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Paper 8A

FINANCIAL MANAGEMENT (FM) THEORY BOOKLET

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100% Coverage of Study Material, Practice Manual, RTP, MTP & Past Exam Questions

CHAPTER ONE

SCOPE & OBJECTIVE OF FINANCIAL MANAGEMENT

Q. 1 : Explain two basic functions of Financial Management.

1. Procurement of Funds:

- Funds can be obtained from different sources having different characteristics in terms of risk, cost and control. The funds raised from the issue of equity shares are the best from the risk point of view since repayment is required only at the time of liquidation.
- However, it is also the most costly source of finance due to dividend expectations of shareholders. On the other hand, debentures are cheaper than equity shares due to their tax advantage.
- However, they are usually riskier than equity shares. There are thus risk, cost and control considerations which a finance manager must consider while procuring funds. The cost of funds should be at the minimum level for that a proper balancing of risk and control factors must be carried out.

2. Effective Utilization of Funds:

- The Finance Manager has to ensure that funds are not kept idle or there is no improper use of funds. The funds are to be invested in a manner such that they generate returns higher than the cost of capital to the firm.
- Besides this, decisions to invest in fixed assets are to be taken only after sound analysis using capital budgeting techniques. Similarly, adequate working capital should be maintained so as to avoid the risk of insolvency.

Q. 2 : Differentiate between Financial Management and Financial Accounting.

- Though financial management and financial accounting are closely related, still they differ in the treatment of funds and also with regards to decision - making.

1. 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 shortage of liquidity as a result of say, uncollectible receivables.
- Whereas, the treatment of funds, in financial management 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.

2. 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 financial accounting ends.

Q. 3 : Explain the limitations of profit maximization objective of Financial Management.

(a) Time factor is ignored.
(b) It is vague because it is not cleared whether the term relates to economics profit, accounting profit, profit after tax or before tax.
(c) The term maximisation is also ambiguous
(d) It ignore, the risk factor.

Q. 4 : Discuss the conflicts in Profit versus Wealth maximization principle of the firm. OR

Distinguish between Profit maximisation vs Wealth maximisation objective of the firm. OR

Write two main objectives of financial management.

1. Profit maximisation

- Profit maximisation is a short-term objective and 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 can arise like the term profit is vague, profit maximisation has to be attempted with a realisation of risks involved, it does not take into account the time pattern of returns and as an objective it is too narrow.

2. Wealth maximisation,

- Wealth maximisation as an objective, means that the company is using its resources in a good manner.
- If the share value is to stay high, the company has to reduce its costs and use the resources properly.
- If the company follows the goal of wealth maximisation, it means that the company will promote only those policies that will lead to an efficient allocation of resources.

Q. 5 : Explain as to how the wealth maximisation objective is superior to the profit maximisation objective.

A firm's financial management may often have the following as their objectives:

(i) The maximisation of firm's profit.
(ii) The maximisation of firm's value / wealth.

- The maximisation of profit is often considered as an implied objective of a firm. To achieve the aforesaid objective various type of financing decisions may be taken. Options resulting into maximisation of profit may be selected by the firm's decision makers. They even sometime may adopt policies yielding exorbitant profits in short run which may prove to be unhealthy for the growth, survival and overall interests of the firm. The profit of the firm in this case is measured in terms of its total accounting profit available to its shareholders.
- The value/wealth of a firm is defined as the market price of the firm's stock. The market price of a firm's stock represents the focal judgment of all market participants as to what the value of the particular firm is. It takes into account present and prospective future earnings per share, the timing and risk of these earnings, the dividend policy of the firm and many other factors that bear upon the market price of the stock.

- The value maximisation objective of a firm is superior to its profit maximisation objective due to following reasons.
  1. 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.
  2. 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.
  3. Shareholders would prefer an increase in the firm's wealth against its generation of increasing flow of profits.
  4. 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 recognizes the importance of distribution of returns.
- 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. 6 : "The profit maximization is not an operationally feasible criterion." Comment on it.

"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. Profit maximization fails to serve as an operational criterion for maximizing the owner's economic welfare. It fails to provide an operationally feasible measure for ranking alternative courses of action in terms of their economic efficiency.

It suffers from the following limitations:

(i) Vague term: The definition of the term profit is ambiguous. Does it mean short term or long term profit? Does it refer to profit before or after tax? Total profit or profit per share?

(ii) Timing of Return: The profit maximization objective does not make distinction between returns received in different time periods. It gives no consideration to the time value of money, and values benefits received today and benefits received after a period as the same.

(iii) It ignores the risk factor.

(iv) The term maximization is also vague.

Q. 7 : "The information age has given a fresh perspective on the role of finance 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?

- The information age has given a fresh perspective on the role 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. In the emergent role Chief Finance Officer acts as a catalyst to facilitate changes in an environment where the organisation succeeds through self-managed teams.
- The Chief Finance Officer must transform himself to a front-end organiser and leader who spends more time in networking, analysing the external environment, making strategic decisions, managing and protecting cash flows. In due course, the role of Chief Finance Officer will shift from an operational to a strategic level. Of course on an operational level the Chief Finance Officer cannot be excused from his backend duties.

- 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.

Q. 8 : Discuss the functions of a Chief Financial Officer.

- The twin aspects viz procurement and effective utilization 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
  - Estimating requirement of funds
  - Decision regarding capital structure
  - Investment decisions
  - Dividend decision
  - Cash management
  - Evaluating financial performance
  - Financial negotiation
  - Keeping touch with stock exchange quotations & behaviour of share prices.

Q. 9 : Write short notes on :
Inter relationship between investment, financing and dividend decisions.

Inter-relationship between Investment, Financing and Dividend Decisions:

- The finance functions are divided into three major decisions, viz., investment, financing and dividend decisions. It is correct to say that these decisions are inter-related because the underlying objective of these three decisions is the same, i.e. maximisation of shareholders' wealth.
- Since investment, financing and dividend decisions are all interrelated, one has to consider the joint impact of these decisions on the market price of the company's shares and these decisions should also be solved jointly.
- The decision to invest in a new project needs the finance for the investment. The financing decision, in turn, is influenced by and influences dividend decision because retained earnings used in internal financing deprive shareholders of their dividends.
- An efficient financial management can ensure optimal joint decisions. This is possible by evaluating each decision in relation to its effect on the shareholders' wealth.
- The above three decisions are briefly examined below in the light of their inter-relationship and to see how they can help in maximising the shareholders' wealth i.e. market price of the company's shares.

