high ratio here means less protection for creditors. A low ratio, on the other hand, indicates a wider safety cushion (i.e. creditors feel the owners funds can help absorb possible losses of income and capital.)
2. This ratio indicates the proportion of debt fund in relation to equity.
3. This ratio is very often offered in capital structure decision as well as in the legislation dealing with the capital structure decisions (i.e. issue of shares and debentures).Lenders is also very keen to know this ratio since it shows relative weights of debt and equity.

FOR ACADEMIC INTEREST ONLY

Q. No.16 DISCUSS THE COMPOSITION OF RETURN ON EQUITY (ROE) USING THE DUPONT MODEL. (MAY 07, 09- 3M) (PM)

<u>**COMPOSITION OF RETURN ON EQUITY USING THE DUPONT MODEL:**</u>

1. There are three components in the calculation of return on equity using the traditional DuPont model- the net profit margin, asset turnover, and the equity multiplier.
2. By examining each input individually, the sources of a company's return on equity can be discovered and compared to its competitors.

a) **Net Profit Margin:** The net profit margin is simply the after-tax profit a company generates for each rupee of revenue.

Net profit margin = Net Income ÷ Revenue

Net profit margin is a safety cushion; the lower the margin, lesser the room for error.

b) **Asset Turnover:** The asset turnover ratio is a measure of how effectively a company converts its assets into sales. It is calculated as follows:

Asset Turnover = Revenue ÷ Assets

The asset turnover ratio tends to be inversely related to the net profit margin; i.e., the higher the net profit margin, the lower the asset turnover.

c) **Equity Multiplier:** It is possible for a company with terrible sales and margins to take on excessive debt and artificially increase its return on equity. The equity multiplier, a measure of financial leverage, allows the investor to see what portion of the return on equity is the result of debt. The equity multiplier is calculated as follows:

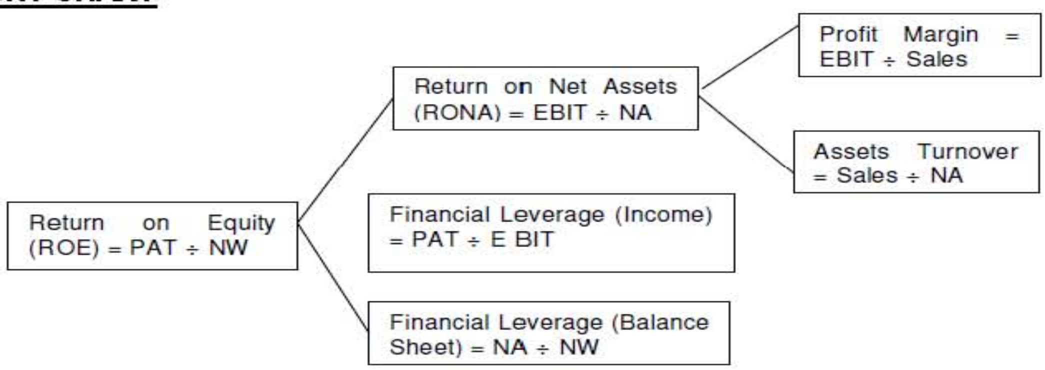
Equity Multiplier = Assets ÷ Shareholders' Equity.

CALCULATION OF RETURN ON EQUITY

To calculate the return on equity using the DuPont model, simply multiply the three components (net profit margin, asset turnover, and equity multiplier.)

Return on Equity = Net profit margin× Asset turnover × Equity multiplier

DU PONT CHART



Du Pont Chart

Q.No.17. DISCUSS HOW FINANCIAL RATIOS HELP IN EVALUATING COMPANY PERFORMANCE ON LONG TERM SOLVENCY AND OVERALL PROFITABILITY ASPECTS. (SM)

LONG-TERM SOLVENCY:

1. Ratio analysis is equally useful for assessing the long-term financial viability of a firm.
2. This aspect of the financial position of a borrower is of concern to the long term creditors, security analysts and the present and potential owners of a business.
3. The long term solvency is measured by the leverage/capital structure and profitability ratios which focus on earning power and operating efficiency.
4. The leverage ratios, for instance, will indicate whether a firm has a reasonable proportion of various sources of finance or whether heavily loaded with debt in which case its solvency is exposed to serious strain.
5. Similarly, the various profitability ratios would reveal whether or not the firm is able to offer adequate return to its owners consistent with the risk involved.

OVERALL PROFITABILITY:

1. Unlike the outside parties which are interested in one aspect of the financial position of a firm, the management is constantly concerned about the overall profitability of the enterprise.
2. That is, they are concerned about the ability of the firm to meet its short-term as well as long-term obligations to its creditors, to ensure a reasonable return to its owners and secure optimum utilization of the assets of the firm.
3. This is possible if an integrated view is taken and all the ratios are considered together.

THE END

9. CASH FLOW & FUNDS FLOW ANALYSIS

TOPIC WISE ANALYSIS OF PAST EXAM PAPERS OF IPCC

No.	ABC	M-09	N-09	M-10	N-10	M-11	N-11	M-12	N-12	M-13	N-13	M-14	N-14	M-15	N-15	M-16	N-16
1.	A	-	-	3	-	-	-	-	-	-	-	-	-	-	-	-	-
2.	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
3.	C	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
4.	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-

Q. No.1 DISTINGUISH BETWEEN CASH FLOW AND FUND FLOW STATEMENT. (PM)(M 10- 3M)

The points of distinction between cash flow and funds flow statement are as below:

No.	Basis	Cash Flow Statement	Fund Flow Statement
1	Object	It indicates change in cash position	It indicates changes in working capital
2	Scope	Its coverage is narrow confined only to cash	Its coverage is wide confined to working capital
3	Opening and closing balances	It is always prepared by opening cash balance and closing cash balances	Opening and closing cash balances are not required.
4	Adjustment	Due weightage is given to outstanding and prepared income and expenses	No adjustment is needed for outstanding and prepaid expenses
5	Preparation of schedule of change in working capital	No need to prepare schedule of changes in working capital.	It is necessary to prepare the schedule of change in working capital
6	Increase or decrease in working capital	Not shown	Always shown
7	Calculation	Cash generated from operation is calculated.	Fund generated from operation is calculated
8	Analysis	Essential for short term financial analysis.	Essential for long term financial analysis.

Q. No.2 “CASH FLOW STATEMENT IS USEFUL FOR SHORT-TERM PLANNING” COMMENT. (SM)

1. The cash flow statement is an important planning tool in the hands of management. A cash flow statement is useful for short-term planning.
2. A business enterprise needs sufficient cash to meet its various obligations in the near future such as payment for purchase of fixed assets, payment of debts maturing in the near future, expenses of the business, etc.

