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**SUBJECT CODE: 8B, MATERIAL NO: 50  
FINANCIAL MANAGEMENT THEORY \_ 40e**

(NEW EDITION THOROUGHLY REVISED & UPDATED UPTO NOV 2018. APPLICABLE FOR MAY / NOV 2019 EXAMINATIONS UNDER NEW SYLLABUS OF CA INTER. THIS MATERIAL IS SYNCHRONISED WITH JULY 2017 EDITION OF ICAI SM. THIS MATERIAL IS ISSUED ON 14.12.18)



# MASTER MINDS

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# 1. SCOPE AND OBJECTIVE OF FINANCIAL MANAGEMENT

## MODEL NO 1: MEANING & ASPECTS OF FINANCIAL MANAGEMENT

**Q.No.1. What is Financial Management? What are the two basic aspects of Financial Management? (B)**  
(NEW SM, OLD SM, PM, N09 - 3M, RTP - M14)

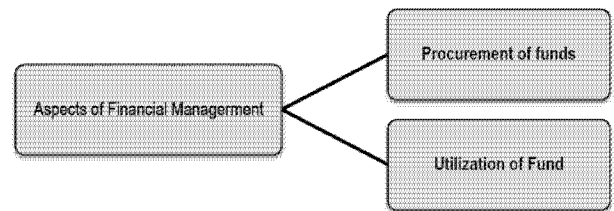
### FINANCIAL MANAGEMENT:

- Financial Management is that managerial activity which is concerned with planning and controlling of the firm's financial resources.
- It is an integrated decision making process concerned with acquiring, financing and managing assets to accomplish the overall goals of a business organization.

### ASPECTS OF FINANCIAL MANAGEMENT:

#### 1) PROCUREMENT OF FUNDS:

- Funds can be obtained from different sources like Equity, Preference capital, Debentures, Term loans, Funding from Banks, International Funding, etc.
- Each source will have different characteristics in terms of risk, cost and control.
- The cost of funds should be at the minimum level and for that risk and control factors must be balanced.
- We should also strike a balance between equity and debt.



#### 2) EFFECTIVE UTILISATION OF FUNDS:

- The finance manager is also responsible for effective utilisation of funds.
- He has to identify the situations where the funds are being kept idle or not properly used.
- Funds must be utilised in a manner so that they generate an income higher than the cost of procuring them.
- For taking long term investment decisions a finance manager can use techniques of Capital Budgeting.
- He shall also allocate optimum funds for Working Capital and shall see that too much funds are not blocked in inventories, book debts, cash, etc.

### SIMILAR QUESTION:

1. Financial management is more than procurement of funds, Explain?

A. Same as above.

**Q.No.2. What are three main considerations in procuring funds? (B)**  
(NEW SM - TBQ 2, OLD SM) (M03 - 3M) (PA)

The Major considerations in procurement of funds are: (1) Risk (2) Cost and (3) Control. They differ with the type of funds. A comparative analysis of Debt and Equity is given below:

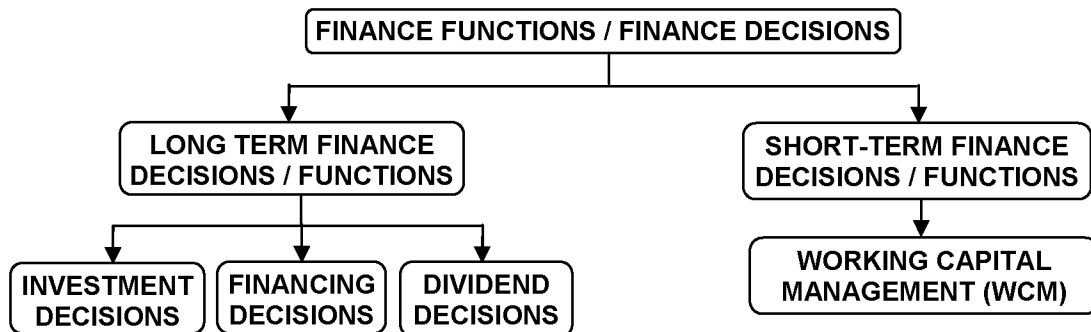
FUND	RISK	COST	CONTROL
OWN FUNDS (EQUITY)	<u>Low Risk - No question of repayment of capital except</u> when the company is under liquidation. Hence best from risk point of view.	<u>Most Expensive</u> - Dividend <u>expectations</u> of share holders are <u>higher</u> than interest rates. Also, dividends are <u>not tax deductible</u> . So, cost will be high.	<u>Dilution of control</u> - Since the capital base might be expanded and new share holders / public are involved. As a result <u>control gets diluted</u> .

<b>LOAN FUNDS (DEBT)</b>	<b>High Risk - Capital</b> Should be <u>repaid</u> as per the agreement. Interest should be paid irrespective of profits.	<b>Comparatively Cheaper</b> – Prevailing interest rates are considered only to the extent of <u>after tax impact</u> .	<b>No dilution of control -</b> Generally there is <u>no voting power</u> , except in some special situations. For E.g. in case of default etc.
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## MODEL NO 2: FINANCE FUNCTIONS / FINANCE DECISIONS

**Q.No.3. What are the major Decisions of Financial Management? (A)**  
(NEW SM, OLD SM, PM, M18 (N) - 2M, MTP – N18, N17 - 4M, N16 - 4M)

Value of a firm will depend on various finance functions / decisions. The finance functions are divided into long term and short term functions / decisions



### I. LONG TERM FINANCE DECISIONS / FUNCTIONS.

#### a) INVESTMENT DECISIONS:

- i) These decisions relate to the selection of various kinds of assets in which different sources of funds will be invested by a firm.
- ii) The investment of funds in a project has to be made after careful assessment of various projects through capital budgeting.
- iii) Some portion of long term funds shall also be used for financing the working capital requirements.

#### b) FINANCING DECISIONS:

- i) These decisions relate to acquiring the optimum finance to meet financial objectives.
- ii) The finance manager has to maintain proper balance between long-term and short-term funds. Within the long term funds, he has to ensure proper balance between Equity & Debt.
- iii) The optimum financing mix will increase return to equity shareholders and thus maximise their wealth.

#### c) DIVIDEND DECISIONS:

- i) These decisions relate to determination as to how much and how frequently cash can be paid out of profits of an organisation as income for its owners/shareholders.
- ii) These decisions have two elements – the amount to be paid out and the amount to be retained to support the growth of the organization.
- iii) An optimal dividend pay-out ratio maximises shareholder's wealth.

### II. SHORT- TERM FINANCE DECISIONS / FUNCTION:

- a) **WORKING CAPITAL MANAGEMENT (WCM):** Generally short term decisions are reduced to management of current assets and current liabilities (i.e., working capital Management)

**SIMILAR QUESTIONS:**

1. Discuss the three major decisions taken by a finance manager to maximize the wealth of shareholders? (MTP N17 - 4M, MTP1 N18 (O) - 4M, MTP2 N18 (N) - 4M, N16 - 4M)
  - A. Same as above.
2. Discuss long term and short term functions / decisions?
  - A. Same as above.
3. Explain various finance functions / decisions?
  - A. Same as above.

**Q.No.4. Explain Inter relationship between Investment, Financing and Dividend decisions? (B) (NEW SM, OLD SM, PM) (RTP: M16) (PA)**

**INTRODUCTION:** The underlying objective of all three decisions of financial management, viz - investment, financing and dividend decisions is "maximization of shareholders wealth". The financial manager has to consider the joint impact of these three decisions on the market price of the company shares.

**INTER LINK BETWEEN 3 DECISIONS:** The three decisions can be linked to maximize shareholders wealth, in the following manner -

- i) **Investment Decisions:** Investment in Long Term projects should be made after Capital Budgeting and uncertainty analysis. Projects which give, reasonable returns (higher than cost) in order to add to the surplus of the Shareholders', should be selected. The returns should be high enough as to distribute reasonable dividends and also retain adequate resources for the Company's growth prospects.
- ii) **Financing Decisions:** Proper balancing between long - term and short - term funds, as well as own funds and loan funds, will help the Firm to minimize its overall cost of capital and increase its wealth value. Low cost of funds will mean higher profit margins, which can be used for dividend distribution as well as internal financing of new projects / growth plans.
- iii) **Dividend Decisions:** The optimum dividend pay-out ratio ensures that shareholders' wealth is optimized. If the company can earn higher rate of return than being distributed to shareholders then it is better to retain the same, rather than declaring the same as dividend.

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

**Q.No.5. Define Finance Function? (B) (NEW SM, OLD SM, PM, N17 - 4M)**

**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 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.

**MODEL NO 3: IMPORTANCE OF FINANCIAL MANAGEMENT**

Q.No.6. Explain the importance of financial management? (C)

(NEW SM, OLD SM)

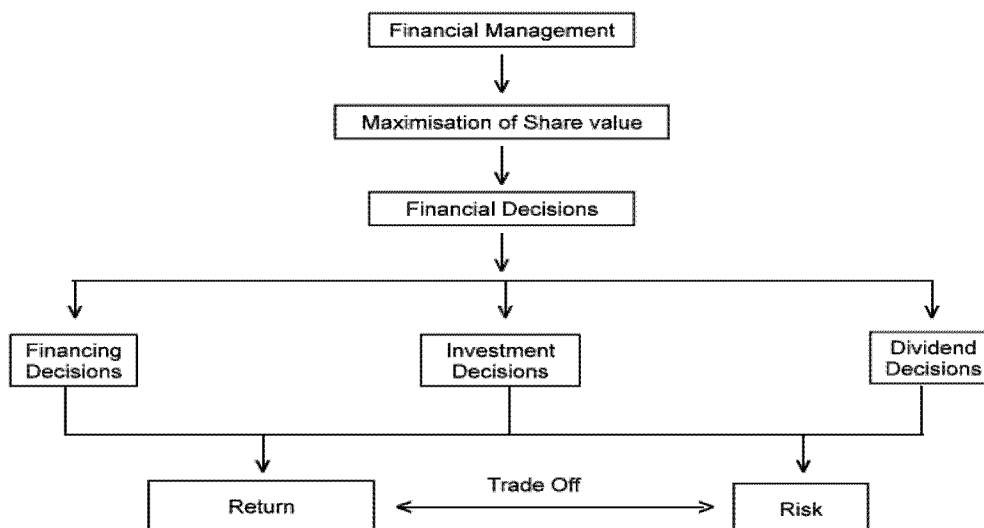
- a) Financial Management is all about planning investment, funding the investment, monitoring expenses against budget and managing gains from investment. Its deals with all matters related to managing the organization's finances.
- b) The best way to demonstrate the importance of good financial management is to describe some of the tasks that it involves:
  - i) Taking care not to over – invest in fixed assets.
  - ii) Balancing cash – outflows with cash – inflows.
  - iii) Ensuring that there is sufficient level of short – term working capital.
  - iv) Setting sales revenue targets that will deliver growth.
  - v) Increasing gross profit by setting the correct pricing for products or services
  - vi) Controlling the level of general and administrative expenses by finding more cost – efficient ways of running day – to – day business operations, and
  - vii) Tax planning that will minimize the taxes that a business has to pay.

**MODEL NO 4: SCOPE OF FINANCIAL MANAGEMENT**

Q.No.7. Explain the scope of financial management? (C)

(NEW SM, OLD SM)

1. **SCOPE OF FINANCIAL MANAGEMENT:** As an integral part of overall management, Financial Management is mainly concerned with
  - a) Acquisition and use of funds by an organisation.
  - b) Determination of size of the enterprise and determination of growth rate.
  - c) Determining the composition of assets of the enterprise.
  - d) Determining the enterprise's financing mix i.e. consideration of level of debt to equity, etc.
  - e) Analyse the planning and control aspects of financial affairs of the enterprise.
2. In the past its scope was limited to procurement of funds but in modern times, Financial Management includes 3 different kinds of decisions viz., Investment, Financing and Dividend.
3. The finance manager, in a bid to maximize shareholders wealth, should strive to maximize returns by avoid unnecessary risks and he should constantly monitor so that funds are properly utilized.