1. Investment decision:

- The investment of long term funds is made after a careful assessment of the various projects through capital budgeting and uncertainty analysis. However, only that investment proposal is to be accepted which is expected to yield at least so much return as is adequate to meet its cost of financing. This have an influence on the profitability of the company and ultimately on its wealth.

2. 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. With the total volume of 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.

3. Dividend decision:

- The finance manager is also concerned with the decision to pay or declare dividend. He 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 shareholders' wealth.
- 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 shareholders' wealth.

Q. 10: Explain 'Finance Function'.

- The finance function is most important for all business enterprises. It remains a focus of all activities. It starts with the setting up of an enterprise.
- It is concerned with raising of funds, deciding the cheapest source of finance, utilization 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, utilizing them properly, increasing the profitability of the organization and maximizing the value of the organization and ultimately the shareholder's wealth.

Q. 11: Explain the role of Finance Manager in the changing scenario of financial management in India.

- 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.
- 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.
- He is now responsible for shaping the fortunes of the enterprise, and is involved in the most vital decision of allocation of capital like mergers, acquisitions, etc. He is working in a challenging environment which changes continuously.
- Emergence of financial service sector and development of internet in the field of information technology has also brought new challenges before the Indian finance managers.
- Development of new financial tools, 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. His role, especially, assumes significance in the present day context of liberalization, deregulation and globalization.

Q. 12: What are the main responsibilities/role of a Chief Financial Officer of an organisation? OR

Elucidate the responsibilities of Chief Financial Officer.

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.
(b) **Investment decisions:** Efficient allocation of funds to specific assets.
(c) **Financial and capital structure decisions:** Raising of funds on favourable terms as possible, i.e., determining the composition of liabilities.
(d) **Management of financial resources** (such as working capital).
(e) **Risk Management:** Protecting assets.

Q. 13 : Discuss emerging issues affecting the future role of Chief Financial Officer (CFO).

(i) **Regulation:** Regulation requirements are increasing and CFOs have an increasingly personal stake in regulatory adherence.
(ii) **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.
(iii) **Technology:** Technology is evolving very quickly, providing the potential for CFOs to reconfigure finance processes and drive business insight through 'big data' and analytics.
(iv) **Risk:** The nature of the risks that organisations face is changing, requiring more effective risk management approaches and increasingly CFOs have a role to play in ensuring an appropriate corporate ethos.
(v) **Transformation:** There will be more pressure on CFOs to transform their finance functions to drive a better service to the business at zero cost impact.
(vi) **Stakeholder Management:** Stakeholder management and relationships will become important as increasingly CFOs become the face of the corporate brand.
(vii) **Strategy:** There will be a greater role to play in strategy validation and execution, because the environment is more complex and quick changing, calling on the analytical skills CFOs can bring.
(viii) **Reporting:** Reporting requirements will broaden and continue to be burdensome for CFOs.
(ix) **Talent and Capability:** A brighter spotlight will shine on talent, capability and behaviours in the top finance role.

Q. 14 : What are the two main aspects of the Finance Function?

Long term Finance Function Decisions

1. Investment decision

❖ These decisions relate to the selection of assets in which funds will be invested by a firm. Funds procured from different sources have to be invested in various kinds of assets. Long term funds are used in a project for various fixed assets and also for current assets.

2. Financing decision

❖ These decisions relate to acquiring the optimum finance to meet financial objectives and seeing that fixed and working capital are effectively managed.

3. Dividend decision

❖ These decisions relate to the determination as to how much and how frequently cash can be paid out of the profits of an organisation as income for its owners/ shareholders. The owner of any profit-making organization looks for reward for his investment in two ways, the growth of the capital invested and the cash paid out as income; for a sole trader this income would be termed as drawings and for a limited liability company the term is dividends.

Short term Finance Function Decision

- Generally short-term decisions are reduced to management of current asset and current liability (i.e., working capital Management).

Q. 15 : What are the roles of Finance Executive in Modern World?

- Today, the role of Financial Executive, is no longer confined to accounting, financial reporting and risk management. Some of the key activities that highlight the changing role of a Finance Executive are as follows :
  - Budgeting
  - Forecasting
  - Managing M & As
  - Profitability analysis relating to customers or products
  - Pricing Analysis
  - Decisions about outsourcing
  - Overseeing the IT function.
  - Overseeing the HR function.
  - Strategic planning (sometimes overseeing this function).
  - Regulatory compliance.
  - Risk management.

CHAPTER TWO
TYPES OF FINANCING

Q. 1 : What is Debt Securitisation? Explain the basics of debt securitisation process.

Debt Securitisation:

- 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.

Process of Debt Securitisation

(i) **The origination function –** A borrower seeks a loan from a finance company, bank, HDFC. The credit worthiness of borrower is evaluated and contract is entered into with repayment schedule structured over the life of the loan.

(ii) **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.

(iii) **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.

Q. 2 : Discuss the eligibility criteria for issue of commercial paper.

The companies satisfying the following conditions are eligible to issue commercial paper.

- The tangible net worth of the company is ` 5 crores or more as per audited balance sheet of the company.
- The fund base working capital limit is not less than ` 5 crores.
- The company is required to obtain the necessary credit rating from the rating agencies such as CRISIL, ICRA etc.
- The issuers should ensure that the credit rating at the time of applying to RBI should not be more than two months old.
- The minimum current ratio should be 1.33:1 based on classification of current assets and liabilities.
- 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.
- All issue expenses shall be borne by the company issuing commercial paper.

Q. 3 : Write short notes on the following:

(1) Global Depository Receipts
(2) Euro Convertible Bonds.
(3) American Depository Receipts (ADRs)
(4) Bridge Finance
(5) Methods of Venture Capital Financing
(6) Advantages of Debt Securitisation
(7) Deep Discount Bonds vs. Zero Coupon Bonds
(8) Venture capital financing
(9) Seed capital assistance
(10) Global Depository Receipts vs. American Depository Receipts.
(11) Floating Rate Bonds
(12) Packing Credit

1. Global Depository Receipts (GDRs)

- It is a negotiable certificate denominated in US dollars which represents a Non-US company's publically traded local currency equity shares. GDRs are created when the local currency shares of an Indian company are delivered to Depository's local custodian Bank against which the Depository bank issues depository receipts in US dollars. The GDRs may be traded freely in the overseas market like any other dollar-expressed security either on a foreign stock exchange or in the over- the-counter market or among qualified institutional buyers.
- By issue of GDRs Indian companies are able to tap global equity market to raise foreign currency funds by way of equity. It has distinct advantage over debt as there is no repayment of the principal and service costs are lower.