3. A historical analysis of the different sources and applications of cash will enable the management to make reliable cash flow projections for the immediate future.
4. It may then plan out for investment of surplus or meeting the deficit, if any.

ITS CHIEF ADVANTAGES AND UTILITY ARE AS FOLLOWS:

a) **Helps in Efficient Cash Management**:- It helps to determine how much cash will be available at a particular point of time to meet obligations like payment to trade creditors, repayment of cash loans, dividends, etc. This helps to provide information about the liquidity and solvency information of an enterprise.
b) **Helps in Internal Financial Management:-** A proper planning of the cash resources will enable the management to make available sufficient cash whenever needed and invest surplus cash, if any in productive and profitable opportunities.
c) **Discloses the Movements of Cash:-** It helps in understanding and analysis of what are the sources and application of the cash for a company. Also it discloses the volume as well as the speed at which the cash flows in the different segments of the business, there by helping to analyze the different segments of the business.
d) **Historical versus Future Estimates:-** Historical cash flow information is often used as an indicator of the amount, timing and certainty of future cash flows.
e) **Discloses the Success or Failure of Cash Planning:-** It helps in determining how efficiently the cash is being managed by the management of the business.
f) **Comparison Between Two Enterprises:-** Cash flow information is useful in assessing the ability of the enterprise to generate cash and cash equivalents and enables users to develop models to assess and compare the present value of the future cash flows of different enterprises. It enhances the comparability of the reporting of operating performance by different enterprises because it eliminates the effects of using different accounting treatments for the same transactions and events.
g) **Analysis of Profitability vis-à-vis Net Cash Flow:-** It is also useful in examining the relationship between profitability and net cash flow.

Q. No.3. WHAT ARE THE LIMITATIONS OF CASH FLOW ANALYSIS. (SM)

1. Cash flow statement cannot be equated with the Income Statement. An Income Statement takes into account both cash as well as non-cash items and, therefore, net cash flow does not necessarily mean net income of the business.
2. The cash balance as disclosed by the cash flow statement may not represent the real liquid position of the business since it can be easily influenced by postponing purchases and other payments.
3. Cash flow statement cannot replace the Funds Flow Statement. Each of them has a separate function to perform.

   In spite of these limitations it can be said that cash flow statement is a useful supplementary instrument.

   The technique of cash flow analysis, when used in conjunction with ratio analysis, serves as a barometer in measuring the profitability and financial position of the business.

Q.No.4 WHAT DO YOU MEAN BY FUNDS FLOW STATEMENT? WRITE ABOUT ITS SIGNIFICANCE OR USES.

A Statement of sources and application of funds us a technical device designed to analyze the changes in the financial condition of a business enterprise between two dates.

– Foulke

Funds Flow statement describes the sources from which additional funds were derived and the use to which these sources were put.

– Anthony.

SIGNIFICANCE OR USES OF FUNDS FLOW STATEMENT: It is very useful tool in the Financial Managers analytical kit. It provides a summary of management decisions on the financing activities of the firm and investment policy. The following are the advantages of Funds Flow Statement.

a) **Analysis of Financial Operations:** The Funds Flow statement reveals the net effect of various transactions on the operational and financial position of the business concern. It highlights the effect of these changes on the liquidity position of the company.

b) **Financial Policies:** Funds Flow statement guides the management in formulating the financial policies such as dividend, reserve etc.

c) **Control Device:** It serves as a measure of control to the management. If actual figures are compared with budgeted projected figures, management can take remedial action if there are any deviations.

d) **Evaluation of firm's financing:** Funds Flow statement helps in evaluating the firms financing. It shows the funds were obtained from various sources and used in the past. Based on this, the financial manager can take corrective action.

e) **Acts as a future guide:** Funds Flow statement acts as a guide for future, to the management. It helps the management to know various problems it is going to face in near future for want of funds.

f) **Appraising the use of Working Capital:** Funds Flow statement helps the management in knowing how effectively the working capital put into use.

g) **Reveals financial soundness:** Funds Flow statement reveals the financial soundness of the business to the creditors, banks, financial institutions.

h) **Changes in working capital:** Funds Flow statement highlights the changes in working capital. This helps the management in framing its investing policy.

Verified By: Bala Subrahmanyam Sir,

Venkanna Sir

Executed By: Dhanalakshmi

THE END

10. TYPES OF FINANCING

Q. NO	ABC Analysis	M-06	N-06	M-07	N-07	M-08	N-08	M-09	N-09	M-10	N-10	M-11	N-11	M-12	N-12	M-13	N-13	M - 14	N-14	M - 15	N - 15	M - 16	N - 16
1	C	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
2	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
3	B	-	-	-	-	2	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
4	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
5	A	-	-	-	-	-	2	-	-	-	-	-	4	-	-	-	-	-	-	-	4	-	-
6	A	-	-	-	3	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
7	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	4	-	-	-	-	-	-	-
8	A	3	-	-	-	3	-	-	-	-	-	4	-	-	-	-	-	-	-	-	-	-	-
9	A	-	-	-	-	-	-	2	-	-	-	-	-	-	-	-	-	4	-	-	-	-	4
10	A	-	-	-	2	2	-	-	-	-	-	-	4	-	-	-	4	-	-	-	-	-	-
11	A	-	-	-	-	--	-	-	-	-	-	-	-	-	-	-	-	-	4	-	-	4	-
12	A	-	-	-	-	2	-	-	-	-	-	-	-	-	-	-	2	-	-	4	-	-	
13	A	-	-	3	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
14	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
15	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
16	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
17	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
18	A	-	-	-	-	-	2	-	-	-	-	-	-	--	-	-	-	2	-	-	-	-	-
19	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
20	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
21	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	2	-	-	-	-	-
22	A	3	-	-	-	-	-	2	-	-	-	-	-	-	-	-	-	2	-	-	-	-	-
23	A	-	-	-	-	-	-	-	-	-	4	-	-	-	-	-	-	-	-	-	-	-	-
24	A	-	-	-	2	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
25	A	3	-	-	-	-	-	-	-	-	-	-	2	-	-	-	-	-	-	-	-	-	4
26	A	-		-	2	-	2	-	-	2	-	-	-	2	-	-	-	-	-	-	-	-	-

1. SOURCES OF FINANCE OF A BUSINESS

Q.No.1. Explain various sources of Business Finance? (SM)

There are several sources of Business Finance / funds of the Company they are,

Sources of Raising Finance

According to Period
1. Long Term Sources
2. Medium Term Sources
3. Short Term Sources

According to Ownership
1. Owner's Capital
2. Borrowed Capital Such as Debentures, Public Deposits, Loans etc.

According to Source of Generation
1. Internal Source e.g. Retained Earnings and Depreciation Funds
2. External Sources e.g. Debentures, Loans etc.