An Overview of Financial Management

**MODEL NO 5: OBJECTIVES OF FINANCIAL MANAGEMENT**

**Q.No.8. Explain the basic objectives of financial management? (A)**

**(NEW SM, OLD SM, OLD PM, N18 (N) - 2M)**

Efficient financial management requires 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 is generally argued that profit maximisation is the Primary objective of a business enterprise.
- b) This implies that finance manager has to make his decisions in a manner so that profits of the concern are maximised.
- c) Profit Maximisation is viewed as a limited objective i.e essential but not sufficient.

**2. WEALTH OR VALUE MAXIMISATION:**

- a) Primary goal of a 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 finance manager to see that, the value of the share should increase in the share market.
- c) This value depends upon (i) Cash flow approach not Accounting profit (ii) Cost benefit analysis (iii) Application of time value of money.

Hence, Wealth Maximisation is a better objective for a business since it represents both return and risk.

- d) Profit maximisation can be considered as a part of wealth maximisation strategy.

**SIMILAR QUESTION:**

**1. Explain "Wealth maximisation" and "Profit maximisation" objectives of financial Management? (NEW SM - TBQ 3)**

A. Same as above.

**Q.No.9. "The Profit maximization is not an operationally feasible criterion." Comment on it. (A)**  
**(NEW SM, OLD SM, OLD PM, RTP N18 (N&O), RTP M18 (N&O), RTP N17, RTP M17, RTP N16, 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. 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.

**SIMILAR QUESTION:**

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

(N18 (O) - 2M)

A. Refer Point No.3 in the above answer.

Q.No.10. Explain as to how the wealth maximisation objective is superior to profit maximisation objective? (A) (NEW SM - TBQ 5, OLD SM, PM, N 03 - 5M, M 03)

First briefly write what is wealth maximization.

**SUPERIORITY OF WEALTH 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:** Maximisation of a firm's value as reflected in the market price of a share is viewed as proper goal of a firm. It can be considered as a part of wealth maximisation strategy.

**SIMILAR QUESTION:**

1. In recent years, there have been a number of environmental, pollution and other regulations imposed on businesses. In view of these changes, is maximisation of shareholder wealth still a realistic objective? (NEW SM-TBQ 5)

A. Write 1 & 2 points above and write below conclusion.

**CONCLUSION:** Wealth maximisation objective takes into account all future cash flows, dividends, EPS, Risk factors along with number environmental, pollution and other regulations imposed on businesses. Therefore in view of all these changes shareholder wealth maximisation still a realistic objective.

Q.No.11. Explain the Limitations of wealth or value maximisation? (B) (NEW SM, OLD SM, PA) (N 07 - 3M)

First briefly write what is wealth maximization.

**LIMITATIONS OF WEALTH OR VALUE MAXIMISATION OBJECTIVE:**

- a) **TIMINGS:** The timing or duration of expected returns is not specified. So, one can't be sure whether an investment fetching Rs.10 Lakhs return after 5 years is more or less valuable than an investment fetching Rs.1.50 lakhs per year for the next 5 years.



- b) **RISK:** The risk factor of projects to be undertaken is not considered properly. A firm with a higher Debt capital may have the same EPS as a firm having a lesser Debt capital in the capital structure. However, the Market Price per share of the two companies shall be different.
- c) **DIVIDENDS:** The effect of dividend policy on Market Price per share is not fully considered. To maximise EPS, companies may not pay any dividend. In such cases EPS may increase but Market Price per share may go down due to adverse reactions from the shareholders.
- d) **VAGUE:** Share Prices are affected by external factors and not only by financial decisions of a Firm. Hence, sole dependence on Financial Decisions for maximizing Wealth can lead to management anxiety and frustration.

However, for routine decision-making purposes, the Finance Manager views Profit Maximization as a short-term objective and Value Maximisation as a medium / Long-Term objective.

**Q.No.12. Discuss the conflicts in Profit vs Wealth maximisation principle of the firm? (A)**  
(NEW SM, OLD SM, PM) (N12 - 4M, N10 - 4M, M09 - 2M, N06 - 4M)

**PROFIT MAXIMISATION:** It is the objective which denotes that a firm must maximize his profit in a given period of time. This objective also implies that all the decisions, functions of financial management should be oriented to profit maximisation.

**WEALTH MAXIMISATION:** It is the fundamental objective of a firm. It denotes that the firm must maximize market value of equity shares. It is also called net present worth maximisation. It recognises view point of firm as well as its Investors (both Debt & Equity).

GOAL	OBJECTIVE	ADVANTAGES	DISADVANTAGES
Profit Maximization	Large amount of profits	<ul style="list-style-type: none"> <li>• Easy to calculate profits.</li> <li>• Easy to determine the link between financial decisions and profits.</li> </ul>	<ul style="list-style-type: none"> <li>• Emphasizes the short term gains.</li> <li>• Ignores risk or uncertainty.</li> <li>• Ignores the timing of returns.</li> <li>• Requires immediate resources.</li> </ul>
Shareholders Wealth Maximisation	Highest market value of shares.	<ul style="list-style-type: none"> <li>• Emphasizes the long term gains.</li> <li>• Recognises risk or uncertainty.</li> <li>• Recognises the timing of returns.</li> <li>• Considers shareholders' return.</li> </ul>	<ul style="list-style-type: none"> <li>• Offers no clear relationship between financial decisions and share price.</li> <li>• Can lead to management anxiety and frustration.</li> </ul>

**Q.No.13. Distinguish between Profit and Wealth maximisation? (A)**  
(STUDENTS SELF STUDY) (NEW SM, OLD SM, M15 - 4M)

PROFIT MAXIMISATION	WEALTH MAXIMISATION
Does not consider the effect of future cash flows, dividend decisions, EPS, etc.	Recognises the effect of all future cash flows, dividends, EPS, etc.
A firm with profit maximisation objective may refrain from payment of dividend to its shareholders.	A firm with wealth maximisation objective may pay regular dividends to its shareholders.
Ignores time pattern of returns.	Recognises the time pattern of returns.
Focus on short – term.	Focus on medium / long-term.

Does not consider the effect of uncertainty / risk.	Recognises the risk – return relationship.
Comparatively easy to determine the relationship between financial decisions and profits.	Does not offer any clear or specific relationship between financial decisions and share market prices.

### **MODEL NO 6: ROLE OF FINANCE EXECUTIVE / CHIEF FINANCIAL OFFICER**

**Q.No.14. Discuss the role of a Chief Financial Officer / Finance Executive? (A)**  
(NEW SM - TBQ 4, OLD SM, PM, M18 (N) - 2M, N11 - 4M, M07 - 3M)

Modern Financial Management has come a long way from traditional corporate finance. During the recent years a new era has started for Chief Financial officers. His role assumes significance in the present day context of liberalization, deregulation and globalisation.

#### **RESPONSIBILITIES OR ROLE OF CHIEF FINANCIAL OFFICER (CFO) / FINANCE EXECUTIVE:**

- Financial analysis and planning:** Determining the proper amount of funds to be employed in the firm i.e. designating the size of the firm and its rate of growth.
- Investment decisions:** Efficient allocation of funds to specific assets.
- Financial and capital structure decisions:** Rising of funds on favourable terms as possible i.e. determining the composition of liabilities.
- Management of financial resources** (such as working capital).
- Risk Management:** Protecting assets.

#### **SIMILAR QUESTIONS:**

- What are the main responsibilities of a Chief Financial Officer / finance executive of an organisation?**  
A. Same as above.
- What are the roles of Finance Executive in Modern World? (M18 (N) - 2M)**  
A. Same as above.

**Q.No.15. Discuss various functions of a Finance Executive / Chief Financial Officer? (B)**  
(NEW SM, OLD SM, PM, TN)

#### **FUNCTIONS OF A FINANCE EXECUTIVE / CHIEF FINANCIAL OFFICER:**

- Estimating the requirements of funds:** A careful estimate of funds is required and the exact timing when such funds are required must be made by preparing the budgets.
- Decision regarding capital structure / financing decisions:** After that, decision has to be taken with respect to various sources from which these funds have to be raised. Risk, Cost and Control aspects should be considered while taking these types of decisions.
- Investment Decisions:** Funds procured from different sources have to be invested in various types of assets by using the techniques of Capital Budgeting.
- Dividend Decisions:** He is also concerned with the decision to declare dividend or not. He has to assist the Directors in deciding the rate of dividend.
- Supply of funds to all parts of organisation or cash management:** He has to ensure that all branches, factories, departments and units of the organisation are supplied with adequate funds.
- Financial negotiations:** He shall negotiate with financial institutions, banks and public depositors for obtaining loans.
- Evaluating financial performance:** He shall constantly review the financial performance of various units of the organization, generally in terms of R.O.I.

- viii) **Cash management:** He shall lay down cash management and cash disbursement policies so as to supply adequate funds to all units of organisation and to ensure that there is no excessive cash.
- ix) Keeping in touch with stock exchange quotations and behaviour of share prices.

**Q.No.16. Emerging Issues / Priorities affecting the Future Role of CFO. (A)**  
(NEW SM, OLD SM, PM) (N16 - 4M, M14 - 4M)

**INTRODUCTION:** The role of CFO has become more and more elevated as businesses are constantly facing changes due the technological progress and unstable economic and political situation. Under these influence the role of CFO is fundamentally changing.

**EMERGING ISSUES / PRIORITIES AFFECTING THE FUTURE ROLE OF CFO:**

- a) **REGULATION:** Regulatory 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.

**SIMILAR QUESTIONS:**

1. What are the Factors causing change in CFO's Work Profile? (PA)
- A. Same as above

**Q.No.17. Explain the Role of Finance executive / chief financial officer (CFO) in today's World vis-a-vis in the past? (A)**  
(NEW SM, OLD 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

### **MODEL NO 7: RELATIONSHIP OF FINANCIAL MANAGEMENT WITH FINANCIAL ACCOUNTING**

**Q.No.18. Relationship between Financial Management and Financial Accounting. (A)**  
(NEW SM, OLD SM, PM) (N09 - 2M) (MTP: M18 (O) - 4M, M17 - 4M, N16 - 4M)

#### **INTER RELATIONSHIP:**

- 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.
- PROVIDES NEEDED INFORMATION:** The outcome of accounting is 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:

- TREATMENT OF FUNDS:** In accounting, the measurement of funds is based on accrual principle. The accrual based accounting data do not reflect fully the financial conditions of organisation. An organisation which is in profits 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.

- 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.

#### **SIMILAR QUESTION:**

- Differentiate between Financial Management and Financial Accounting.
- A. Same as above.

### **MODEL NO 8 & 9: FOR NEW SYLLABUS ONLY**

### **MODEL NO 8: FINANCIAL DISTRESS AND INSOLVENCY**

**Q.No.19. What is Financial Distress and explain its relationship with Insolvency? (A)**  
(NEW SM) (MTP: M18 (N) - 4M, PA)

- MEANING:** Financial distress is a position where Cash inflows of a firm are inadequate to meet all its current obligations.
- REASONS:** Financial Distress may arise due to -

- i) Fall in demand / market for a Firm's Products / Services,
  - ii) Increase in Cost of Inputs, i.e. Raw Material, Labour, Services, etc. without corresponding in Prices,
  - iii) Higher levels of Debt which require regular servicing of interest,
  - iv) Diversion of Working Capital Funds for long term (Asset Generation / Term Loan Repayment) purposes, etc.
3. **IMPACT:** If Financial professionals of the firm don't manage it properly, such Financial Distress may gradually lead to insolvency and dissolution of the Firm. Hence, proper and professional Financial Management is necessary to handle Financial Distress in an effective manner.