2. Euro Convertible Bond

- Euro Convertible bonds are quasi-debt securities (unsecured) which can be converted into depository receipts or local shares. ECBs offer the investor an option to convert the bond into equity at a fixed price after the minimum lock in period. The price of equity shares at the time of conversion will have a premium element. The bonds carry a fixed rate of interest. These are bearer securities and generally the issue of such bonds may carry two options viz. call option and put option. A call option allows the company to force conversion if the market price of the shares exceeds a particular percentage of the conversion price. A put option allows the investors to get his money back before maturity. In the case of ECBs, the payment of interest and the redemption of the bonds will be made by the issuer company in US dollars. ECBs issues are listed at London or Luxemburg stock exchanges.
- An issuing company desirous of raising the ECBs is required to obtain prior permission of the Department of Economic Affairs, Ministry of Finance, Government of India, Companies having 3 years of good track record will only be permitted to raise funds. The condition is not applicable in the case of projects in infrastructure sector. The proceeds of ECBs would be permitted only for following purposes:
  (i) Import of capital goods
  (ii) Retiring foreign currency debts

(iii) Capitalising Indian joint venture abroad
(iv) 25% of total proceedings can be used for working capital and general corporate restructuring.

- The impact of such issues has been to procure for the issuing companies' finances at very competitive rates of interest. For the country a higher debt means a forex outgo in terms of interest.

3. American Depository Receipts (ADRs)

- American Depository Receipts (ADRs) are securities offered by non- US companies who want to list on any of the US exchanges. It is a derivative instrument. It represents a certain number of company's shares. These are used by depository bank against a fee income. ADRs allow US investors to buy shares of these companies without the cost of investing directly in a foreign stock exchange. ADRs are listed on either NYSE or NASDAQ. 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.

4. Bridge Finance

- 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. However, once the loans are approved in principle, firms in order not to lose further time in starting their projects arrange for bridge finance. Such temporary loan is normally repaid out of the proceeds of the principal term loans. 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.

5. Methods of Venture Capital Financing

- The venture capital financing refers to financing and funding of the small scale enterprises, high technology and risky ventures. Some common methods of venture capital financing are as follows:

(i) **Equity financing:** The venture capital undertakings generally requires funds for a longer period but may not be able to provide returns to the investors during the initial stages. Therefore, the venture capital finance is generally provided by way of equity share capital. The equity contribution of venture capital firm does not exceed 49% of the total equity capital of venture capital undertakings so that the effective control and ownership remains with the entrepreneur.

(ii) **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. In India Venture Capital Financers charge royalty ranging between 2 to 15 per cent; actual rate depends on other factors of the venture such as gestation period, cash flow patterns, riskiness and other factors of the enterprise. Some Venture Capital financers give a choice to the enterprise of paying a high rate of interest (which could be well above 20 per cent) instead of royalty on sales once it becomes commercially sound.

(iii) **Income Note:** It is a hybrid security which combines the features of both conventional loan and conditional loan. The entrepreneur has to pay both interest and royalty on sales but at substantially low rates. IDBI's Venture Capital Fund provides funding equal to 80-87.5% of the project's cost for commercial application of indigenous technology or adopting imported technology to domestic applications.

(iv) **Participating Debenture:** Such security carries charges in three phases- in the start- up phase, no interest is charged, next stage a low rate of interest is charged upto a particular level of operations, after that, a high rate of interest is required to be paid.

6. Advantages of Debt Securitisation

- Debt securitisation is a method of recycling of funds and is especially beneficial to financial intermediaries to support lending volumes. Simply stated, under debt securitisation a group of illiquid assets say a mortgage or any asset that yields stable and regular cash flows like bank loans, consumer finance, and credit card payment are pooled together and sold to intermediary. The intermediary then issue debt securities.
- The advantages of debt securitisation to the originator are the following:
  - (i) The asset is shifted off the Balance Sheet, thus giving the originator recourse to off balance sheet funding.
  - (ii) It converts illiquid assets to liquid portfolio.
  - (iii) It facilitates better balance sheet management; assets are transferred off balance sheet facilitating satisfaction of capital adequacy norms.
  - (iv) The originator's credit rating enhances.
- For the investors securitisation opens up new investment avenues. Though the investor bears the credit risk, the securities are tied up to definite assets.

7. Deep Discount Bonds vs. Zero Coupon Bonds

- Deep Discount Bonds (DDBs) are in the form of zero interest bonds. These bonds are sold at a discounted value and on maturity face value is paid to the investors. In such bonds, there is no interest payout during lock- in period.
- IDBI was first to issue a Deep Discount Bonds (DDBs) in India in January 1992. The bond of a face value of ` 1 lakh was sold for ` 2,700 with a maturity period of 25 years.
- A zero coupon bond (ZCB) does not carry any interest but it is sold by the issuing company at a discount. The difference between discounted value and maturing or face value represents the interest to be earned by the investor on such bonds.

8. Venture Capital Financing

- The term venture capital refers to capital investment made in a business or industrial enterprise, which carries elements of risks and insecurity and the probability of business hazards. Capital investment may assume the form of either equity or debt or both as a derivative instrument. The risk associated with the enterprise could be so high as to entail total loss or be so insignificant as to lead to high gains.
- The European Venture Capital Association describes venture capital as risk finance for entrepreneurial growth oriented companies. It is an investment for the medium or long term seeking to maximise the return.
- Venture Capital, thus, implies an investment in the form of equity for high-risk projects with the expectation of higher profits. The investments are made through private placement with the expectation of risk of total loss or huge returns. High technology industry is more attractive to venture capital financing due to the high profit potential. The main object of investing equity is to get high capital profit at saturation stage.
- In broad sense under venture capital financing venture capitalist makes investment to purchase debt or equity from inexperienced entrepreneurs who undertake highly risky ventures with potential of success.

9. Seed Capital Assistance

- The seed capital assistance has been designed by IDBI for professionally or technically qualified entrepreneurs. All the projects eligible for financial assistance from IDBI, directly or indirectly through refinance are eligible under the scheme.
- The project cost should not exceed ` 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.
- 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.