However, for the sake of convenience, the different sources of funds can also be classified into the following categories:

1. *Security Financing-Financing through Shares and Debentures*
2. *Internal Financing-Financing through retained earnings, Depreciation.*
3. *Loan Financing-financing through both short term and long-term loans.*
4. *International Financing.*
5. *Other sources.*

Q.No.2. Equity Share Capital as a source of Long term Finance. (SM)

Equity Share Capital: *A public ltd company may raise funds from promoters or from the investing public by way of owners capital or equity capital by issuing ordinary equity shares.*

Characteristics of Owners or Equity Share Capital:

a) **Permanent capital:** Equity Share Capital is the permanent capital because it is not generally redeemable during the life time of the company unless the company decides to buy back its own shares.

b) **Risk:** Equity shareholders are practically owners of the company as they undertake the highest risk. They are entitled to dividends after satisfying the income claims of other stakeholders.

c) **Cost:** Equity Shareholders are entitled to net residual income i.e. Profit after Tax and Preference Dividend and their expectations are high. Therefore, the cost of Equity Capital is high.

d) **Security:** Ordinary share capital also provides a security to other suppliers of funds. Any institution giving loan to a company would make sure the debt-equity ratio is comfortable to cover the debt.

Q.No.3. Preference Share Capital as a source of Long term Finance. (SM)

Preference Share: *These are a special kind of shares, the holders of such shares enjoy priority, both as regards to the payment of a fixed amount of dividend and also towards repayment of capital on winding up of the company.*

Characteristics of Preference Share Capital:

a) Long term funds can be raised through a public issue of shares.

b) Such shares are normally cumulative.

c) Rate of dividend is normally higher than the rate of interest on debentures, loans etc.

d) They carry a stipulation of period and they are repaid at the end of the period.

e) It is a hybrid form of financing which imbibes within itself some characteristics of equity capital and some attributes of debt capital.

f) The shares would carry a cumulative dividend of specified limit for a period of say three years after which the shares are converted into equity shares. These shares are attractive for projects with a long gestation period.

g) Preference share are redeemed at a pre decided future date.(they are irredeemable)

Q.No.4. What is Debenture? What are the features of Debentures? (SM)

Debenture: *A Debenture is a written instrument acknowledging a Debt and containing provision as regards the repayment of principal and the payment of interest at a fixed rate. It represents a debt. The persons who contribute money through debentures are called debenture holders.*

Features / Characteristics of Debentures:

a) Debentures are normally issued in different denominations and carry different rates of interest.

b) Debentures are issued on the basis of a debenture trust deed which lists the terms and conditions on which the debentures are floated.

c) Debentures are either secured or unsecured.

d) The cost of capital raised through debentures is quite low since the interest payable on debentures can be charged as an expense before tax.

e) From the investors' point of view, debentures offer a more attractive prospect than the preference shares since interest on debentures is payable whether or not the company makes profits.

f) Debentures are thus instruments for raising long-term debt capital.

g) The period of maturity normally varies from 3 to 10 years and may also increase for projects having high gestation period.

2. VENTURE CAPITAL

Q.No.5. What is Venture Capital Financing? What are the characteristics of Venture Capital Financing? (SM) (MTP - N15 - 4M, N15 - 4M)

Venture Capital financing: Venture Capital Financing refers to financing of high risk ventures promoted by new, qualified entrepreneurs who require funds to give shape to their ideas. Generally, venture capital funding is associated with heavy initial investment a business which involves huge risk. Here, a financier (called venture capitalist) invests in the equity or debt of an entrepreneur (Promoter / venture capital undertaking) who has a potentially successful business idea, but does not have the desired track record or financial backing.

Characteristics of venture capital financing:

a) It is basically an equity finance in new companies.

b) It can be viewed as a long term investment in growth-oriented small / medium firms.

c) It provides support to investor in form of sales strategy, business networking and management expertise, enabling the growth of the entrepreneur.

Alternative Questions:

1. Write short note on Venture Capital Financing.

A. Same as above.

Q.No.6. What are the methods of Venture Capital Financing? (SM)

Methods of venture capital financing:

a) **Equity Financing:** VCU's generally require funds for a longer period but may not be able to provide returns to the investors during initial stages. Hence, equity share capital financing is advantageous. The investor's contribution does not exceed 49% of the total equity capital of the VCU. Hence, the effective control and ownership remains with the entrepreneur.

b) **Conditional Loan:** A conditional Loan is repayable in the form of a royalty after the venture is able to generate sales. No interest is paid on such loans. The rate of royalty (say 2% to 15 %) may be based on factors like – (i) gestation period, (ii) cash flow patterns, (iii) extent of risk, etc. Sometimes, the VCU has a choice of paying a high rate of interest (say 20%) instead of royalty on sales once the activity becomes commercially sound.

c) **Income Note:** It is a hybrid type of finance, which combines the features of both conventional loan & conditional loan. The VCU has to pay both interest and royalty on sales but at substantially low rates.

d) **Participating Debentures:** Interest on such debentures is payable at three different rates based on the phase of operations i.e.

   i) Start-up and commissioning phase –NIL interest,

   ii) Initial Operations stage –Low rate of interest and

   iii) After a particular level of operations – High rate of interest.

Alternative Questions:

1. **What are the varies methods through which a venture capital undertaking can rise finance?**

A. Same as above.

Q.No.7. What are the various factors that must be considered for Venture Capital Undertaking? (SM)(M13 - 4M)

Factors that a Venture Capitalist should consider before financing any risky project are as follows:

a) **Level of expertise of company's management:** Most of venture capitalist believes that the success of a new project is highly dependent on the quality of its management team. They expect that entrepreneur should have a skilled team of managers. Managements also be required to show a high level of commitments to the project.

b) **Level of expertise in production:** Venture capital should ensure that entrepreneur and his team should have necessary technical ability to be able to develop and produce new product or service.

c) **Nature of new product or service:** The venture capitalist should consider whether the development and production of new product / service should be technically feasible. They should employ experts in their respective fields to examine idea proposed by the entrepreneur.

d) **Future Prospects:** Since the degree of risk involved in investing in the company is quite fairly high, venture capitalists should seek to ensure that the prospects for future profits compensate for the risk. Therefore, they should see a detailed business plan setting out the future business strategy.

e) **Competition:** The venture capitalist should seek assurance that there is actually a market for a new product. Further venture capitalists should see the research carried on by the entrepreneur.

f) **Risk borne by entrepreneur:** The venture capitalist is expected to see that the entrepreneur bears a high degree of risk. This will assure them that the entrepreneur have the sufficient level of the commitments to project as they themselves will have a lot of loss, should the project fail.

g) **Exit Route:** The venture capitalist should try to establish a number of exist routes. These may include a sale of shares to the public, sale of shares to another business, or sale of shares to original owners.

h) **Board membership:** In case of companies, to ensure proper protection of their investment, venture capitalist should require a place on the Board of Directors. This will enable them to have their say on all significant matters affecting the business.