### **MODEL NO 9: AGENCY PROBLEM AND AGENCY COST**

**Q.No.20. What is Agency Problem? (A)**

**(NEW SM, PA)**

1. **MEANING:** The Agency Problem is a conflict of interest inherent in any relationship where one party is expected to act in another's best interests. The Agency Problem is more relevant in Corporate Entities (rather than Proprietor / Partnership Firms), due to a conflict of interest between a Company's Management and the Company's Shareholders.
2. **CONCEPT:**
  - a) In a Company, the Directors / Managers act as Agents for the Shareholders (i.e. Principals). Agency Problem is the chance that Managers may place personal goals ahead of the goals of Shareholders.
  - b) Agency Problem arises if managers' interests are not aligned to the interests of the Debt Lender and Equity Investors.
  - c) Managers are supposed to make decisions that will maximize Shareholder Wealth even though it is in the Managers' best interest to maximize their own wealth.
3. **REASON:** This problem arises due to an issue with Incentives. An Agent may be motivated to act in a manner that is not favorable for the Principal, if the Agent is presented with an Incentive to act in this way.

**Q.No.21. What is Agency Cost? (A)**

**(NEW SM)(MTP N18)**

- i) Agency Cost is the additional cost borne by the shareholders to monitor the manager and control their behavior so as to maximise shareholders wealth.
- ii) It is not always possible to eliminate the Agency Problem completely. However, the Manager can be motivated to act in the Shareholders' best interests, by incurring appropriate Agency Costs, which can reduce the impact of Agency problem.
- iii) Agency Costs may be classified as under –
  - **Monitoring:** Direct influence by Shareholders, Shareholders' Approval for certain acts, Borrowings, etc.
  - **Bonding:** Performance-based incentives, Managerial Compensation linked to Company's Profits, ESOPs, etc.
  - **Opportunity:** The threat of firing, and bringing in a new set of Managers to run the Company,
  - **Structuring:** The threat of takeovers.

**Q.No.22. How to address Agency Problem? (A)**

**(NEW SM)**

- i) The Agency Problem arises if manager's interests are not aligned to the interests of the debt lender and equity investors.

- ii) Agency problem between the managers and shareholders can be addressed if the interests of the managers are aligned to the interests of the share - holders.
- iii) Following efforts have been made to address these issues:
- Managerial compensation is linked to profit of the company to some extent and also with the long term objectives of the company.
  - Employee is also designed to address the issue with the underlying assumption that maximisation of the stock price is the objective of the investors.
  - Effecting monitoring can be done.

**SIMILAR QUESTION:**

1. State Agency Cost. Discuss the ways to reduce the effect of it. (MTP1 N18 (N) - 4M)
- A. Refer Question 21 and 22

**ADVANCED QUESTIONS**

**Q.No.23.** “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? (C) (NEW SM, OLD SM, OLD PM, PA)

**OPINION:** 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.

**JUSTIFICATION:**

- CHANGE IN ROLE:** 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.
- ORGANISER / FACILITATOR:** In his new emergent role, Chief Finance Officer acts as a catalyst to facilitate changes in an environment where the company succeeds through self-managed teams in each function e.g. production, marketing, purchase scheduling etc. The Chief Finance Officer must now transform himself to a front-end organiser or a leader, whose role will be in networking the functions of various sub-units or teams.
- STRATEGIC LEVEL ROLE:** The CFO must analyse the external environment and take strategic decisions in order to manage and optimize the Firm's cash flows. Thus the role of the CFO shifts from an operational level to a strategic level. However, the operational level duties (back-end duties) will still have to be carried out.
- KNOWLEDGE MANAGER:** The CFO knowledge requirements will extend from routine things like capital productivity and cost of capital etc. to specialized aspects like human resources initiatives and competitive environment analysis etc.

So The CFO must develop and sharpen his management skills in order to meet the needs of emerging situations

**SIMILAR QUESTION:**

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

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**Q.No.24. Explain the role of Finance Manager in the changing scenario of financial management in India? (C)**  
(NEW SM, OLD SM, PM)

**ROLE OF FINANCE MANAGER IN THE CHANGING SCENARIO OF FINANCIAL MANAGEMENT IN INDIA:**

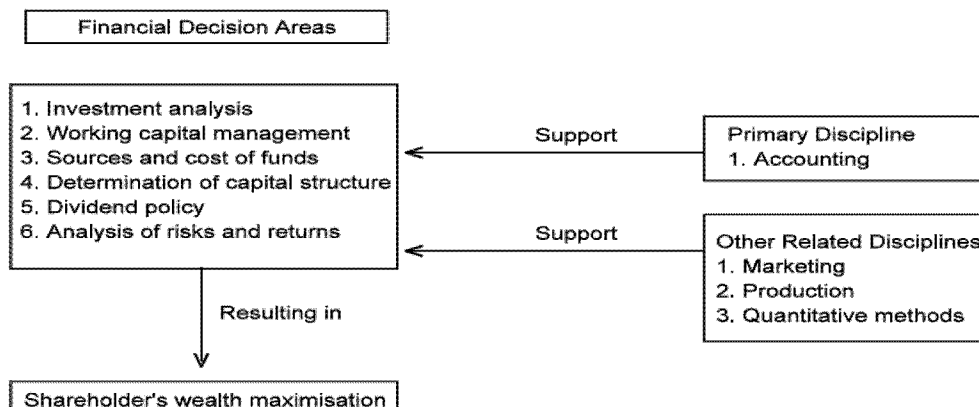
- In the modern enterprise, the finance manager occupies a key position and his role is becoming more and more pervasive and significant in solving the finance problems.
- The traditional role of the finance manager was confined just to raising of funds from a number of sources, but the recent development 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.
- 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 assumes significance in the present day context of liberalization, deregulation and globalization.

**Q.No.25. Explain the relationship of Financial Management with Other Related Disciplines? (B)**  
(NEW SM, OLD SM)

**FINANCIAL MANAGEMENT AND OTHER RELATED DISCIPLINES:**

- Financial management must draw on other related disciplines such as marketing, production and quantitative methods apart from accounting for its day to day decision making process.
- For instance, financial managers should consider the impact of new product development and promotion plans made in marketing area since their plans will require capital outlays and have an impact on the projected cash flows.
- Likewise, changes in the production process may require capital expenditures which the financial managers must evaluate and finance.
- Even economics can also be considered as one of the major disciplines which help the financial manager to gain knowledge of what goes on in the world outside the business.
- Finally, the tools and techniques of analysis developed in the quantitative methods discipline are helpful in analyzing complex financial management problems.

**The below figure depicts the relationship between financial management and supportive disciplines:**



**Q.No.26. Explain how financial management is evaluated? (C) (NEW SM, OLD SM, PM)**

Financial management evolved gradually over the past 50 years. The evolution of financial management is divided into three phases. Financial Management evolved as a separate field of study at the beginning of the century. The three stages of its evolution are:

- 1. THE TRADITIONAL PHASE:** During this phase, financial management was considered necessary only during occasional events such as takeovers, mergers, expansions, liquidation, etc. Also, when taking financial decisions in the organization, the needs of outsiders (investment bankers, people who lend money to the business and other such people) to the business was kept in mind.
- 2. THE TRANSITIONAL PHASE:** During this phase, the day – to – day problems that financial managers faced were given importance. The general problems related to funds analysis, Planning and control were given more attention in this phase.
- 3. THE MODERN PHASE:** Modern phase is still going on. The scope of financial management has greatly increased now. It is important to carry out financial analysis for a company. This analysis helps in decision making. During this phase, many theories have been developed regarding efficient markets, capital budgeting, option pricing, valuation models and also in several other important fields in financial management.

### MULTIPLE CHOICE QUESTIONS – FOR SELF STUDY

- Management of all matters related to an organisation's finances is called:
  - Cash inflows and outflows
  - Allocation of resources
  - Financial management
  - Finance.
- Which of the following is not an element of financial management?
  - Allocation of resources
  - Financial Planning
  - Financial Decision-making
  - Financial control.
- The most important goal of financial management is:
  - Profit maximisation
  - Matching income and expenditure
  - Using business assets effectively
  - Wealth maximisation.
- To achieve wealth maximization, the finance manager has to take careful decision in respect of:
  - Investment
  - Financing
  - Dividend
  - All the above.
- Early in the history of finance, an important issue was:
  - Liquidity
  - Technology
  - Capital structure
  - Financing options.
- Which of the following are microeconomic variables that help define and explain the discipline of finance?
  - Risk and return
  - Capital structure
  - Inflation
  - All of the above.

#### KEY:

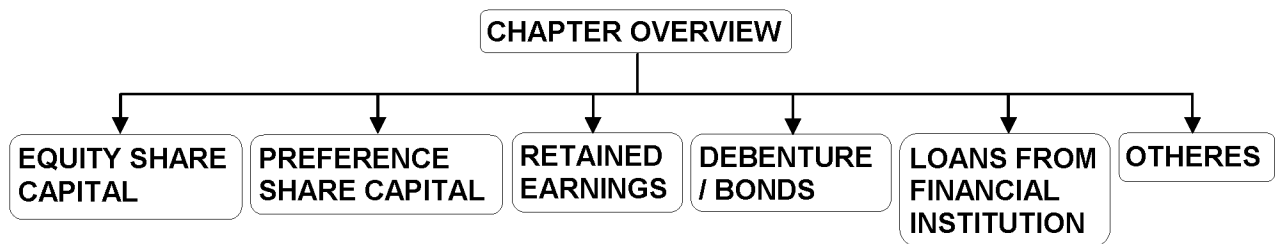
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**THE END**



## 2. TYPES OF FINANCING



### **MODEL NO 1: CLASSIFICATION OF FINANCIAL SOURCES**

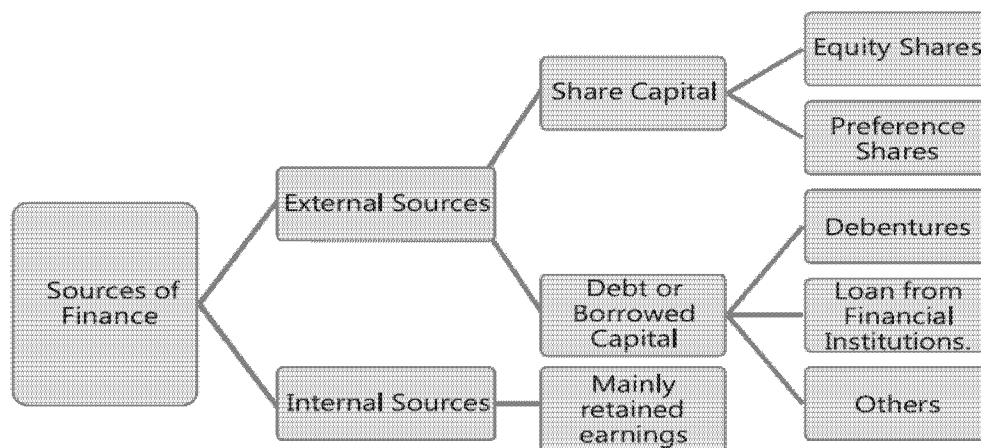
**Q.No.1. Classify various types of “Financial Sources” of a business? (C)  
(NEW SM) (FOR NEW SYLLABUS ONLY)**

There are mainly two ways of classifying various financial sources

- i) Based on basic Sources.
- ii) Based on Maturity of repayment period.