10. Global Depository Receipts and American Depository Receipts

- 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. 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.
- Whereas, American Depository Receipts (ADR) are securities offered by non-US companies who want to list on any of the US exchange. Each ADR represents a certain number of a company's regular shares. ADRs allow US investors to buy shares of these companies without the costs of investing directly in a foreign stock exchange. ADRs are issued by an approved New York bank or trust company against the deposit of the original shares. 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.

11. Floating Rate Bonds

- These are the bonds where the interest rate is not fixed and is allowed to float depending upon the market conditions. These are ideal instruments which can be resorted to by the issuers to hedge themselves against the volatility in the interest rates. They have become more popular as a money market instrument and have been successfully issued by financial institutions like IDBI, ICICI etc.

12. Packing Credit

- Packing credit is an advance made available by banks to an exporter. Any exporter, having at hand a firm export order placed with him by his foreign buyer on an irrevocable letter of credit opened in his favour, can approach a bank for availing of packing credit. An advance so taken by an exporter is required to be liquidated within 180 days from the date of its commencement by negotiation of export bills or receipt of export proceeds in an approved manner. Thus Packing Credit is essentially a short-term advance.
- Normally, banks insist upon their customers to lodge the irrevocable letters of credit opened in favour of the customer by the overseas buyers. The letter of credit and firms' sale contracts not only serve as evidence of a definite arrangement for realisation of the export proceeds but also indicate the amount of finance required by the exporter. Packing Credit, in the case of customers of long standing may also be granted against firm contracts entered into by them with overseas buyers.

Q. 4 : STATE THE DIFFERENT TYPES OF PACKING CREDIT.

Packing credit may be of the following types:

(i) **Clean Packing credit :** 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. It is a clean type of export advance. Each proposal is weighted according to particular requirements of the trade and credit worthiness of the exporter. A suitable margin has to be maintained. Also, Export Credit Guarantee Corporation (ECGC) cover should be obtained by the bank.

(ii) **Packing credit against hypothecation of goods :** 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. At the time of utilising 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 whenever there is any movement in stocks.

(iii) **Packing credit against pledge of goods :** 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. The possession of the goods so pledged lies with the bank and is kept under its lock and key.

(iv) **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.

(v) **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. 5 : NAME THE VARIOUS FINANCIAL INSTRUMENTS DEALT WITH IN THE INTERNATIONAL MARKET.

Some of the various financial instruments dealt with in the international market are:

(a) Euro Bonds
(b) Foreign Bonds
(c) Fully Hedged Bonds
(d) Medium Term Notes
(e) Floating Rate Notes
(f) External Commercial Borrowings
(g) Foreign Currency Futures
(h) Foreign Currency Option
(i) Euro Commercial Papers.

Q. 6 : DISCUSS THE ADVANTAGES OF RAISING FUNDS BY ISSUE OF EQUITY SHARES.

(i) It is a permanent source of finance. Since such shares are not redeemable, the company has no liability for cash outflows associated with its redemption.

(ii) Equity capital increases the company's financial base and thus helps further the borrowing powers of the company.

(iii) The company is not obliged legally to pay dividends. Hence in times of uncertainties or when the company is not performing well, dividend payments can be reduced or even suspended.

(iv) The company can make further issue of share capital by making a right issue.

Q. 7 : "Financing a business through borrowing is cheaper than using equity." Briefly explain.

(i) Debt capital is cheaper than equity capital from the point of its cost and interest being deductible for income tax purpose, whereas no such deduction is allowed for dividends.

(ii) Issue of new equity dilutes existing control pattern while borrowing does not result in dilution of control.

(iii) In a period of rising prices, borrowing is advantageous. The fixed monetary outgo decreases in real terms as the price level increases.

Q. 8 : State the main features of deep discount bonds.

- 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. In such bonds, there is no interest payout during the lock- in period. The investors can sell the bonds in stock market and realise the difference between face value and market price as capital gain.
- IDBI was the first to issue deep discount bonds in India in January 1993. The bond of a face value of ` 1 lakh was sold for ` 2700 with a maturity period of 25 years.

Q. 9 : Explain in brief the features of Commercial Paper.

- 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:

  (i) Enabling the highly rated corporate borrowers to diversify their sources of short term borrowings, and

  (ii) 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 ` 5 lakh or multiples therefore. All eligible issuers are required to get the credit rating from credit rating agencies.

Q. 10 : Explain the term 'Ploughing back of Profits'.

Meaning

- Ploughing back of Profits or Retained earnings means retention of profit.
- In other words, that part of surplus profit which is not distributed as dividend are termed as Retained Profit or Ploughing back of Profits.

Features

- Retained Earnings are an internal source of long term financing and are treated as long term funds.
- Such funds belong to the ordinary shareholders and increase the net worth of the company.
- A public limited company must plough back a reasonable amount of profit every year keeping in view the legal requirements in this regard and its own expansion plans.
- Such funds also entail almost no risk.
- Further, control of present owners is also not diluted by retaining
- profits.

Q. 11 : Distinguish between Operating Lease and Financial Lease.

S.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. 12 : State the main elements of Leveraged Lease.

- Under this lease, a third party is involved beside lessor and lessee. The lessor borrows a part of the purchase cost (say 80%) of the asset from the third party i.e., lender. The asset so purchased is held as security against the loan.
- 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. The lessor is entitled to claim depreciation allowance.

Q. 13 : Discuss the advantages of preference share capital as an instrument of raising funds.

Advantages of Issue of Preference Shares are:

(i) No dilution in EPS on enlarged capital base.
(ii) There is no risk of takeover as the preference shareholders do not have voting rights.
(iii) There is leveraging advantage as it bears a fixed charge.
(iv) The preference dividends are fixed and pre-decided. Preference shareholders do not participate in surplus profit as the ordinary shareholders
(v) Preference capital can be redeemed after a specified period.

Q. 14 : Explain briefly the features of External Commercial Borrowings (ECBs).

- External Commercial Borrowings are loans taken from non-resident lenders in accordance with exchange control regulations. These loans can be taken from:
  - International banks
  - Capital markets
  - Multilateral financial institutions like IFC, ADB, IBRD etc.
  - Export Credit Agencies
  - Foreign collaborators
  - Foreign Equity Holders.
- ECBs can be accessed under automatic and approval routes depending upon the purpose and volume.
- In automatic there is no need for any approval from RBI / Government while approval is required for areas such as textiles and steel sectors restructuring packages.