3. DEBT SECURITISATION

Q.No.8. What is debt securitisation? Explain the basics of debt securitisation process? (PM) (MTP1-N15, M 06-3M, M 08-3M, M 11-4M)

<u>Debt Securitisation:</u> It is a method of recycling of funds. It is especially beneficial to financial intermediaries to support the lending volumes. Assets generating steady cash flows are packaged together and against this asset pool, market securities can be issued, e.g. housing finance, auto loans, and credit card receivables.

<u>Process of Debt Securitisation:</u>

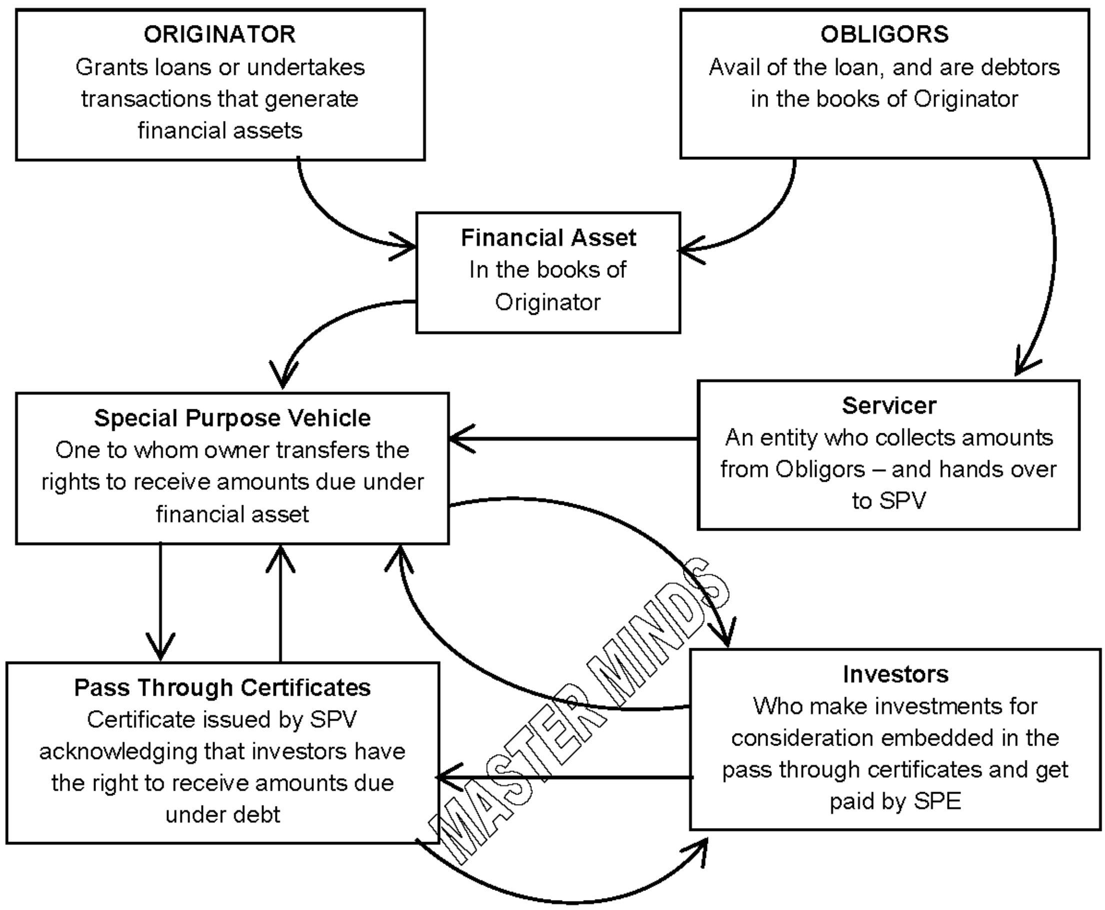
a) **The origination function** – A borrower seeks a loan from a finance company or bank. The credit worthiness of borrower is evaluated and contract is entered into with repayment schedule structured over the life of the loan.

b) **The Pooling function** – Similar loans on receivables are clubbed together to create an underlying pool of assets. The pool is transferred in favour of Special purpose Vehicle (SPV), which acts as a trustee for investors.

c) **The securitisation function** – SPV will structure and issue securities on the basis of asset pool. The securities carry a coupon and expected maturity which can be asset based/ mortgage based. These are generally sold to investors through merchant bankers. Investors are – pension funds, mutual funds, insurance funds.

The process of securitization is generally without recourse i.e. investors bear the credit risk and issuer is under an obligation to pay to investors only if the cash flows are received by him from the collateral. The benefits to the originator are that assets are shifted off the balance sheet, thus giving the originator recourse to off-balance sheet funding.

Debt Securitization flow



Alternative Questions:

1. **Explain the concept of Debt Securitisation.**

A. Same as above.

2. **How Debt Securitisation works?**

A. Same as above.

3. **Debt securitization is a new way of rising finance. Discuss.**

A. Same as above.

Q.No.9. Discuss the benefits to the originator of Debt Securitization. (Or) Advantages of Debt Securitisation. (PM) (N 16 - 4M, M 13 - 4M)

Benefits to the Originator of Debt Securitization: The benefits to the originator of debt securitization are as follows:

a) The assets are shifted off the balance sheet, thus giving the originator recourse to off balance sheet funding.

b) It converts illiquid assets to liquid portfolio.

c) It facilitates better balance sheet management as assets are transferred off balance sheet facilitating satisfaction of capital adequacy norms.

d) The originator's credit rating enhances.

e) For the investors securitisation opens up new investment avenues. Though the investor bears the credit risk, the securities are tied up to definite assets.

4. LEASE FINANCE

Q.No.10. Write a short note on Lease Finance? (SM)

1. **Lease Finance:**
   a) Leasing is a general contract between the owner and user of the asset over a specified period of time.
   b) The asset is purchased initially by the lessor (leasing company) and thereafter leased to the user (lessee company) which pays a specified rent at periodical intervals.
   c) Thus, leasing is an alternative to the purchase of an asset out of own or borrowed funds. Moreover, lease finance can be arranged much faster as compared to term loans from financial institutions.
2. **Types of Lease Contracts:**
   a) **Operating Lease:**
      i) A lease is classified as an operating lease if it does not secure for the lessor the recovery of capital outlay plus a return on the funds invested during the lease term.
      ii) Normally, these are callable lease and are cancelable with proper notice. The term of this type of lease is shorter than the asset's economic life.
      iii) The leasee is obliged to make payment until the lease expiration, which approaches useful life of the asset.
      iv) An operating lease is particularly attractive to companies that continually update or replace equipment and want to use equipment without ownership, but also want to return equipment at lease end and avoid technological obsolescence.
   b) **Finance Lease:**
      i) A financial lease is longer term in nature and non-cancelable.
      ii) It is an leasing arrangement that is to finance the use of equipment for the major parts of its useful life. The lessee has the right to use the equipment while the lessor retains legal title.
      iii) It is also called capital lease, at it is nothing but a loan in disguise.
      iv) Thus it can be said, a contract involving payments over an obligatory period of specified sums sufficient in total to amortise the capital outlay of the lessor and give some profit.