#### **SOURCES OF FINANCE BASED ON BASIC SOURCES:**

Based on basic sources of finance, types of financing can be classified as below:



### **MODEL NO 2: EQUITY SHARE CAPITAL**

**Q.No.2. Write a Short note on Equity Share Capital as a source of Long Term Finance? (B)  
(NEW SM, OLD SM)**

**EQUITY SHARE CAPITAL:** Equity share capital is the amount of capital raised by the Companies by way of issue of Equity shares, subject to the regulations laid down in the companies Act, SEBI guidelines and related laws.

#### **CHARACTERISTICS OF OWNERS CAPITAL 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. The dividend payable to them is an appropriation of profits not a charge against profits.
- 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) **No security:** while issuing equity there is no need to give a 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. Explain Advantages & Disadvantages of Equity Share Capital? (B)**  
(NEW SM, OLD SM, PM, MTP - N18,N16)

First briefly write what is Equity Share Capital.

1. **ADVANTAGES:**

- Permanent source:** Since such Equity Shares are not redeemable, the Company has no liability for cash outflows associated with its redemption.
- Security or financial base:** Equity Share capital provides a security (financial base) to other suppliers of funds. So, a company with a high Paid-Up Equity Capital can raise further funds from other sources easily.
- Dividend is discretionary:** 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.
- Enhances the capacity to raise further debt:** Equity share capital increases the capacity of the company to raise further debt.
- The company can make further issue of share capital by making rights issue.

2. **DISADVANTAGES:**

- High cost:** The cost of ordinary shares is higher because dividends are not tax deductible and also the floatation costs of such issues are higher.
- High risk:** Investors find ordinary shares riskier because of uncertain dividend payments and capital gains.
- Uncertainty of EPS:** The issue of new equity shares reduces the Earning Per Share of the existing shareholders until and unless the profits are proportionately increased.
- Dilution of control:** The issue of new equity shares can also reduce the ownership and control of the existing shareholders.

**Q.No.4. "Equity capital does not carry any cost." Do you agree with this statement? Explain? (B)**  
(NEW SM, OLD SM)

**OPINION:** "Equity capital does carry some cost".

**JUSTIFICATION:**

No, the statement is incorrect. The cost of ordinary shares is usually the highest.

This is due to the fact that such shareholders expect a higher rate of return (as their risk is the highest) on their investment as compared to other suppliers of long-term funds.

**MODEL NO 3: PREFERENCE SHARE CAPITAL**

**Q.No.5. What is Preference Share Capital? What are the characteristics, merits & demerits of Preference Share Capital? (B)**  
(NEW SM, OLD SM, PA)

**PREFERENCE SHARE CAPITAL:** 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:**

- a) **Preference Dividend:** Preference Dividend Rate is normally higher than the rate of interest on debentures, loans, etc. This is an appropriation of profits and not a charge against profits.
- b) **Hybrid Form of financing:** Preference Capital has features of both Debt and Equity. It can be compared with Debt since the rate of dividend is fixed and the Capital is repayable at the end of a period. It can also be likened to Equity because dividend is not tax-deductible.
- c) **Redeemability & Convertibility:** Generally, Preference Shares carry a stipulation of repayment at the end of a time period. Sometimes, they may also carry the option of conversion into Equity Capital.
- d) **Cumulative Option:** Preference Shares may be issued as cumulative, i.e. the dividend payable in a year of loss gets carried over to subsequent years till there are adequate profits to pay the accumulated dividends.

**Q.No.6. Discuss the Advantages and Disadvantages of raising funds by issue of Preference Shares? (B)**  
(NEW SM, OLD SM, PM)

*First briefly write what is Preference Share Capital.*

**ADVANTAGES OF PREFERENCE SHARE CAPITAL:**

- a) No dilution in EPS on enlarged capital base, if equity is issued it reduces EPS, thus affecting the market perception about the company.
- b) There is leveraging advantage as it bears a fixed charge. Non-payment of preference dividends does not force company into liquidity.
- c) There is no risk of takeover as the preference shareholders do not have voting rights except in case where dividend arrears exist.
- d) The preference dividends are fixed and pre-decided. Hence preference shareholders do not participate in surplus profits as the ordinary shareholders.
- e) Preference capital can be redeemed after a specified period.

**DISADVANTAGES OF PREFERENCE SHARE CAPITAL FROM COMPANY'S POINT OF VIEW:**

- a) One of the major disadvantages of preference shares is that preference dividend is not tax deductible and so does not provide a tax shield to the company. Hence a preference share is costlier to the company than debt e.g. debenture.
- b) Preference dividends are cumulative in nature. This means that although these dividends may be omitted, they shall need to be paid later. Also, if these dividends are not paid, no dividend can be paid to ordinary shareholders. The non-payment of dividend to ordinary shareholders could seriously impair the reputation of the company concerned.

**Q.No.7. What is the difference between Equity share and Preference share? (A)**  
(NEW SM) (FOR NEW SYLLABUS ONLY)

An equity share and a preference share can be distinguished as follows:

BASIS OF DISTINCTION	EQUITY SHARE	PREFERENCE SHARE
1. <b>Preferential rights as to the payment of dividend</b>	Payment of equity dividend is made <u>after</u> the payment of preference dividend.	Payment of preference dividend is made <u>before</u> the payment of equity dividend.
2. <b>Rate of dividend-fixed or fluctuating</b>	The rate of equity dividend may <u>fluctuate</u> from year to year depending upon the decision of Directors and Members.	The rate of preference dividend is <u>fixed</u> .

<b>3. Convertibility</b>	It cannot be convertible.	It may be convertible
<b>4. Voting rights</b>	Equity shareholders generally <u>enjoy</u> voting rights.	Preference shareholders <u>do not</u> have any voting rights except at their class meetings.
<b>5. Preferential right as to the repayment of capital</b>	Repayment of equity share capital is made <u>after</u> the repayment of preference share capital.	Repayment of preference share capital is made <u>before</u> the repayment of equity share capital.
<b>6. Arrears of dividend</b>	<i>In case of an equity share, arrears of dividend <u>cannot accumulate</u>.</i>	<i>In case of preference shares, arrears of dividend <u>may accumulate</u>.</i>
<b>7. Redeemability</b>	<i>It is <u>not redeemable</u> during the life time of the company unless the company decides to buy-back its shares.</i>	<i>It is <u>redeemable</u> during the life time of the company.</i>
<b>8. Right to receive premium on redemption</b>	<i>It <u>cannot</u> carry a right to receive premium on redemption</i>	<i>It <u>may</u> carry a right to receive premium on redemption.</i>
<b>9. Fluctuation in Market Value</b>	<i>It's market value <u>fluctuates</u>.</i>	<i>It's market value usually does <u>not fluctuate</u>.</i>

**MODEL NO 4: RETAINED EARNINGS**

**Q.No.8. What is Retained Earnings or ploughing back of profits? What are the Advantages & Limitations of using Retained Earnings as source of finance? (A) (NEW SM, OLD SM, PM)**

**RETAINED EARNINGS OR PLOUGHING BACK OF PROFITS:**

- i) Retaining Earning are the accumulated profits and plough them back into business.
- ii) Such accumulated profits are called Retained Earnings.
- iii) They belong to the Equity Shareholders and increase the Net Worth of the company.
- iv) In other words, it is the surplus generated from operations, after meeting all the contractual, statutory and working requirements of funds, is available for future capital expenditure.
- v) This constitutes the Internal Funds generation of the company.

**1. ADVANTAGES OF USING RETAINED EARNINGS:**

- a) **No Explicit Cost:** It does not involve any explicit cost in terms of floatation costs (e.g. expenses on printing, advertisement and distribution of prospectus, brokerage, underwriting commission). Hence, it is cheaper than issue of shares.
- b) **More Dependable:** It is more dependable than external sources since it is not required to depend upon external investors who may or may not subscribe the issue.
- c) **No fixed obligation:** It does not involve any fixed obligation to pay any dividend on profits reinvested.
- d) **No Effect on control:** It's use does not affect the control over the management of the company since there is no addition to the number of shareholders.
- e) **No Security:** It does not require the security of assets to be offered.
- f) **Increases Capacity to raise debt:** It increases the capacity of the company to raise further debt.
- g) **Increase Financial Strength:** Accumulation of reserves increases financial strength of the company.
- h) **Source for Bonus Shares:** It acts as a source of issuing Bonus Shares.

**2. LIMITATIONS OF USING RETAINED EARNINGS:**

- a) **Available only to profitable companies:** This source of financing is available only to profitable companies.
- b) **Concentration of Economic Power:** Growth of companies through accumulation of reserves leads to concentration of economic power.
- c) **Involves Opportunity Cost:** It involves opportunity cost (i.e. the return which the shareholders could have earned if the profits were distributed). The management sometimes does not consider this cost while declaring dividend to equity shareholders.
- d) **Danger of Over-Capitalization:** There is always a danger of over capitalization if the company retains profits on continuous basis year after year without requirements of funds for profitable investments.

**MODEL NO 5: DEBT CAPITAL**

Q.No.9. Write a Short note on Debenture capital as a Source of Long Term Fund? (A)  
(NEW SM, OLD 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 includes debenture stock, bonds and or other instrument of a company evidencing a debt, whether constituting a charge on the assets of the company or not.

**FEATURES OF DEBENTURES:**

- a) **Fixed Interest:** The rate of interest payable on debentures is fixed and is payable on the face value of the debentures.
- b) **No Voting Rights:** The Debenture holders do not enjoy voting rights except at their class meetings. They do not have rights to elect directors and to participate in the management.
- c) **Redeemable:** The debentures are redeemable during the life of the company.
- d) **Secured or unsecured:** Debentures are normally secured against the assets of the company. Sometimes it may be unsecured basing condition of the debenture trust deed.
- e) **Credit Rating:** Credit Rating is compulsory for public issue of debentures or private placement to Mutual Funds. The rating is based on track record, profitability, debt servicing capacity, credit worthiness and the risk of lending.

Q.No.10. What are the Advantages & Disadvantages of Debentures? (A) (NEW SM, OLD SM)

First briefly write what is Debenture.

**ADVANTAGES:**

- a) **Low Cost:** Cost of Debt Capital is lower when compared to Equity or Preference Capital. Thus gearing or leverage effect is advantageous for companies with good Return on Capital Employed (ROCE).
- b) **No dilution of Control:** Debenture financing does not result in dilution of control.
- c) In a period of rising prices, debenture issue is advantageous. The fixed monetary outgo decreases in real terms as the price level increases.

**DISADVANTAGES:**

- a) Debenture interest and capital repayment are obligatory payments. Interest shall be payable even in case of insufficient profits for the year.
- b) There may be restrictive covenants (conditions) in a debenture trust deed.

- c) Debenture financing increases the financial risk associated with the Firm.
- d) Since debentures need to be paid during maturity, a large amount of cash outflow is needed at that time.

**Q.No.11. What are different kinds of Debentures?**

**(A) (NEW SM, OLD SM)**

Depending upon the terms and conditions, they may be various types as given below:

- 1. Non-convertible debentures:** These types of debentures do not have any feature of conversion and are repayable on maturity.
- 2. Fully convertible debentures:** these are the debentures which can be converted into equity shares as per the terms of issue in relation to price and the time of conversion. Interest rates on such debentures are generally less than the non-convertible debentures.
- 3. Partly convertible debentures:** Those debentures which carry features of both convertible and non-convertible debentures belong to this category.
- 4. Secured Debentures:** these are the debentures which are secured either on a particular asset or on all the assets of the company in general. According to SEBI Guidelines, non-convertible debentures for a term exceeding 18 months must be secured.
- 5. Unsecured Debentures** are those, which are not secured on any asset. The holders of these debentures are treated as ordinary creditors.
- 6. First Mortgage Debentures** are those, which have a first claim on the assets charged.
- 7. Redeemable Debentures** are those which are repayable after a specified period in lump sum or by installments during the life time of the company
- 8. Irredeemable debentures (or Perpetual Debentures)** are those, which are not redeemable during the lifetime of the company.