Q. 15 : Discuss the 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.

Q. 16 : Differentiate between Factoring and Bills discounting.

The differences between Factoring and Bills discounting are:

(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 the case of bills discounting, the Negotiable Instruments Act is applicable.

Q. 17 : What is factoring? Enumerate the main advantages of factoring.

- Factoring 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. 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.

Advantages of Factoring

The main advantages of factoring are:

(i) The firm can convert accounts receivables into cash without bothering about repayment.
(ii) Factoring ensures a definite pattern of cash inflows.
(iii) Continuous factoring virtually eliminates the need for the credit department. Factoring is gaining popularity as useful source of financing short-term funds requirement of business enterprises because of the inherent advantage of flexibility it affords to the borrowing firm. The seller firm may continue to finance its receivables on a more or less automatic basis. If sales expand or contract it can vary the financing proportionally.
(iv) Unlike an unsecured loan, compensating balances are not required in this case. Another advantage consists of relieving the borrowing firm of substantially credit and collection costs and from a considerable part of cash management.

Q. 18 : Discuss the factors that a venture capitalist should consider before financing any risky project.

(i) Quality of the management team is a very important factor to be considered. They are required to show a high level of commitment to the project.
(ii) The technical ability of the team is also vital. They should be able to develop and produce a new product / service.
(iii) Technical feasibility of the new product / service should be considered.

(iv) Since the risk involved in investing in the company is quite high, venture capitalists should ensure that the prospects for future profits compensate for the risk.
(v) A research must be carried out to ensure that there is a market for the new product.
(vi) The venture capitalist himself should have the capacity to bear risk or loss, if the project fails.
(vii) The venture capitalist should try to establish a number of exist routes.
(viii) In case of companies, venture capitalist can seek for a place on the Board of Directors to have a say on all significant matters affecting the business.

Q. 19 : What are Masala Bonds?

- Masala (means spice) bond is an Indian name used for Rupee denominated bond that Indian corporate borrowers can sell to investors in overseas markets.
- These bonds are issued outside India but de- nominated in Indian Rupees.
- NTPC raised `2,000 crore via masala bonds for its capital expenditure in the year 2016.

Q. 20 : Explain 'Sales & Lease Back'.

- 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.
- Under this arrangement, the asset are not physically exchanged but it all happen in records only.
- 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.
- 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 gels the lease rentals.

Q. 21 : What is meant by venture capital financing? State its various methods.

Meaning of Venture Capital

- The venture capital financing refers to financing and funding of the small scale enterprises, high technology and risky ventures.

Methods of Venture Capital financing

1. Equity financing

- The venture capital undertakings generally requires funds for a longer period but may not be able to provide returns to the investors during the initial stages.
- Therefore, the venture capital finance is generally provided by way of equity share capital.

2. 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.
- In India, Venture Capital Financers charge royalty ranging between 2 to 15 per cent; actual rate depends on other factors of the venture such as
- gestation period,
- cash flow patterns,
- riskiness and

- other factors of the enterprise.

3. Income Note

- It is a hybrid security which combines the features of both conventional loan and conditional loan.
- The entrepreneur has to pay both interest and royalty on sales but at substantially low rates.

4. Participating Debenture

- Such security carries charges in three phases :
- in the startup phase, no interest is charged,
- next stage a low rate of interest is charged upto a particular level of operations,
- after that, a high rate of interest is required to be paid.

Q. 22 : Distinguish between the Preference Shares and Debentures.

Basis	Preference Share	Debenture
Ownership	Preference Share Capital is a special kind of share i.e. part of ownership.	Debenture is a type of loan which can be raised from the public.
Dividend/ Interest	It carries fixed percentage of dividend.	It carries fixed percentage of interest.
Charge or appropriation	Dividend on preference share is appropriation against profits.	Interest on debentures is charge against profits.
Nature	Preference shares are a hybrid form of financing with some characteristic of equity shares and some attributes of Debt Capital.	Debentures are instrument for raising long term capital with a period of maturity.

Q. 23 : Explain in brief following financial instruments :
(1) Euro Bonds
(2) Floating Rate Notes
(3) Euro Commercial Paper
(4) Fully Hedged Bond

1. Euro Bonds

- These are the Bonds issued or traded in a country using a currency other than the one in which the bond is denominated. These are issued by multinational corporations, for example, a British company may issue a Eurobond in Germany, denominating it in U.S. dollars.

2. 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.

3. Euro Commercial Paper

- These are short term money market instruments. They are for maturities less than one year. They are usually designated in US Dollars.

4. Fully Hedged Bond

- Usually in foreign bonds, the risk of currency fluctuations exists. Fully hedged bonds eliminate the risk by selling in forward markets the entire stream of principal and interest payments.

CHAPTER 3

COST OF CAPITAL

Q. 1 : WHAT DO YOU UNDERSTAND BY WEIGHTED AVERAGE COST OF CAPITAL?

Meaning

- The composite or overall cost of capital of a firm is the weighted average of the costs of the various sources of funds.
  - Weights are taken to be in the proportion of each source of fund in the capital structure.
  - While making financial decisions, this overall or weighted cost is used.
  - Each investment is financed from a pool of funds which represents the various sources from which funds have been raised.
  - 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.

Calculation

The weighted average cost of capital is calculated by :

- Calculating the cost of specific source of fund e.g. cost of debt, equity etc;
- Multiplying the cost of each source by its proportion in capital structure; and
- Adding the weighted component cost to get the firm's WACC represented by k0.

  k0 = k1 w1 + k2 w2 + ...
  Where,
  k1, k2 are component costs and w1, w2 are weights.

CHAPTER - 4
LEVERAGE

Q. 1 : What do you understand by Business Risk and Financial Risk?

1. Business Risk

- Business risk refers to the risk associated with the firm's operations.
  - 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).
  - 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.

2. Financial Risk

- Financial risk refers to the additional risk placed on firm's shareholders as a result of debt use in financing.
  - Companies that issue more debt instruments would have higher financial risk than companies financed mostly by equity.
  - Financial risk can be measured by ratios such as firm's financial
  - leverage multiplier, total debt to assets ratio etc.