Alternative Questions:

1. Discuss in brief the concept of Lease Finance.

A. Same as above.

Q.No.11. Distinguish between Financial lease and Operating lease.
(PM)(M16 -4M, RTP- N14, N 11-4M, N 14-4M)

Difference between Financial Lease and Operating Lease:

No.	Finance Lease	Operating Lease
1.	The risk and reward incident to ownership are passed on the lessee. The lessor only remains the legal owner of the asset.	The lessee is only provided the use of the asset for a certain time. Risk incident to ownership belongs only to the lessor.
2.	The lessee bears the risk of obsolescence.	The lessor bears the risk of obsolescence.
3.	The lease is non-cancellable by either party under it.	The lease is kept cancellable by the lessor.
4.	The lessor does not bear the cost of repairs, maintenance or operations.	Usually, the lessor bears the cost of repairs, maintenance or operations.
5.	The lease is usually full payout.	The lease is usually non-payout.

Q.No.12. What are the other types of Leases? (SM)

1. **Sale and Lease back: (M 15-4M)**
   a) Under this type of lease, the owner of an asset sells the asset to a party (the buyer), who in turn leases back the same asset to the owner in consideration of a lease rentals.
   b) Under this arrangement, the asset is not physically exchanged but it all happens in records only.
   c) The main advantage of this method is that the lessee can satisfy himself completely regarding the quality of an asset and after possession of the asset convert the sale into a lease agreement.
   d) Under this transaction, the seller assumes the role of lessee and the buyer assumes the role of a lessor. The seller gets the agreed selling price and the buyer gets the lease rentals.
2. **Leveraged Lease: (N 13 – 2M)**
   a) Under this lease, a third party is involved besides lessor and lessee.
   b) The lessor borrows a part of the purchase cost (say 80%) of the asset from the third party i.e., lender and asset so purchased is held as security against the loan.
   c) The lender is paid off from the lease rentals directly by the lessee and the surplus after meeting the claims of the lender goes to the lessor.
   d) The lessor is entitled to claim depreciation allowance.
3. **Sales – aid lease:**
   a) Under this lease contract, the lessor enters into a tie up with a manufacturer for marketing the latter’s product through his own leasing operations, it is called a sales-aid-lease.
   b) In consideration of the aid in sales, the manufacturer may grant either credit, or a commission to the lessor. Thus, the lessor earns from both sources. i.e. from lessee as well as the manufacturer.
4. **Close-ended and Open-ended leases: (M 08 - 2M)**
   a) In the close-ended lease, the assets get transferred to the lessor at the end of lease and the risk of obsolescence, residual value etc., remain with the lessor being the legal owner of the asset.
   b) In the open-ended lease, the lessee has the option of purchasing the asset at the end of the lease period.

5. COMMERCIAL PAPER

Q.No.13. Explain in brief the features of Commercial Paper. (PM) (M 07-3M, MTP2-N15)

Commercial Paper (CP): A commercial paper is an unsecured money market instrument issued in the form of a promissory note. Since the CP represents an unsecured borrowing in the money market, the regulation of CP comes under the purview of the Reserve Bank of India which issued guidelines in 1990 on the basis of the recommendations of the Vaghul Working Group.

These guidelines were aimed at:

a) Enabling the highly rated corporate borrowers to diversify their sources of short term borrowings.

b) To provide an additional instrument to the short term investors.

It can be issued for maturities between 7 days and a maximum upto one year from the date of issue. These can be issued in denominations of Rs. 5 lakh or multiples therefore. All eligible issuers are required to get the credit rating from credit rating agencies.

Alternative Questions:

1. Write short note on Commercial Paper.

A. Same as above.

Q.No.14. Discuss the eligibility criteria for issue of commercial paper. (M 05-3M) (PM)

The companies satisfying the following conditions are eligible to issue commercial paper.

a) The tangible net worth of the company is Rs. 5 crores or more as per audited balance sheet of the company.

b) The fund base working capital limit is not less than Rs. 5 crores.

c) The company is required to obtain the necessary credit rating from the rating agencies such as CRISIL, ICRA etc.

d) The issuers should ensure that the credit rating at the time of applying to RBI should not be more than two months old.

e) The minimum current ratio should be 1.33:1 based on classification of current assets and liabilities.

f) For public sector companies there are no listing requirement but for companies other than public sector, the same should be listed on one or more stock exchanges.

g) All issue expenses shall be borne by the company issuing commercial paper.

6. EXPORT FINANCING

Q.No.15. Write short notes on Pre-Shipment finance for export (Packing Credit Facility). (SM) (RTP-N15)

Meaning: Packing credit is an advance extended by banks to an exporter for the purpose of buying, manufacturing, processing, packing and shipping goods to overseas buyers.

Applicability:

a) *If an exporter has a firm export order placed with him by his foreign customer (buyer) or an irrevocable letter of credit opened in his favor, he can approach a bank for packing credit facility.*

b) *The 'Letter of Credit' and 'Firm Sale Contracts' serve as evidence of a definite arrangement for realization of the export proceeds and also indicate the amount of finance required by the exporter.*

c) *In the case of long standing customers, Packing Credit may also be granted against firm contracts entered into by them with overseas buyers.*

d) *An advance so taken by an exporter is required to be liquidated (settled) within 180 days from the date of its commencement by negotiation of export bills or receipt of export proceeds in an approved manner.*

e) *Thus packing credit is essentially a short-term advance.*

Q.No.16. Write short notes on Types of Packing Credit. (SM)

Types of Packing Credit:

1. **Clean Packing Credit:**

   a) This is an advance made available to an exporter only on production of a firm export order or a letter of credit without exercising any charge or control over raw material or finished goods.

   b) It is a clean type of export advance. Each proposal is weighed according to particular requirements of the trade and credit worthiness of the exporter.

   c) A suitable margin has to be maintained. Also, Export Credit Guarantee Corporation (ECGC) cover should be obtained by the bank.

2. **Packing credit against hypothecation of goods:**

   a) Export finance is made available on certain terms and conditions where the exporter has pledge able interest and the goods are hypothecated to the bank as security with stipulated margin.

   b) At the time of utilizing the advance, the exporter is required to submit, along with the firm export order or letter of credit relative stock statements and thereafter continue submitting them every fortnight and/or whenever there is any movement in stocks.