**Q.No.12. Difference between Preference Shares and Debentures. (A)**

**(NEW SM – TBQ 6, N15 - 4M) (FOR NEW SYLLABUS ONLY)**

**DIFFERENCE BETWEEN PREFERENCE SHARES AND DEBENTURES:**

<u>BASIS OF DISTINCTION</u>	<u>PREFERENCE SHARES</u>	<u>DEBENTURES</u>
<b>1. Ownership</b>	Share is a part of owned <u>capital</u> .	Debenture constitutes a <u>loan</u> .
<b>2. Reward for investment</b>	Reward is the payment of Fixed <u>dividend</u> and also towards repayment of capital in case of winding up of a company.	Reward is the payment of Fixed percentage of <u>interest</u> .
<b>3. Nature</b>	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
<b>4. Charge vs. Appropriation</b>	Payment of dividend is an <u>appropriation</u> out of profit and this cannot be made if there is no profit.	Payment of interest is a <u>charge</u> against profits and is to be made even if there is no profit.
<b>5. Priority as to payment of interest / dividend</b>	<i>Payment of dividend gets <u>no priority</u> over the payment of interest.</i>	<i>Payment of interest gets <u>priority</u> over the payment of dividend.</i>

Q.No.13. "What is meant by Bond? How Bonds can be broadly classified?"

(A) (NEW SM) (FOR NEW SYLLABUS STUDENTS ONLY)

**BONDS:**

Bond is fixed income security created to raise fund. Bonds can be raised through Public Issue and through Private Placement.

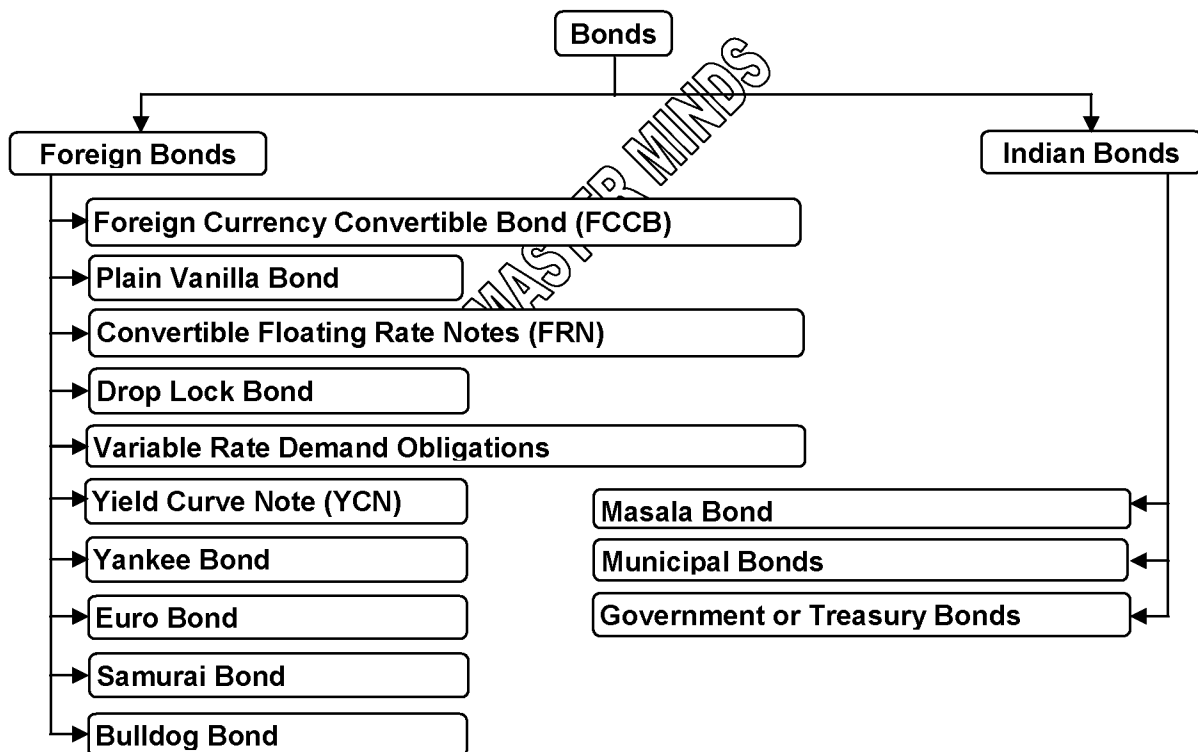
**TYPES OF BOND:**

Based on call, Bond can be divided as

- i) Callable bonds and
  - ii) Puttable bonds
- i) **CALLABLE BONDS:** A callable bond has a call option which gives the issuer the right to redeem the bond before maturity at a predetermined price known as the call price (Generally at a premium).
  - ii) **PUTTABLE BONDS:** Puttable bonds give the investor a put option (i.e. the right to sell the bond) back to the company before maturity.

Q.No.14. Salient Features of various Bonds prevailing in the market. (A)

(NEW SM) (FOR NEW SYLLABUS STUDENTS ONLY)



**VARIOUS BONDS WITH THEIR SALIENT FEATURES ARE AS FOLLOWS:**

i) **FOREIGN BONDS:**

S.NO.	NAME OF BOND	SALIENT FEATURE
1.	Foreign Currency Convertible Bond (FCCB)	i) This bond comes at a very low rate of interest. ii) The advantage to the issuer is that the issuer can get foreign currency at a very low cost. iii) The risk is that in case the bond has to be redeemed on the date of maturity, the issuer has to make the payment and at that time the issuer may not have the money.

2.	<b>Plain Vanilla Bond</b>	<ul style="list-style-type: none"> <li>i) The issuer would pay the principal amount along with the interest rate.</li> <li>ii) This type of bond would not have any options.</li> <li>iii) This bond can be issued in the form of discounted bond or can be issued in the form of coupon bearing bond.</li> </ul>
3.	<b>Convertible Floating Rate Notes (FRN)</b>	<ul style="list-style-type: none"> <li>i) A convertible FRN with an option for the holder to convert it into longer term debt security with a specified coupon</li> <li>ii) It protects an investor against falling interest rate</li> <li>iii) The long- term debt security can be sold in the market and the investor can earn profit</li> <li>iv) Capital gain is not applicable to FRN</li> </ul>
4.	<b>Drop Lock Bond</b>	<ul style="list-style-type: none"> <li>i) A Floating Rate Note with a normal floating rate</li> <li>ii) The floating rate bond would be automatically converted into fixed rate bond if interest rate falls below a predetermined level</li> <li>iii) The new fixed rate stays till the drop lock bond reaches its maturity</li> <li>iv) The difference between the convertible floating rate note and drop lock bond is that the former is long option holder structure and the later one is the short option structure</li> </ul>
5.	<b>Variable Rate Demand Obligations</b>	<ul style="list-style-type: none"> <li>i) A normal floating rate note with a nominal maturity</li> <li>ii) The holder of the floating rate note can sell the obligation back to the trustee at: At par, Plus accrued interest</li> <li>iii) It gives the investor an option to exit, so more liquid than the normal FRN</li> </ul>
6.	<b>Yield Curve Note (YCN)</b>	<ul style="list-style-type: none"> <li>i) A structured debt security</li> <li>ii) Yield increases when prevailing interest rate declines</li> <li>iii) Yield decreases when prevailing interest rate increases</li> <li>iv) This is used to hedge the interest rate</li> <li>v) This works like inverse floater</li> </ul>
7.	<b>Yankee Bond</b>	<ul style="list-style-type: none"> <li>i) Bonds denominated in dollars</li> <li>ii) Bonds issued by non- US banks and non-US corporations</li> <li>iii) Bonds are issued in USA</li> <li>iv) Bonds are to be registered in SEC (Securities and Exchange Commission)</li> <li>v) Bonds are issued in tranches</li> <li>vi) Time taken can be up to 14 weeks Interest rate is dollar LIBOR (London Interbank Offered Rate)</li> </ul>
8.	<b>Euro Bond</b>	<ul style="list-style-type: none"> <li>i) Bonds issued or traded in a country using a currency other than the one in which the bond is denominated. This means that the bond uses a certain currency, but operates outside the jurisdiction of the central bank that issues that currency</li> <li>ii) Eurobonds are issued by multinational corporations, for example, a British company may issue a Eurobond in Germany, denominating it in U.S. dollars</li> <li>iii) It is important to note that the term has nothing to do with the euro, and the prefix "euro-" is used more generally to refer to deposit outside the jurisdiction of the domestic central bank</li> </ul>
9.	<b>Samurai Bond</b>	<ul style="list-style-type: none"> <li>i) Denominated in Japanese Yen (JPY)</li> <li>ii) Issued in Tokyo</li> <li>iii) Issuer Non-Japanese Company</li> <li>iv) Regulations: Japanese</li> <li>v) Purpose: Access of capital available in Japanese market</li> <li>vi) Issue proceeds can be used to fund Japanese operation</li> <li>vii) Issue proceeds can be used to fund a company's local opportunities.</li> <li>viii) It can also be used to hedge foreign exchange risk</li> </ul>



10.	<b>Bulldog Bond</b>	<ul style="list-style-type: none"> <li>i) Denominated in Bulldog Pound Sterling/Great Britain Pound (GBP)</li> <li>ii) Issued in London</li> <li>iii) Issuer Non-UK Company</li> <li>iv) Regulations: Great Britain</li> <li>v) Purpose: Access of capital available in UK market</li> <li>vi) Issue proceeds can be used to fund UK operation</li> <li>vii) Issue proceeds can be used to fund a company's local opportunities</li> </ul>
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ii) **INDIAN BONDS:**

S.NO.	NAME OF BOND	SALIENT FEATURE
1.	<b>Masala Bond (M18 (N)-2M)</b>	<p>Masala (means spice) bond is an Indian name used for Rupee denominated bond that Indian corporate borrowers can sell to investors in overseas markets.</p> <ul style="list-style-type: none"> <li>i) These bonds are issued outside India but denominated in Indian Rupees.</li> <li>ii) NTPC raised Rs.2,000 crore via masala bonds for its capital expenditure in the year 2016.</li> </ul>
2.	<b>Municipal Bonds</b>	<p>Municipal bonds are used to finance urban infrastructure are increasingly evident in India.</p> <ul style="list-style-type: none"> <li>i) Ahmedabad Municipal Corporation issued a first historical Municipal Bond in Asia to raise Rs.100 crore from the capital market for part financing a water supply project</li> </ul>
3.	<b>Government or Treasury Bonds</b>	<p>Government or Treasury bonds are bonds issued by Government of India, Reserve Bank of India, any state Government or any other Government department.</p>

Note: You can expect a question in the exam on any one part / point.

**MODEL NO 6: COMMERCIAL BANKS**

**Q.No.15. Write a short note on loans from Commercial Banks as a Source Finance? (B) (NEW SM, OLD SM)**

**LOANS FROM COMMERCIAL BANKS:** The primary role of the commercial banks is to cater to the short term requirements of industry. Of late, however, banks have started taking an interest in long term financing of industries in several ways.

- a) Banks provide services such as accepting deposits, making business loans, without interfere in the management of the company.
- b) Banks provide long term loans for the purpose of expansion or setting up of new units. Their repayment is usually scheduled over a long period of time. The liquidity of such loans is said to depend on the anticipated income of the borrowers.
- c) As part of the long term funding for a company, the banks also fund the long term working capital requirement (it is also called WCTL i.e. working capital term loan). It is funding of that portion of working capital which is always required (the minimum level) and is not impacted by seasonal requirement of the company.