Q. 2 : Distinguish between Business Risk and Financial Risk.

Basis	Business Risk	Financial Risk
Meaning	Business Risk refers to the risk associated with the firm's operations. In other words, Business Risk is defined as risk of running a business.	Financial Risk refers to the additional risk placed on the firm's shareholders as a result of use of debt.
Type of cost	It occurs due to fixed operating cost.	It occurs due to fixed financing cost.
Avoidable or Unavoidable	Business Risk is generally unavoidable.	Financial Risk can be avoided by not using the source of finance involving fixed payment.
Higher Risk	Higher the fixed operating cost, higher the Business Risk.	Companies that issue more debt instruments would have higher financial risk than companies financed mostly or entirely by equity.

Q. 3 : "Operating risk is associated with cost structure, whereas financial risk is associated with capital structure of a business concern." Critically examine this statement.

Validity of statement

- The statement is valid that "Operating risk is associated with cost structure whereas financial risk is associated with capital structure of a business concern".

Explanation

- 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.
- 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.

CHAPTER - 5

CAPITAL STRUCTURE

Q. 1 : WHAT DO YOU UNDERSTAND BY CAPITAL STRUCTURE? HOW DOES IT DIFFER FROM FINANCIAL STRUCTURE?

1. Meaning of Capital Structure

- Capital Structure refers to the combination of debt and equity which a company uses to finance its long-term operations.
- 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.

2. Financial Structure

- On the other hand, Financial Structure is the entire left-hand side of the balance sheet which represents all the long-term and short-term sources of capital.
- Thus, capital structure is only a part of financial structure.

Q. 2 : DISCUSS FINANCIAL BREAK–EVEN AND EBIT–EPS INDIFFERENCE ANALYSIS.

1. Financial Break Even

- Financial break-even point is the minimum level of EBIT needed to satisfy all the fixed financial charges i.e. interest and preference dividend.
- It denotes the level of EBIT for which firm's EPS equals zero.
- 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.

2. EBIT–EPS indifference analysis

- EBIT-EPS analysis is a vital tool for designing the optimal capital structure of a firm.
- The objective of this analysis is to find the EBIT level that will equate EPS regardless of the financing plan chosen.

Computation

$$\boxed{\frac{(\text{EBIT} - \text{I1})\,(1 - \text{t})}{n1} = \frac{(\text{EBIT} - \text{I2})\,(1 - \text{t})}{n2}}$$

Where
EBIT = Indifference point
n1 = Number of equity shares in Alternative 1
n2 = Number of equity shares in Alternative 2
I1 = Interest charges in Alternative 1
I2 = Interest charges in Alternative 2
t = Tax Rate
Alternative 1 = All equity finance
Alternative 2 = Debt-equity finance.

Q. 3 : List the fundamental principles governing capital structure. OR State the principles that should be followed while designing the capital structure of a company.

1. 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).

2. 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 unfavourable business situation.

3. Control Principle

- While designing a capital structure, the finance manager may also keep in mind that existing management control and ownership remains undisturbed.

4. 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.

5. Other Considerations

- Besides above principles, other factors such as nature of industry, timing of issue and competition in the industry should also be considered.

Q. 4 : What is Over Capitalisation? State its causes and consequences.

Meaning of Over Capitalisation

- 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

- Raising more money through issue of shares or debentures than company can employ profitably.
- Borrowing huge amount at higher rate than rate at which company can earn.
- Excessive payment for the acquisition of fictitious assets such as goodwill etc.
- Improper provision for depreciation, replacement of assets and distribution of dividends at a higher rate.
- Wrong estimation of earnings and capitalization.

Consequences

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

Q. 5 : WHAT DO YOU MEAN BY CAPITAL STRUCTURE? STATE ITS SIGNIFICANCE IN FINANCING DECISION.

1. Meaning of 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.

2. Significance in Financing Decision

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

3. 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.

CHAPTER - 6

THEORIES OF CAPITAL STRUCTURE

Q. 1 : WHAT IS NET OPERATING INCOME THEORY OF CAPITAL STRUCTURE? EXPLAIN THE ASSUMPTIONS ON WHICH THE NOI THEORY IS BASED.

Meaning

- According to this approach, there is no relationship between the cost of capital and value of the firm.
- The value of the firm is independent of the capital structure of the firm.

Assumptions

- There are no taxes.
- The market capitalizes the value of the firm as a whole. Thus, the split between debt and equity is not important.
- The increase in proportion of debt in capital structure leads to change in risk perception of the shareholders i.e. increase in cost of equity (Ke). The increase in cost of equity is such as completely offset the benefits of using cheaper debt.
- The overall cost of capital remains same for all degrees of debt equity mix.

CHAPTER - 7

INVESTMENT DECISIONS (CAPITAL BUDGETING)

Q. 1 : EXPLAIN THE TERM DESIRABILITY FACTOR.

- 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'.

Formula

$$\frac{\textit{Sum of Discounted Cash Inflows}}{\textit{Initial Cash Outlay or Total Discounted Cash Outflow}}$$

Acceptance Criteria

- A project is acceptable if its profitability index value is greater than 1.

Q. 2 : DISTINGUISH BETWEEN NET PRESENT VALUE METHOD AND INTERNAL RATE OF RETURN METHOD.

1. Introduction

- 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.
- 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 favours another.

2. Causes of difference

- The different rankings given by NPV and IRR methods could be due to
  - Size disparity problem,
  - time disparity problem and
  - unequal expected lives.

3. Absolute value or percentage

- The net present value is expressed in financial values whereas internal rate of return (IRR) is expressed in percentage terms.

4. Reinvestment of cash flows

- In the net present value, 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. 3 : WHAT IS 'INTERNAL RATE OF RETURN'? EXPLAIN.

Meaning

- It is that rate at which discounted cash inflows are equal to the discounted cash outflows.

- Computation
- This rate is to be found by trial and error method.
- This rate is used in the evaluation of investment proposals.
- In this method, the discount rate is not known but the cash outflows and cash inflows are known.

Relevance

- 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.

Q. 4 : Which method of comparing a number of investment proposals is most suited if each proposal involves different amount of cash inflows? Explain and state its limitations.

- Profitability Index (PI) method is best suited if each investment proposal involves different amount of cash inflows. PI considers both present value of cash inflows and present value of cash outflows.

Formula

$$\boxed{\frac{\textit{Sum of Discounted Cash Inflows}}{\textit{Initial Cash Outlay or Total Discounted Cash Outflow}}}$$

1. Acceptance Criteria

- A project is acceptable if its profitability index value is greater than 1.