3. **Packing credit against pledge of goods:**

   a) Export finance is made available on certain terms and conditions where the exportable finished goods are pledged to the banks with approved clearing agents who will ship the same from time to time as required by the exporter.

   b) The possession of the goods so pledged lies with the bank and is kept under its lock and key.

   c) **E.C.G.C. guarantee:** Any loan given to an exporter for the manufacture, processing, purchasing, or packing of goods meant for export against a firm order qualifies for the packing credit guarantee issued by Export Credit Guarantee Corporation.

4. **Forward exchange contract:** Another requirement of packing credit facility is that if the export bill is to be drawn in a foreign currency, the exporter should enter into a forward exchange contact with the bank, thereby avoiding risk involved in a possible change in the rate of exchange.

Q.No.17. What are the various modes in which Post-Shipment Finance can be given for Export Trade? (PM)

1. **Post-shipment Finance:**
   a) **Purchase/discounting of documentary export bills:** Finance is provided to exporters by purchasing export bills drawn payable at sight or by discounting usance export bills covering confirmed sales and backed by documents including documents of the title of goods such as bill of lading, post parcel receipts, or air consignment notes.
   b) **E.C.G.C. Guarantee:** Post-shipment finance, given to an exporter by a bank through purchase, negotiation or discount of an export bill against an order, qualifies for post-shipment export credit guarantee. It is necessary, however, that exporters should obtain a shipment or contracts risk policy of E.C.G.C. Banks insist on the exporters to take a contracts shipments (comprehensive risks) policy covering both political and commercial risks.
   c) **Advance against export bills sent for collection:** Finance is provided by banks to exporters by way of advance against export bills forwarded through them for collection, taking into account the creditworthiness of the party, nature of goods exported, usance, standing of drawee, etc. appropriate margin is kept.
   d) **Advance against duty draw backs, cash subsidy, etc.:** To finance export losses sustained by exporters, bank advance against duty draw-back, cash subsidy, etc., receivable by them against export performance. Such advances are of clean nature, hence necessary precaution should be exercised.
2. **Other facilities extended to exporters.**
   a) On behalf of approved exporters, banks establish letters of credit on their overseas or up country suppliers.
   b) Guarantees for waiver of excise duty, etc. due performance of contracts, bond in lieu of cash security deposit, guarantees for advance payments etc., are also issued by banks to approved clients.
   c) Banks also endeavour to secure for their exporter-customers status reports of their buyers and trade information on various commodities through their correspondents.

7. INTERNATIONAL FINANCING

Q.No.18. What are the financial instruments in International Markets? (SM)

1. **External Commercial Borrowings(ECB) :**
   a) ECBs refer to commercial loans availed from non-resident lenders with minimum average maturity of 3 years.
   b) Borrowers can raise ECBs through internationally recognized sources like (i) international banks, (ii) international capital markets.
   c) ECB's can be accessed under two routes viz (i) Automatic route and (ii) Approval route.
   d) Under the Automatic route there is no need to take the RBI / Government approval whereas such approval is necessary under the Approval route.

2. **Euro Bonds:** Euro Bonds are debt instruments which are not denominated in the currency of the country in which they are issued. E.g. A Yen note floated in Germany. Such Bonds are generally issued in a bearer form rather than as registered bonds and in such cases they do not contain the investor's names or the country of their origin.

3. **Foreign Bonds:** These are debt instruments issued by foreign corporations of Foreign Governments. These bonds are denominated in the currency of the country where they are issued, however, in case these bonds are issued in a currency other than the investors home currency, they are exposed to exchange rate risks. An example of a foreign bond 'A British firm placing dollar denominated bonds in USA'.

4. **Fully Hedged Bonds:** As mentioned above, in foreign bonds, the risk of currency fluctuations exist. Fully hedged bonds eliminate the risk by selling in forward markets the entire stream of principal and interest payments.

5. **Medium Term Notes:** Under this programme, several lots of bonds can be issued, all having different features e.g. different coupon rates, different currencies etc. The timing of each lot can be decided keeping in mind the future market opportunities. The entire documentation and various regulatory approvals can be taken at one point of time.

6. **Floating rate notes:** These are issued up to seven years maturity. Interest rates are adjusted to reflect the prevailing exchange rates. They provide cheaper money than foreign loans.

7. **Euro commercial papers (ECP):** ECPs are short term money market instruments. They are for maturities less than one year. They provide cheaper money than foreign loans.

8. **Foreign currency option:** A FC option is the right to buy or sell, spot, future or forward, a specified foreign currency. It provides a hedge against financial and economic risks.

9. **Foreign Currency futures:** FC futures are obligations to buy or sell a specified currency in the present for settlement at a future date.

10. **Foreign Euro Bonds:** In domestic capital markets of various countries the Bonds issues referred to above are known by different names such as Yankee Bonds in the US, Swiss Frances in Switzerland, Samurai Bonds in Tokyo and Bulldogs in UK.

11. **Euro Convertible Bonds:** A convertible bond is a debt instrument which gives the holders of the bond an option to convert the bonds into a pre-determined number of equity shares of the company.

12. **Euro Convertible Zero Bonds:** These bonds are structured as a convertible bond. No interest is payable on the bonds. But conversion of bonds takes place on maturity at a pre-determined price.

13. **Euro Bonds with Equity Warrants:** These bonds carry a coupon rate determined by market rates. The warrants are detachable. Pure bonds are traded at a discount. Fixed Income Funds Management may like to invest for the purposes of regular income.

Alternative Questions:

1. **Discuss the financial Instruments used in international financing.**

A. Same as above.

(Note: Individually, each "Financial Instrument" may be asked for 2 marks.)

Q.No.19. Write short notes on Euro-Issues by Indian companies? (SM)

a) Indian companies are permitted to raise foreign currency resources through issue of ordinary equity shares through Global Depository Receipts (GDRs) / American Depository Receipts (ADRs) and / or issue of Foreign Currency Convertible Bonds (FCCB) to foreign investors i.e. institutional investors or individuals (including NRIs) residing abroad.

b) Such investment is treated as Foreign Direct investment.

c) The government guidelines on these issues are covered under the Foreign Currency Convertible Bonds and Ordinary Shares (Through depositary receipt mechanism) scheme, 1993 and notifications issued after the implementation of the said scheme.