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**Q.No.16. Discuss in briefly any two long term sources of finance for a partnership firm? (A)**  
(NEW SM, OLD SM, MTP2 N18 (O) - 4M, MTP M18 (N) - 4M, MTP N17 - 4M, MTP N16 - 4M)

The two sources of long-term finance for a partnership firm are as follows:

**LOANS FROM COMMERCIAL BANKS:** Commercial banks provide long term loans for the purpose of expansion or setting up of new units. Their repayment is usually scheduled over a long period of time. The liquidity of such loans is said to depend on the anticipated income of the borrowers. As a part of long term funding for a partnership firm, the banks also fund the long term working capital requirement (it is also called WCTL i.e. working capital term loan).

**LEASE FINANCING:** Leasing is a general contract between the owner and user of the asset over a specified period of time. The asset is purchased initially by the lessor (leasing company) and thereafter leased to the user (lessee firm) which pays a specified rent at periodical intervals. 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.

### MODEL NO 7: BRIDGE FINANCE

**Q.No.17. What do you mean by Bridge Finance? (A)**  
(NEW SM, OLD SM, OLD PM, RTP M18 (N&O), N16 - 2M)

1. **MEANING:** Bridge Finance refers to loans taken by a company usually from commercial banks, for a short period, pending disbursement of loans sanctioned by Financial Institutions.

2. **SANCTION:**

- When a promoter or an enterprise approaches a financial institution for a long-term loan, there may be some normal time delays in project evaluation, administrative & procedural formalities and final sanction.
- Since the project commencement cannot be delayed, the promoter may start his activities after receiving "in-principle" approval from the lending institution.
- To meet his temporary fund requirements for starting the project, the promoter may arrange short-term loans from commercial banks or from the lending institution itself.
- Such temporary finance, pending sanction of the loan, is called as "Bridge Finance".
- This Bridge Finance may be used for –
  - Paying advance for factory land / Machinery acquisition.
  - Purchase of Equipment's etc.

3. **TERMS:**

- Interest:** The interest rate on Bridge Finance is higher when compared to term loans.
- Repayment:** These are repaid or adjusted out of the term loans as and when the loan is disbursed by the concerned institutions.
- Security:** These are secured by hypothecating movable assets, personal guarantees & Promissory notes.

### MODEL NO 8: VENTURE CAPITAL FINANCING

**Q.No.18. What is Venture Capital Financing? Explain characteristics of Venture Capital Financing? (A)**  
(NEW SM, OLD SM, OLD PM)

**MEANING:**

- Venture Capital Financing refers to financing of new high risk ventures promoted by qualified entrepreneurs who lack experience and funds to give shape to their ideas.

2. In broad sense, under venture capital financing venture capitalist make investment to purchase equity or debt securities from inexperienced entrepreneurs who undertake highly risky ventures with a potential of success.

### CHARACTERISTICS OF VENTURE CAPITAL FINANCING:

Some of the characteristics of Venture Capital Funding are: -

- 1) It is basically an equity finance in new companies.
- 2) It can be viewed as a long term investment in growth-oriented small/medium firms.
- 3) Apart from providing funds, the investor also provides support in form of sales strategy, business networking and management expertise, enabling the growth of the entrepreneur.

**Q.No.19. Explain various methods of Venture Capital Financing? (A)**  
(NEW SM, OLD SM, OLD PM, PA, N18 (O) - 4M, N15 - 4M)

*First briefly write what is Venture Capital Financing.*

### 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.

### SIMILAR QUESTION:

1. **State the methods of Venture Capital Financing.** (MTP1 N18 (O) - 4M)
- A. Refer above answer.

**Q.No.20. Discuss the factors that a venture capitalist should consider before financing any risky project. (A)**  
(OLD SM, OLD PM)

Factors to be considered by a Venture Capitalist 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 exit 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.

**SIMILAR QUESTION:**

1. What are the various factors that must be considered for Venture Capital Undertaking? (PA)
  - A. Same as above.

**MODEL NO 10: DEBT SECURITISATION**

**Q.No.21. What do you mean by Debt Securitization? (A)**  
 (NEW SM, OLD SM, OLD PM, PA, RTP: N17, M17, N16, M16, M 03, M 04, N 04, M 06, M 08 - 3M, M 11- 4M)

**MEANING OF DEBT SECURITISATION:**

1. Debt Securitisation is the process of converting some non liquid assets (e.g. Loan receivables, Mortgage backed receivables, credit card balances, Hire purchase Debtors, Trade Debtors, etc.) are pooled into marketable securities that can be sold to investors there by getting finance.
2. It is the method of recycling funds, where in securities generating steady cash flows are packaged together and against this asset pool, market securities can be issued.
3. Parties in the Securitization process are as under:
 

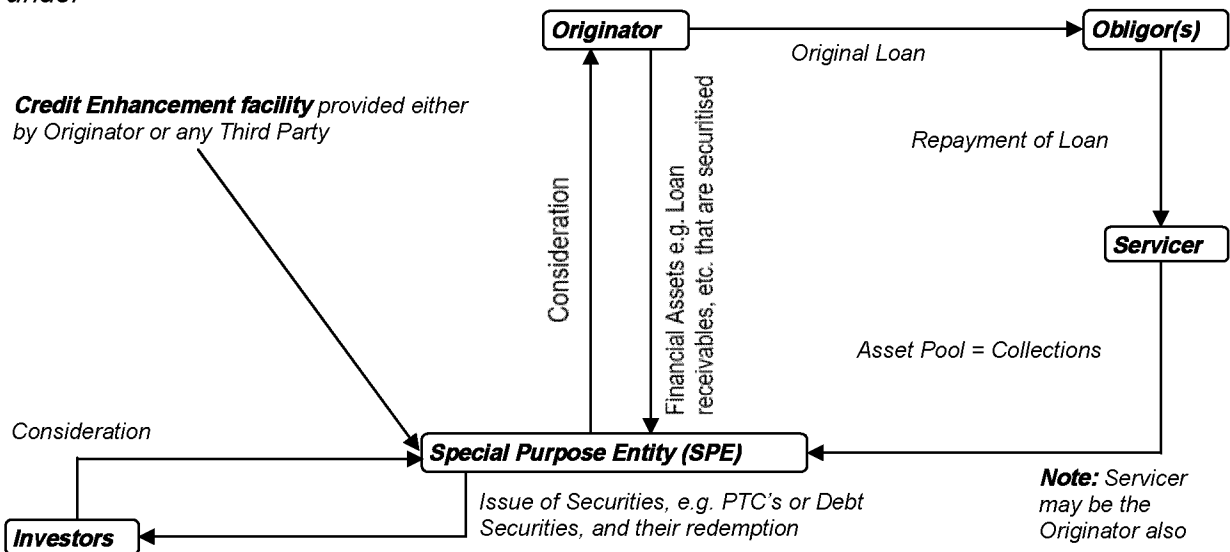
a) Originator	b) Obligator	
c) Servicer	d) Special Purpose Entity (SPE)	e) Investors

**4. SECURITIZATION PROCESS:**

- a) **Initial lending / origination function:** Originator gives various loans to different borrowers (obligors). Borrowers have to repay the loans in EMIs (Interest + Principal). These EMIs constitute financial assets / receivables for the originator.
- b) **Securitization Function:**
  - i) Financial Assets / Receivables or defined rights therein, are transferred, fully or partly, by the originator to a SPE.
  - ii) SPE pays the originator immediately in cash or in any other consideration for taking over the financial assets.
  - iii) The assets transferred are termed as 'Securitized Assets' and the assets or rights retained by the originator are called 'Retained Assets'.
- c) **Financing Function:** SPE finances the assets transferred to it by issue of securities such as Pass through Certificates (PTCs) and / or debt securities to investors. These are generally sold to investors (Mutual Funds, LIC, etc), through Merchant Bankers.

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5. **SECURITIZATION FLOW:** The parties involved and the Securitisation process is described as under-



**Note:** Special Purpose Entity (SPE) may also be called Special Purpose Vehicle (SPV).

**Q.No.22. What are the Advantages of Securitization or Debt Securitization? (A)**  
(NEW SM, OLD SM) (N16 – 4M)

First briefly write what is Debt Securitization.

#### ADVANTAGES OF SECURITIZATION OR DEBT SECURITIZATION:

##### i) To the originator:

- The assets are shifted off the Balance Sheet, thus giving the originator recourse to off-balance sheet funding.
- It converts illiquid assets to liquid portfolio.
- It facilitates better Balance Sheet management as assets are transferred off Balance Sheet facilitating satisfaction of capital adequacy norms.
- The originator's credit rating enhances.

##### ii) To the Investor:

- Securities are tied up to definite assets (Asset Pool).
- New Investment avenues are opened up.

### **MODEL NO 11: LEASE FINANCING**

**Q.No.23. Write a short note on Lease Financing? (B)** (OLD SM, NEW SM)

#### LEASE FINANCING:

- It is a general contract between the owner or lessor and user or lessee of the asset over a specified period of time.
- 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. 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.

**MODEL NO 11: SHORT TERM SOURCES OF FINANCE**

**Q.No.24. What are the various sources available to meet short term financial requirements of a company? (A)**  
(NEW SM, OLD SM, M18 (N) – 4M)

**MEANING:** Short term financing is that form of financing which embraces borrowing and lending of funds for a short period usually one year or less in duration. These are secured for financing for current assets.

1. **TRADE CREDIT:** Trade Credit represents credit granted by suppliers of goods, in the normal course of business. It is common to almost all business operations. The duration of such trade credit is based on various factors including prevailing practices, and is usually between 15 to 90 days.
2. **ACCRUED EXPENSES:** Accrued expenses represent liabilities which a company has to pay for the services which it has already received like wages, taxes, interest and dividends. Such expenses arise out of the day-to-day activities of the company and hence represent a spontaneous source of finance.
3. **DEFERRED INCOME:** Deferred income, on the other hand, reflects the amount of funds received by a company in lieu of goods and services to be provided in the future. Since these receipts increase a company's liquidity, they are also considered to be an important source of spontaneous finance.
4. **ADVANCES FROM CUSTOMERS:** Manufacturers and contractors engaged in producing or constructing costly goods involving considerable length of manufacturing or construction time usually demand advance money from their customers at the time of accepting their orders for executing their contracts or supplying the goods. This is a cost free source of finance and really useful.
5. **COMMERCIAL PAPER:** A Commercial paper is an unsecured Money Market Instrument issued in the form of Promissory Note. Since the CP represents an unsecured borrowing in money market, the regulation of CP comes under the purview of RBI which is based on recommendations of Vaghul Working Group.
6. **TREASURY BILLS:** Treasury bills are a class of Central Government Securities. Treasury bills, commonly referred to as T-Bills are issued by Government of India to meet short term borrowing requirements with maturities ranging between 14 to 364 days.
7. **CERTIFICATES OF DEPOSIT (CD):** A certificate of deposit (CD) is basically a savings certificate with a fixed maturity date of not less than 15 days up to a maximum of one year.
8. **BANK ADVANCES:** Money provided by bank to business entities for fulfilling short term financial requirement is known as Advances. These are credit facilities extended by banks to fulfill the Short Financial requirement of a business.

**Q.No.25. Write a short note on various types of deposits which serves as short term sources of finance? (A)**  
(NEW SM, OLD SM)

**TYPES OF DEPOSITS:**

1. **INTER CORPORATE DEPOSITS (ICD'S):**
  - a) Companies can borrow funds for a short period, for example 6 months or less, from other companies which have surplus liquidity.
  - b) Such Deposits made by one company in another are called Inter-Corporate Deposits (ICD's) and are subject to the provisions of the companies Act, 2013.
  - c) The rate of interest on ICD's varies depending upon the amount involved and time period.
2. **CERTIFICATE OF DEPOSIT (CD):**
  - a) The CD is a document of title similar to a Fixed Deposit Receipt (FDR) issued by a bank.