2. Superiority

- PI is known as a superior method of comparing a number of investment proposal than Net present value method (NPV).

3. Limitations

- Profitability index fails as a guide in resolving capital rationing where projects are indivisible.
- Once a single large project with high NPV is selected, possibility of accepting several small projects which together may have higher NPV than the single project is excluded.
- Also, situations may arise where a project with a lower profitability index selected may generate cash flows in such a way that another project can be taken up 1 or 2 years later, the total NPV in such case being more than the one with a project with highest Profitability Index.

CHAPTER - 8

ESTIMATION OF WORKING CAPITAL

Q. 1 : DISCUSS THE ESTIMATION OF WORKING CAPITAL NEED BASED ON OPERATING CYCLE PROCESS.

Meaning

- One of the methods for forecasting working capital requirement is based on the concept of operating cycle.
- The determination of operating capital cycle helps in the forecast, control and management of working capital.
- The duration of working capital cycle may vary depending on the nature of the business.

Relevance

- The length of operating cycle is the indicator of performance of management.
- The net operating cycle represents the time interval for which the firm has to negotiate for Working Capital from its Bankers.
- It enables to determine accurately the amount of working capital needed for the continuous operation of business activities.

Formula

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

$$\boxed{\textbf{Operating Cycle} = R + W + F + D - C}$$

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

CHAPTER - 9

DEBTOR'S MANAGEMENT

Q. 1 : DIFFERENTIATE BETWEEN FACTORING AND BILLS DISCOUNTING.

Basis	Factoring	Bill Discounting
Other name	Factoring is called as "Invoice Factoring".	Bills discounting is known as 'Invoice discounting.'
Parties	In Factoring, the parties are known as the client, factor and debtor.	In Bills discounting, they are known as drawer, drawee and payee.
Purpose	Factoring is a sort of management of book debts.	Bills discounting is a sort of borrowing from commercial banks.
Relevant statute	For factoring, there is no specific act.	In the case of bills discounting, the Negotiable Instruments Act is applicable.

Q. 2 : EXPLAIN BRIEFLY THE ACCOUNTS RECEIVABLE SYSTEMS.

- Manual systems of recording the transactions and managing receivables are cumbersome and costly.
- The automated receivable management systems automatically update all the accounting records affected by a transaction.
- 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. 3 : WHAT IS FACTORING? ENUMERATE THE MAIN ADVANTAGES OF FACTORING.

Meaning

- 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.
- Its operation is very simple.
- Clients enter into an agreement with the "factor" working out a factoring arrangement according to his requirements.
- The factor then takes the responsibility of monitoring, follow-up, collection and risk-taking and provision of advance.
- The factor generally fixes up a limit customer-wise for the client (seller).

Advantages

1. Convertibility

- The biggest advantages of factoring are the immediate conversion of receivables into cash.

2. Reduction in Costs

- Continuous factoring virtually eliminates the need for the credit department due to saving in collection and administration cost.

3. Certainty

- Factoring ensures a definite pattern of cash inflows.

4. No feature of loan

- There is no debt repayment, no compromise to balance sheet, no long term agreements or delays associated with other methods of raising capital.

CHAPTER - 10
TREASURY & CASH MANAGEMENT

Q. 1 : WRITE SHORT NOTE ON WILLIAM J. BAUMAL VS. MILLER–ORR CASH MANAGEMENT MODEL.

- 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.
- 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.
- 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

- When the cash balance reaches the upper limit, the transfer of cash equal to 'h – z' is invested in marketable securities account.
- When it touches the lower limit, a transfer from marketable securities account to cash account is made.
- 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.
- These limits satisfy the demands for cash at the lowest possible total costs.

Q. 2 : STATE THE ADVANTAGE OF ELECTRONIC CASH MANAGEMENT SYSTEM.

- Significant saving in time.
- Decrease in interest costs.
- Less paper work.
- Greater accounting accuracy.
- More control over time and funds.

- Supports electronic payments.
- Faster transfer of funds from one location to another, where required.
- Speedy conversion of various instruments into cash.
- Making available funds wherever required, whenever required.
- Reduction in the amount of 'idle float' to the maximum possible extent.
- Ensures no idle funds are placed at any place in the organization.
- It makes inter-bank balancing of funds much easier.
- It is a true form of centralised 'Cash Management'.
- Produces faster electronic reconciliation.
- Allows for detection of book-keeping errors.
- Reduces the number of cheques issued.
- Earns interest income or reduce interest expense.

Q. 3 : What is Virtual Banking? State its advantages.

Meaning

- 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.

Advantages

- Lower cost of handling a transaction.
- The increased speed of response to customer requirements.
- The lower cost of operating branch network along with reduced staff costs leads to cost efficiency.
- Possibility of improved and a range of services being made available to the customer rapidly, accurately and at his convenience.

Q. 4 : 'Management of marketable securities is an integral part of investment of cash.' Comment.

- 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.
- 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.
- The selection of securities should be guided by three principles namely
  - safety,
  - maturity and
  - marketability.

Q. 5 : Explain the following :
(1) Concentration Banking
(2) Lock Box System

1. Concentration Banking

- In concentration banking, the company establishes a number of strategic collection centres in different regions instead of a single collection centre at the head office.
- 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.
- Payments received by the different collection centres are deposited with their respective local banks which in turn transfer all surplus funds to the concentration bank of head office.

2. Lock Box System

- Another means to accelerate the flow of funds is a lock box system.
- The purpose of lock box system is to eliminate the time between the receipts of remittances by the company and deposited in the bank.
- A lock box arrangement usually is on regional basis which a company chooses according to its billing patterns.

Q. 6 : Explain four kinds of float with reference to management of cash.

1. Billing Float

- The time between the sale and the mailing of the invoice is the billing float.

2. Mail Float

- This is the time when a cheque is being processed by post office, messenger service or other means of delivery.

3. 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.

4. Bank processing float

- This is the time from the deposit of the cheque to the crediting of funds in the seller's account.

Q. 7 : Evaluate the role of cash budget in effective cash management system.

- Cash Budget is the most significant device to plan for and control cash receipts and payments.
- It plays a very significant role in effective Cash Management System.
- This represents cash requirements of business during the budget period.

The various roles of cash budgets in Cash Management System are :

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

Q. 8 : DESCRIBE THE THREE PRINCIPLES RELATING TO SELECTION OF MARKETABLE SECURITIES.

1. Safety

- Return and risks go hand in hand.
- As the objective in this investment is ensuring liquidity, minimum risk is the criterion of selection.