Q.No.20. Write short notes on Global Depository Receipts (GDR'S)? (PM)(MTP1-M15)

a) A negotiable certificate: A Depository Receipt (DR) is basically a negotiable certificate, denominated in US Dollars that represents a non – US company's Publicly trade local currency (Say, Indian Rupee) Equity Shares.

b) How delivered: GDR's are created when the local currency shares of an Indian Company are delivered to the depository's local custodian bank, against which the Depository Bank issues GDR's in US Dollars.

c) How they can be traded: These GDRs may be freely traded in the overseas markets like any other Dollar denominated security through either a Foreign Stock Exchange or through Over The Counter (OTC) market or among a restricted group like Qualified Institutional Buyers (QIB's).

d) Advantages to Indian Companies: By issue of GDR Indian companies are able to tap global equity market to raise foreign currency funds by way of equity.

e) Advantage then debt: It has distinct advantage over debt as there is no repayment of principle and service costs are lower.

<u>**Alternative Questions:**</u>

1. Give full detailed information about the GDR.

A. Same as above.

Q.No.21. What are the Characteristics of Global Depository Receipts (GDR'S)?

a) Holders of GDR's participate in the economic benefits of being ordinary shareholders, though they do not have voting rights.

b) GDRs are settled through Euro-clear International book entry systems.

c) GDRs are listed on the Luxemburg stock exchange. (European Market).

d) Trading takes place between professional market makers on an OTC (Over The Counter) basis.

e) As far as the case difference between GDR and ADR of liquidation of GDRs is concerned, an investor my get the GDR cancelled any time after a cooling period of 45 days.

Q.No.22. Write short notes on American Depository Receipts (ADRS)? (PM)

a) American Depository Receipts (ADRs) are securities offered by non- US companies who want to list on any of the US exchanges.

b) It is a derivative instrument. It represents a certain number of company's shares.

c) These are used by depository bank against a fee income.

d) ADRs allow US investors to buy shares of these companies without the cost of investing directly in a foreign stock exchange.

e) ADRs are listed on either NYSE or NASDAQ.

f) It facilitates integration of global capital markets.

The company can use the ADR route either to get international listing or to raise money in international capital market.

Q.No.23. What is the difference between GDR and ADR? (PM) (RTP-N14)

a) Global Depository Receipts (GDRs) are basically negotiable certificates denominated in US dollars that represent a non-US company's publicly traded local currency equity shares.

b) These are created when the local currency shares of Indian company are delivered to the depository's local custodian bank, against which the depository bank issues Depository Receipts in US dollars.

c) Whereas, American Depository Receipts (ADR) are securities offered by non-US companies who want to list on any of the US exchange.

d) Each ADR represents a certain number of a company's regular shares.

e) ADRs allow US investors to buy shares of these companies without the costs of investing directly in a foreign stock exchange.

f) ADRs are issued by an approved New York bank or trust company against the deposit of the original shares.

g) These are deposited in a custodial account in the US. Such receipts have to be issued in accordance with the provisions stipulated by the SEC USA which are very stringent.

The Indian companies have preferred the GDRs to ADRs because the US market exposes them to a higher level or responsibility than a European listing in the areas of disclosure, costs, liabilities and timing.

Q.No.24. Write short notes on Indian Depository Receipts (IDR's). (PM)

The concept of the depository receipt mechanism which is used to raise funds in foreign currency has been applied in the Indian Capital Market through the issue of Indian Depository Receipts (IDR's). IDR's are similar to ADR's / GDR's in the sense that foreign companies can issue IDR's to raise funds from the Indian Capital Market in the same lines as an Indian company uses ADR's / GDR's to raise foreign capital. The IDR's are listed and traded in India in the same way as other Indian securities are traded.

Q.No.25. Write a short note on Bridge Finance? (PM) (N 16 -4M ,RTP - N15)

a) Bridge finance refers, normally, to loans taken by the business, usually from commercial banks for a short period, pending disbursement of term loans by financial institutions, normally it takes time for the financial institution to finalise procedures of creation of security, tie-up participation with other institutions etc., even though a positive appraisal of the project has been made.

b) However, once the loans are approved in principle, firms in order not to lose further time in starting their projects arrange for bridge finance.

c) Such temporary loan is normally repaid out of the proceeds of the principal term loans.

d) It is secured by hypothecation of moveable assets, personal guarantees and demand promissory notes. Generally rate of interest on bridge finance is higher as compared with that on term loans.

Q.No.26. What are the others sources of finance?

1. **Seed Capital Assistance:** **(M05 - 3M, M10 - 2M)**

a) The seed capital assistance has been designed by IDBI for professionally or technically qualified entrepreneurs.

b) All the projects eligible for financial assistance from IDBI, directly or indirectly through refinance are eligible under the scheme.

c) The project cost should not exceed Rs.2 crores and the maximum assistance under the project will be restricted to 50% of the required promoters contribution or Rs.15 lacs whichever is lower.

d) The seed capital assistance is interest free but carries a security charge of one percent per annum for the first five years and an increasing rate thereafter.

2. **Internal Cash Accruals:** *It is the surplus generated from operations, after meeting all the contractual, statutory and working requirement of funds, is available for further capital expenditure.*

3. ***Unsecured Loans:***

a) *Unsecured loans are typically provided by promoters to meet the promoter's contribution norm. These loans are considered as part of the equity for the purpose of calculating of debt equity ratio.*

b) *These loans cannot be repaid without the prior approval of financial institutions.*

4. ***Deferred Payment Guarantee:***

a) *Many a time suppliers of machinery provide deferred credit facility under which payment for the purchase of machinery can be made over a period of time.*

b) *The entire cost of the machinery is financed and the company is not required to contribute any amount initially towards acquisition of the machinery.*

c) *Normally, the supplier of machinery insists that bank guarantee should be furnished by the buyer. Such a facility does not have a moratorium period for repayment. Hence, it is advisable only for an existing profit making company.*

5. ***Capital Incentives:***

a) *The capital incentives usually consist of a lump sum subsidy and exemption from or deferment of sales tax and octroi duty.*

b) *The quantum of incentives is determined by the degree of backwardness of the location.*

c) *Special capital incentives are sanctioned and released to the units only after they have complied with the requirements* of the relevant scheme.

6. Deep Discount Bonds: **(N08-2M, M12 - 2M, N07 - 2M)**

a) Deep Discount Bonds (DDB's) are in the form of zero interest bonds.

b) These bonds are sold at a discounted value and on maturity face value is paid to the investors.

c) In such bonds, there is no interest payout during lock-in period.

d) IDBI was first to issue a Deep Discount Bonds (DDB's) in India in January 1992. The bond of a face value of Rs.1 lakh was sold for Rs.2,700 with a maturity period of 25 years.

7. Secured Premium Notes: **(M08-2M)**

a) Secured Premium Notes is issued along with a detachable warrant and is redeemable after a notified period of say 4 to 7 years.

b) The conversion of detachable warrant into equity shares will have to be done within time period notified by the company.