- b) There is no prescribed interest rate on such CD's. It is based on prevailing market conditions.
- c) The main advantage is that the banker is not required to encash the CD before maturity. But the investor is assured of liquidity because he can sell the CD in secondary market.

### 3. PUBLIC DEPOSITS:

- a) Public deposits are a very important source for short-term and medium term finance.
- b) A company can accept public deposits from members of the public and shareholders, subject to the stipulations laid down by RBI from time to time.
- c) The maximum amounts that can be raised by way of Public Deposits, maturity period, procedural compliance, etc. are laid down by RBI, from time to time.
- d) These deposits are unsecured loans and are used for working capital requirements. They should not be used for acquiring fixed assets since they are to be repaid within a period of 3 years.
- e) **Merits of Public Deposits from Company's Point of View:**
  - i) **No security:** The deposits are not required to be covered by securities by way of mortgage, hypothecation etc.
  - ii) **Easy Invitation:** The deposits can be easily invited by offering a rate of interest higher than the interest on bank deposits

### **MODEL NO 12: TRADE CREDIT**

**Q.No.26. What is Trade Credit? Explain merits and demerits of Trade Credit? (B)**  
(NEW SM, OLD SM)

**MEANING:** Trade Credit represents credit granted by suppliers of goods, in the normal course of business. It is common to almost all business operations. The duration of such trade credit is based on various factors including prevailing practices, and is usually between 15 to 90 days.

#### MERITS OF TRADE CREDIT:

- a) Trade credit is readily available according to the prevailing customers.
- b) Trade credit is a flexible source of finance which can be easily adjusted to the changing needs for purchases.
- c) Trade creditors generally adjust the time of payment in view of past dealings.
- d) Trade credit does not involve any floatation costs.

#### DE-MERITS OF TRADE CREDIT:

- a) The cost of trade credit may increase if the supplier tries to pass it on to the buyer in the shape of increased prices.
- b) Payment of Bills of exchange accepted or Promissory note issued against credit is required to be made at the maturity date of the bill or note, otherwise legal action may follow to recover the payment.

**Q.No.27. Explain the importance of trade credit and accruals as source of working capital. What is the cost of these sources? (A)**  
(NEW SM, OLD SM, OLD PM, MTP1 N18 (N) - 4M, MTP1 M18 (N&O) - 4M, M17 - 4M)

- i) Trade credit and accruals as source of working capital refers to credit facility given by suppliers of goods during the normal course of trade. It is a short term source of finance. SSI firms in particular are heavily dependent on this source for financing their working capital needs. The major advantages of trade credit are – easy availability, flexibility and informality.

- ii) There can be an argument that trade credit is a cost free source of finance. But it is not. It involves implicit cost. The supplier extending trade credit incurs cost in the form of opportunity cost of funds invested in trade receivables. 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.

### **MODEL NO 13: COMMERCIAL PAPER**

**Q.No.28. Explain features of Commercial Paper? (A) (NEW SM TBQ-3, OLD SM, PM, PA)**

#### **COMMERCIAL PAPER:**

- A Commercial Paper is an unsecured money market instrument issued in the form of a promissory note.
- The Reserve Bank of India introduced the commercial paper scheme in the year 1989 with a view to enabling highly rated corporate borrowers to diversify their sources of short-term borrowings and to provide an additional instrument to investors.
- Commercial papers are issued in denominations of Rs. 5 lakhs or multiples thereof and the interest rate is generally linked to the yield on the one-year government bond. It is issued at a discount on face value, and redeemable at its face value. The difference between the initial investment and the maturity value, constitutes the income of the investor.

#### **ADVANTAGES:**

- Simplicity:** Documentation involved in issue of Commercial Paper is simple and minimum.
- Cash flow management:** The issuer company can issue Commercial Paper with suitable maturity periods (not exceeding one year), tailored to match the cash flows of the company.
- Alternative for bank finance:** A well-rated company can diversify its source of finance from banks to short-term money markets, at relatively cheaper cost.
- Returns to investors:** CP's provide investors with higher returns than the banking system.
- Incentive for financial strength:** Companies which raise funds through CP becomes well-known in the financial world for their strengths. They are placed in a more favorable position for raising long-term capital also.
- Commercial paper is sold on an unsecured basis and also could not consists any restrictive conditions.**
  - Limitations of commercial papers.*
  - Only highly credit rating firms can use it as short term source of finance. New and moderately rated firms generally are not in a position to issue CP.*
  - CP can neither be redeemed before maturity nor can be extended beyond maturity.*

**Q.No.29. Discuss the eligibility criteria for issue of commercial paper? (B) (OLD SM, PM)**

#### **ELIGIBILITY CRITERIA FOR ISSUER OF COMMERCIAL PAPER:**

- The companies satisfying the following conditions are eligible to issue commercial paper. The tangible net worth of the company is Rs. 5 crores or more as per audited balance sheet of the company.
- The fund base working capital limit is not less than Rs. 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.



- v) The minimum current ratio should be 1.33:1 based on classification of current assets and liabilities.
- vi) 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.
- vii) All issue expenses shall be borne by the company issuing commercial paper.

**Q.No.30. What are the various forms in which Short Term Finance can be obtained from Banks? (B) (NEW SM, OLD SM)**

### 1. SHORT TERM LOANS:

- a) It is a single advance, wherein the entire amount of loan is disbursed at one time by transfer to the current account of the borrower.
- b) Interest & other charges like inspection, insurance, processing charges, etc. are charged to this account.
- c) Repayment of installments by the borrower as per the agreed schedule is credited to this account.
- d) Loan accounts are not running accounts like Overdraft and Cash Credit accounts.

### 2. OVERDRAFT:

- a) Under this facility, a fixed limit is granted within which the borrower is allowed to overdraw from his account.
- b) Technically, overdrafts are repayable on demand, but they generally continue for longer periods by annual renewal of limits, and constitute working capital financing.
- c) The borrower can use and draw upto the extent of limit sanctioned, according to his requirements. Interest is charged on daily balance.
- d) These accounts are running or operative like Cash Credit and Current Accounts and hence cheque books are provided.

### 3. CLEAN OVERDRAFT:

- a) A clean OD refers to an advance by way of overdraft facility, but not backed up by any tangible security.
- b) Request for clean advances are entertained only from financially sound parties, who are reputed for their integrity.
- c) The bank has to rely upon the personal security of the borrowers and considers (i) Past operations of the party, (ii) Turnover / operations in the account, (iii) Satisfactory dealings for considerable period and (iv) Reputation in the market.
- d) As a safeguard, banks take guarantees from other related persons who are credit worthy, before granting this facility.

### 4. CASH CREDITS:

- a) It is an arrangement under which a customer is allowed an advance up to certain limit against credit granted by bank.
- b) It is sanctioned against pledge or hypothecation of goods / stocks.
- c) The customer need not borrow the entire amount of advance at one time; he can only draw to the extent of his requirements and deposit surplus funds in his account.
- d) Interest is charged only on the amount actually availed of by the customer and not on the full amount.
- e) Technically, cash credit advances are repayable on demand, but these are continued and also enhanced from time-to-time by the borrower and the bank as a part of working capital financing.

f) *These accounts are running or operative accounts like Overdrafts and Current Accounts and hence cheque books are provided.*

#### 5. **ADVANCES AGAINST GOODS:**

- Under this arrangement, the Bank grants advance as a percentage of value of goods offered as security.
- The term 'goods' include all forms of movables which are offered to the bank as security. They may be agricultural commodities or industrial raw materials or partly finished goods.
- When goods are provided as security, they provide a reliable source of repayment. Advances against them are safe and liquid.
- Generally, the goods are offered as security / charge to the bank either by way of pledge or by way of hypothecation.
- For calculation of drawing limits, valuation of the goods is made from time to time. The bank also takes periodical statements of stocks from the borrower.

#### 6. **BILLS PURCHASED / DISCOUNTED:**

- These advances are allowed against the security of bills which may be clean or documentary.
- Bills are sometimes purchased from approved customers in whose favour limits are sanctioned. Before granting a limit the banker satisfies himself as to the credit worthiness of the drawer.
- The term 'bills purchased' gives the impression that the bank becomes the owner or purchaser of such bills, in actual practice the bank holds the bills only as security for the advance.
- The bank, in addition to the rights against the parties liable on the bills, can also exercise a pledge's rights over the goods covered by the documents.

Note: You can expect a question in the exam on any one part / point.

### **MODEL NO 14: EXPORT FINANCING**

**Q.No.31. Write short notes on financing of Export Trade by Banks? (C) (NEW SM, OLD SM)**

#### **EXPORT FINANCING PROVIDED BY BANKS:**

- Exports play an important role in accelerating the economic growth of developing countries like India. Export Credit is a very important factor which enables exporters in efficiently executing their export orders.
- The commercial banks provide short term export finance mainly by way of pre and post-shipment credit.
- Export finance is granted in rupees as well as in foreign currency.
- RBI has initiated several measures to ensure timely and hassle free flow of credit to the export sector, which include Rationalization and Liberalization of export credit interest rates, flexibility in repayment / prepayment of pre-shipment credit, special financial package for large value exporters, export finance for agricultural exports, Gold card scheme for exporters etc.
- Further, banks have been granted freedom by RBI to source funds from abroad without any limit, exclusively for the purpose of granting export credit in foreign currency.
- The advances by commercial banks for export financing are in the form of:
  - Pre-shipment finance i.e. before shipment of goods.
  - Post-shipment finance i.e. after shipment of goods.

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**Q.No.32. Write short notes on Pre-Shipment finance for export (Packing Credit Facility)? (A)**  
(NEW SM, OLD SM, PM, RTP: M18 (N, O))

1. **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.
2. **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.33. State the different types of Packing Credit? (A)**  
(NEW SM TBQ-1, OLD SM, PM) (M18 (O) - 4M, N14 - 4M)

**TYPES OF PACKING CREDIT:** (Extended only on production of a 'Firm Export Order' or a 'Letter of Credit')

a) **CLEAN PACKING CREDIT:**

- i) This is an advance made available to an exporter only on production of a firm export order without exercising any charge or control over raw material or finished goods that constitute the supply.
- ii) The bank takes into consideration trade requirements, credit worthiness of exporter and its margin.
- iii) The bank should obtain Export Credit Guarantee Corporation (ECGC) insurance cover.

b) **PACKING CREDIT AGAINST HYPOTHECATION OF GOODS:**

- i) 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.
- ii) 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/or whenever there is any movement in stocks.

c) **PACKING CREDIT AGAINST PLEDGE OF GOODS:**

- i) The goods which constitute the supply are pledged to the bank as security, with the stipulated margin.
- ii) The goods shall be handed over to approved clearing agents who ship the same from time to time required by the exporter.
- iii) The effective possession of the goods so pledged lies with the bank and is kept under its lock.

d) **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.

e) **FORWARD EXCHANGE CONTRACT:** It is 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.34. What are the various modes in which Post-Shipment Finance can be given for Export Trade? (B) (NEW SM, OLD SM)**

Post-shipment finance, i.e. after shipment of goods, can be in the following forms:

**1. PURCHASE / DISCOUNTING OF DOCUMENTARY EXPORT BILLS:**

- a) Just like discounting / purchasing of local supply bills, banks provide finance to exporters by purchasing export bills drawn payable at sight or by discounting usance export bills.
- b) Such bills should be based on confirmed sales orders and supported by documentary evidence for actual export like packing list, bill of lading, post parcel receipts or air consignment notes.