2. 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.

3. 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.

Q. 9 : EXPLAIN BRIEFLY THE FUNCTIONS OF TREASURY DEPARTMENT.

- The functions of treasury department management are to ensure proper usage, storage and risk management of liquid funds so as to ensure that the organisation is able to meet its obligations, collect its receivables and also maximize the return on its investments.

Towards this end, the treasury function may be divided into the following :

1. Cash

- The efficient collection and payment of cash both inside the Management organisation and to third parties is the function of treasury department.
- Treasury normally manages surplus funds in an investment portfolio.

2. 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.

3. 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.

4. 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.

5. Corporate Finance

- Treasury department is involved with both acquisition and disinvestment activities within the group.
- In addition, it is often responsible for investor relations.

CHAPTER - 11

WORKING CAPITAL FINANCE

Q. 1 : ENUMERATE THE VARIOUS FORMS OF BANK CREDIT IN FINANCING WORKING CAPITAL OF A BUSINESS ORGANIZATION.

1. 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, govt. securities, life insurance policies and fixed deposit receipts, etc.

2. 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.

3. 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.

4. 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.

5. 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.

6. 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.

7. 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.

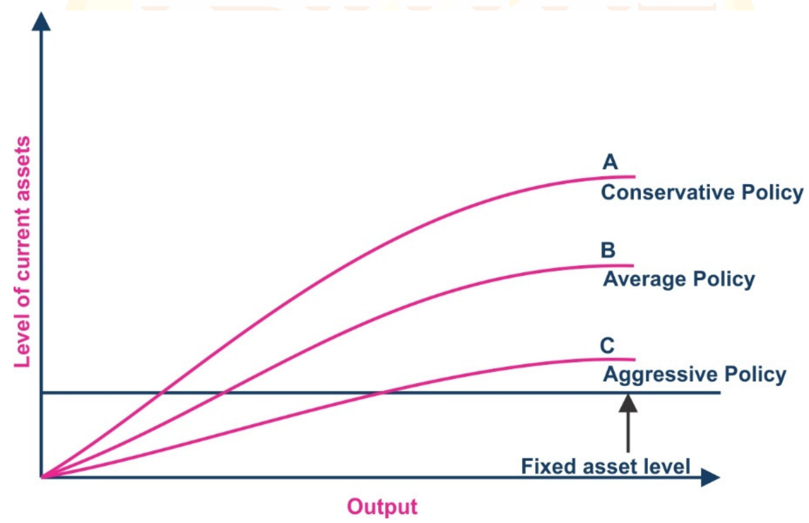
- An advance against the pledge of such documents is an advance against the pledge of goods themselves.

8. 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.

Q. 2 : DISCUSS THE LIQUIDITY VS. PROFITABILITY ISSUE IN MANAGEMENT OF WORKING CAPITAL.

- Working capital management entails the control and monitoring of all components of working capital i.e. cash, marketable securities, debtors, creditors etc.
- Finance manager has to pay particular attention to the levels of current assets and their financing.
- To decide the level of financing of current assets, the risk return trade off must be taken into account.
- The level of current assets can be measured by creating a relationship between current assets and fixed assets.
- A firm may follow a conservative, aggressive or moderate policy.



- 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. 3 : DISCUSS THE RISK-RETURN CONSIDERATIONS IN FINANCING CURRENT ASSETS.

1. Introduction

- The financing of current assets involves a trade-off between risk and return.
- A firm can choose from short or long term sources of finance.
- Short term financing is less expensive than long term financing but at the same time, short term financing involves greater risk than long term financing.
- Depending on the mix of short term and long term financing, the approach followed by a company may be referred as matching approach, conservative approach and aggressive approach.

2. Matching Approach

- In matching approach, long-term finance is used to finance fixed assets and permanent current assets and short term financing to finance temporary or variable current assets.

3. Conservative Approach

- Under the conservative plan, the firm finances its permanent assets and also a part of temporary current assets with long term financing and hence less risk of facing the problem of shortage of funds.

4. Aggressive Approach

- An aggressive policy is said to be followed by the firm when it uses more short term financing than warranted by the matching plan and finances a part of its permanent current assets with short term financing.

CHAPTER - 12
RATIO ANALYSIS

Q. 1 : EXPLAIN BRIEFLY THE LIMITATIONS OF FINANCIAL RATIOS.

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 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

- Seasonal factors may also influence financial data.

4. Biased ratios

- 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. No standard set of ratios

- 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.

CHAPTER - 13

RISK ANALYSIS IN CAPITAL BUDGETING

Q. 1 : WHAT IS CERTAINTY EQUIVALENT.

1. Definition

- As per CIMA terminology, "An approach to dealing with risk in a capital budgeting context.
- It involves expressing risky future cash flows in terms of the certain cashflow which would be considered, by the decision maker, as their equivalent, that is the decision maker would be indifferent between the risky amount and the (lower) riskless amount considered to be its equivalent."

2. Mechanism

- The certainty equivalent is a guaranteed return that the management would accept rather than accepting a higher but uncertain return.
- This approach allows the decision maker to incorporate his or her utility function into the analysis.
- In this approach, a set of risk less cash flow is generated in place of the original cash flows.

3. Advantages

- It is simple and easy to understand and apply.
- It can easily be calculated for different risk levels applicable to different cash flows.

4. Disadvantages

- There is no Statistical or Mathematical model available to estimate certainty Equivalent.
- Certainty Equivalent are subjective and vary as per each individual's estimate.

Q. 2 : WRITE TWO MAIN REASONS FOR CONSIDERING RISK IN CAPITAL BUDGETING DECISIONS.

1. Opportunity Cost

- There is an opportunity cost involved while investing in a project for the level of risk. Adjustment of risk is necessary to help make the decision as to whether the returns out of the project are proportionate with the risks borne and whether it is worth investing in the project over the other investment options available.

2. Real Value

- Risk adjustment is required to know the real value of the Cash Inflows.

Q. 3 : EXPLAIN THE STEPS OF SENSITIVITY ANALYSIS.

Sensitivity Analysis is conducted by following the steps as below:

1. Finding variables, which have an influence on the NPV (or IRR) of the project
2. Establishing mathematical relationship between the variables.
3. Analysing the effect of the change in each of the variables on the NPV (or IRR) of the project.