8. Zero Interest fully Convertible Debentures: **(SM)**

a) These are fully convertible debentures which do not carry any interest.

b) The debentures are compulsorily and automatically converted after a specified period of time and its holders are entitled to new equity shares of the company at a predetermined price.

c) The company is benefited since no interest is to be paid on it.

d) The investor is benefited if the market price of the company's shares is very high since he tends to get equity shares of the company at an agreed lower rate.

9. Zero Coupon Bonds: **(SM)(M 04 - 3M)**

a) Zero coupon bonds do not carry any interest.

b) It is sold by the issuing company at a discount. The difference between the discounted value and maturing or face value represents the interest to be earned by the investor on such bonds.

c) It operates in the same manner as a DDB, but the lock-in period is comparatively less.

10. Double Option Bonds: **(SM)**

a) These were first issued by the IDBI.

b) The face value of each bond is Rs.5,000. The bond carries interest at 15% p.a. compounded half-yearly from the date of allotment.

c) The bond has a maturity period of 10 years.

d) Each bond has two parts in the form of two separate certificates, one for principal of Rs.5,000 and other for interest (including redemption premium) of Rs.16,500. both these certificates are listed on all major stock exchanges.

e) The investor has the facility of selling either one or both parts at any time he wishes so.

11. Option Bonds: **(SM)**

a) These are cumulative and non-cumulative bonds where interest is payable on maturity or periodically.

b) Redemption premium is also offered to attract investors.

c) These were issued by institutions like IDBI, ICICI, etc.

12. Inflation Bonds: **(SM)**

a) Inflation bonds are bonds in which interest rate is adjusted for inflation.

b) Thus, the investor gets an interest free from the effects of inflation.

c) For example, if the interest rate is 11% and the inflation is 3%, the investor will earn 14% meaning thereby that the investors protected against inflation.

13. Floating rate bonds: **(SM)**

a) In this type of bond, the interest rate is not fixed and is allowed to float depending upon the market conditions.

b) This is an instrument used by issuing companies to hedge themselves against the volatility in the interest rates.

c) Financial institutions like IDBI, ICICI, etc. have raised funds from these bonds.

TWO MARKS QUESTIONS

1) Inter Corporate Deposits:(ICD'S)

a) The companies can borrow funds for a short period say 6 months from other companies which have surplus liquidity.

b) The rate of interest on inter corporate deposits varies depending upon the amount involved and time period.

2) Certificate of Deposit (CD):

a) The certificate of deposit is a document of title similar to a time deposit receipt issued by a bank except that there is no prescribed interest rate on such funds.

b) The main advantage of CD is that banker is not required to encash the deposit before maturity period and the investor is assured of liquidity because he can sell the CD in secondary market.

3) Public Deposits:

a) Public deposits are very important source of short-term and medium term finances. Theses are unsecured loans to be repaid within a period of 3 years.

b) A company can accept public deposits subject to the stipulations of Reserve Bank of India from time to time maximum up to 35 per cent of its paid up capital and reserves, from the public and shareholders.

4) Features of Deep Discount Bonds: **(N 07 & 08 - 2M & M12 - 4M)**

a) Deep discount bonds are a form of zero-interest bonds. These bonds are sold at discounted value and on maturity; face value is paid to the investors.

b) In such bonds, there is no interest payout during the lock- in period.

c) The investors can sell the bonds in stock market and realise the difference between face value and market price as capital gain.

5) Features of Secured Premium Notes (SPN's): **(PM) (M 08)**

a) Secured premium notes are issued along with detachable warrants and are redeemable after a notified period of say 4 to 7 years.

b) This is a kind of NCD attached with warrant. It was first introduced by TISCO, which issued the SPN's to existing shareholders on right basis.

c) Subsequently the SPN's will be repaid in some number of equal installments.

d) The warrant attached to SPN's gives the holder the right to apply for and get allotment of equity shares as per the conditions within the time period notified by the company.

6) Euro Convertible Bond:

a) Euro Convertible bonds are quasi-debt securities (unsecured) which can be converted into depository receipts or local shares.

b) ECB's offer the investor an option to convert the bond into equity at a fixed price after the minimum lock in period.

c) An issuing company desirous of raising the ECB's is required to obtain prior permission of the Department of Economic Affairs, Ministry of Finance, and Government of India.

7) Deep Discount Bonds vs. Zero Coupon Bonds: (MTP1-M15)

a) Deep Discount Bonds (DDB's) are in the form of zero interest bonds.

b) These bonds are sold at a discounted value and on maturity face value is paid to the investors.

c) In such bonds, there is no interest payout during lock-in period.

d) IDBI was first to issue a Deep Discount Bonds (DDB's) in India in January 1992. The bond of a face value of Rs.1 lakh was sold for Rs. 2,700 with a maturity period of 25 years.

e) A zero coupon bond (ZCB) does not carry any interest but it is sold by the issuing company at a discount.

f) The difference between discounted value and maturing or face value represents the interest to be earned by the investor on such bonds.

8) Ploughing back of Profits: (PM) (M 07, N 09)

a) Long-term funds may also be provided by accumulating the profits of the company and ploughing them back into business. Such funds belong to the ordinary shareholders and increase the net worth of the company.

b) A public limited company must plough back a reasonable amount of its profits each year keeping in view the legal requirements in this regard and its own expansion plans.

c) Such funds also entail almost no risk. Further, control of present owners is also not diluted by retaining profits.

9) Foreign Direct Investment (FDI)

a) FDI can come in various forms. It can be a loan capital, direct investment and also portfolio investment etc.

b) The growing international production and trade require increased amount of international investment. As a result, the flow of international investment has been increasing.

c) The country requires international investment for enhancing the production, trade and distribution capabilities.

Q.No.10. What is the frame work in India in respect of issue of Commercial Papers?

These are regulated by the RBI. The main elements of the present framework are:

a) CP's can be issued for periods ranging between 15 days and one year.

b) Renewal of CP's is treated as fresh issue.

c) The minimum size of issue is Rs.25 lakh & the minimum unit of subscription is Rs.5 lakh.

d) The maximum amount that a company can raise by way of CPs is 100% of the working capital limit.

e) A company can issue CPs only if it has a minimum tangible net worth of Rs.4 crore, at least a credit rating of P2 (Crisil), A2 (Icra), PR-2 (Care) and D-2 (Duff & Phelps).

Q.No.11.Floating-rate bonds are designed to minimize the holders' interest rate risk; while convertible bonds are designed to give the investor the ability to share in the price appreciation of the company's stock." Do you agree with this statement?

Floating rate bonds allow the investor to earn a rate of interest income tied to current interest rates, thus negating one of the major disadvantages of fixed income investments while Convertible bonds allow the investor to benefit from the appreciation of the stock price, either by converting to stock or holding the bond, which will increase in price as the stock price increases.

Verified By: Bala Subrahmanyam Sir,
Venkanna Sir

Executed By: Dhanalakshmi

THE END