**2. E.C.G.C. GUARANTEE:**

- a) Banks Provides Post-shipment finance through purchase, negotiation or discount of an export bill against an order, qualifies for post-shipment export credit guarantee from ECGC.
- b) Banks insist on the exporters to take contracts shipments (comprehensive risks) policy covering both political and commercial risks.
- c) ECGC, on acceptance of the policy, will fix credit limits for individual exporters and the Corporation's liability will be limited to the extent of the limit so fixed for the exporter concerned irrespective of the amount of the policy.

**3. ADVANCE AGAINST EXPORT BILLS SENT FOR COLLECTION:**

- a) Banks also provide advance to exporters against export bills forwarded through them for collection.
- b) The evaluation factors include the credit worthiness of the party, nature of goods exported, usance, standing of drawee, margin, etc.

**4. ADVANCE AGAINST DUTY DRAWBACK, CASH SUBSIDY, ETC:**

- a) Banks also provide advance against duty draw-back, cash subsidy, etc, receivable by exporters against export performance
- b) It is insisted that the export bills are either negotiated or forwarded for collection through the Bank, so that the Bank is in a position to verify the exporter's claims for duty draw-backs, cash subsidy, etc.
- c) An advance so availed by an exporter should be settled within 180 days from the date of shipment of the relative goods.

**Q.No.35. List the facilities extended by banks to exporters, in addition to Pre & Post Shipment Finance? (C) (NEW SM, OLD SM)**

1. **LETTERS OF CREDIT:** On behalf of approved exporters, banks establish letters of credit on their overseas or up country suppliers.
2. **GUARANTEES:** Guarantees for waiver of excise duty, due performance of contracts, bond in lieu of cash security deposit, guarantees for advance payments, etc, are also issued by banks to approved clients.
3. **DEFERRED PAYMENT FINANCE:** Banks provide finance to approved clients undertaking exports on deferred payment terms.
4. **CREDIT REPORTS:** Banks also try to secure for their exporter-customers, status reports of their buyers and trade information on various commodities through their correspondents.
5. **GENERAL INFORMATION:** Banks may also provide economic intelligence on various countries, currencies, etc, to their exporter clients, on need basis.

**MODEL NO 15: FACTORING**

Q.No.36. Write short notes on Factoring? (A)

(NEW SM, OLD SM, PM, M17 – 4M)

**MEANING OF FACTORING:**

1. Factoring is a financial service, which involves financing and collecting receivable. It is both a financial as well as management support to supplier of goods / services.
2. It is a method of converting non-productive assets (receivables) into productive assets (cash).
3. Factoring may be defined as a contract between the supplier of goods / service and the factor under which the factor agrees to perform at least two of the following functions:
  - i) To finance the assigned book debts (receivables).
  - ii) To maintain account relating to receivables.
  - iii) To collect book debts.
  - iv) To provide protection against default in payment by debtors.
  - v) To provide credit administration services to the clients to decide whether or not and how much credit should be extended to the customers.

Q.No.37. Advantages and Disadvantages of Factoring (A)

(NEW SM, OLD SM, PM, M17 – 4M)

*First briefly write what is Factoring.***ADVANTAGES OF FACTORING:**

- a) Elimination of trade discounts.
- b) Prompt payments and credits.
- c) Improves scope for operating leverage.
- d) Reduction of administrative cost of book debts.
- e) Increase in return to the client.
- f) Improvement in liquidity.
- g) Provides insurance against bad debts.
- h) It is neither a loan nor a deposit but facilitates liquidity.
- i) It avoids increased debts.
- j) Current assets are efficiently managed thus reducing working capital requirements.
- k) Better credit discipline amongst customers by regular realization of dues, effective control of sales journal, reduced credit risk, better working capital management etc.

**DISADVANTAGES OF FACTORING:**

- a) Image of the client may suffer because Factoring Agency is not considered as a good sign of efficient management.
- b) Factoring may not be of much use where companies have nation-wide networking branches.
- c) Financial evaluation may not be accurate.
- d) If the client has cheaper means of finance and credit (where goods are sold against advance payment) factoring may not be useful.

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**Q.No.38. Distinguish Factoring and Bill Discounting? (A)**  
(NEW SM, OLD SM, PM) (N17 – 4M, M15 – 4M)

- 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.

### **MODEL NO 16: OTHER SOURCES OF FINANCING**

**Q.No.39. Other sources of finance (B)** (NEW SM, OLD SM, PM)

1. **SEED CAPITAL ASSISTANCE:** Seed capital is the funding required to get a new business to be started. It uses for preliminary activities such as Market research, product research & development and Business plan development.
2. **INTERNAL CASH ACCRUAL:** In case of existing profit making companies, which undertake an expansion or diversification program, the surplus generated from operations after meeting all the contractual, statutory working requirement of funds is available for financing capital expenditure.
3. **UNSECURED LOANS:**
  - a) These are provided by Promoters to meet their contribution loan.
  - b) Rate of interest chargeable on these loans should be less than or equal to rate of interest on institutional loans.
  - c) Interest on these loans can be payable only after the payment of institutional dues.
  - d) Such loans cannot be repaid without approval of institution.
  - e) These loans are treated as part of equity for the purpose of calculating Debt Equity Ratio.
4. **DEFERRED PAYMENT GUARANTEE IN CASE OF FIXED ASSETS:**
  - a) Suppliers of Machinery may provide deferred credit facility under which payment for the purchase of machinery can be made over a period of time.
  - b) Sometimes, a initial down payment is made and the balance paid in suitable installments.
  - c) In some other cases, the entire cost of the machinery is financed and the company is not required to contribute any amount initially towards acquisition of the machinery.
  - d) Normally, the supplier of machinery insists that a bank guarantee should be furnished by the buyer.
  - e) Deferred payment guarantee does not have a moratorium period for repayment. Hence, it is advisable only for an existing profit making company.
5. **CAPITAL INCENTIVES:**
  - a) These incentives consist of lump sum subsidy and exemption from/ or deferment of Sales Tax and Octroi Duty.
  - b) Its quantum is sanctioned by the implementing agency as a Percentage of its fixed capital investment subject to an overall ceiling.
  - c) Special capital incentives are sanctioned and released to the units only after they have complied with the requirements of the relevant scheme.

- d) The requirements may be classified into the Initial effective steps and Final effective steps.
- e) **Initial effective steps:**
- i) Formation of firm / company
  - ii) Acquisition of land in backward area and registration.
  - iii) Registration for manufacture of the products.
- f) **Final effective steps:**
- i) Obtain clearance under FEMA.
  - ii) Capital goods clearance / import license
  - iii) Conversion of letter of intent to industrial license.
  - iv) Tie up of the means of finance.
  - v) All clearance required for setting up of the unit.
  - vi) Aggregate expense incurred for the project should exceed 25% of the project cost and at least 10% of the fixed assets should have been created / acquired.

The release of special capital incentives by the concerned State Government generally takes one or two years. The promoters therefore find it convenient to avail bridge finance against the capital incentives.

**Note:** You can expect a question in the exam on any one part / point.

### **MODEL NO 17: SEED CAPITAL ASSISTANCE**

Q.No.40. What do you mean by Seed Capital Assistance? (A) (NEW SM, OLD SM, M05, M10 - 3M)

#### **SEED CAPITAL ASSISTANCE:**

- a) **MEANING:** Seed capital is the funding required to get a new business to be started. It uses for preliminary activities such as Market research, product research & development and Business plan development. (N18 (O) - 4M)
- b) **APPLICABILITY:** Seed capital assistance scheme is designed by IDBI for professionally or technically qualified entrepreneurs and / or persons possessing relevant experience, skills and entrepreneurial traits. All the projects eligible for financial assistance from IDBI directly or indirectly through refinance are eligible under the scheme.
- c) **AMOUNT OF FINANCE:** The project cost should not exceed Rs.2 crores. The maximum assistance under the scheme will be-
- i) 50% of the required Promoter's contribution, or
  - ii) Rs.15 lakhs, whichever is lower.
- d) **INTEREST AND CHARGES:** The assistance is initially interest free but carries a service charge of 1% p.a for the first five years and at increasing rate thereafter. When the financial position and profitability is favorable, IDBI may change interest at a suitable rate even during the currency of the loan.
- e) **REPAYMENT:** The repayment schedule is fixed depending upon the repaying capacity of the unit with an initial moratorium of upto five years.
- f) **OTHER AGENCIES:** For projects with a project cost exceeding Rs.2 crores, seed capital may be obtained from the Risk Capital and Technology Corporation Ltd. (RCTC). For small projects costing upto Rs.5 lakhs, assistance under the national equity funds of the SIDBI may be availed.

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**Q.No.41. Write a brief note on some New Financial Instruments? (A) (NEW SM, OLD SM)**

In addition to Deep Discount Bonds & Commercial Papers, the following are some new financial instruments.

**1. ZERO INTEREST FULLY CONVERTIBLE DEBENTURES:**

- 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.

**2. ZERO COUPON BONDS:**

(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.

**3. DOUBLE OPTION BONDS:**

- 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.

**4. OPTION BONDS:**

- 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.

**5. INFLATION BONDS:**

- 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.

**6. FLOATING RATE BONDS:**

(PM, RTP - M18 (N, O)

- 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.

**Note: You can expect a question in the exam on any one part / point.**



**Q.No.42. Write about Secured Premium Notes (SPN's)? (A)**  
(NEW SM TBQ-4, OLD SM, PM) (M 08-2M)

**SECURED PREMIUM NOTES (SPN'S):** Secured Premium Notes are issued along with a detachable warrant and is redeemable after a specified period, say 4 to 7 years.

- a) There is an option to convert the SPN's into equity shares.
- b) The conversion of detachable warrant into equity shares will have to be done within the time period specified by the company.

**Q.No.43. What do you mean by Deep Discount Bonds (DDB's)? (A)**  
(NEW SM, OLD SM, PM, N07 - 2M, N08 - 2M, M12 - 4M)

**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 realize the difference between face value and market price as capital gain.

### **MODEL NO 19: INTERNATIONAL FINANCING**

**Q.No.44. What are the major sources in International Financing (or) Foreign currency funds? (B)**  
(NEW SM, OLD SM)

**INTERNATIONAL FINANCING:** The essence of financial management is to raise and utilize the funds effectively. This also holds good for the procurement of funds in the International Capital Markets. There are various avenues for a multi-national organisation to raise funds through external sources, Viz:

1. **COMMERCIAL BANKS:** Like domestic loans, commercial banks all over the world extend foreign currency loans also for international operations. These banks also provide facility to overdraw, over and above the loan amount. Interest is changed on overdrawn amount.
2. **DEVELOPMENT BANKS:** Development banks offer long & medium term loans including FC loans. Many agencies at the national level offer a number of concessions to foreign companies to invest within their country and to finance exports from their countries. E.g. EXIM Bank of USA.
3. **DISCOUNTING OF TRADE BILLS:** Discounting of trade bills is used as short term financing method. This method is widely used in Europe and Asian countries to finance both domestic and International business. Under this arrangement, companies holding bills of exchange, get the bills discounted by commercial banks before their maturity.
4. **INTERNATIONAL AGENCIES:** A number of international agencies have emerged over the years to finance international trade & business. The more notable among them include The International Finance Corporation (IFC), The International Bank for Reconstruction and Development (IBRD), The Asian Development Bank (ADB), The International Monetary Fund (IMF), etc.
5. **INTERNATIONAL CAPITAL MARKETS:** Today, modern organisations including MNC's depend upon sizeable borrowings in Rupees as well as Foreign Currency (FC). In order to cater to the needs of such organisations, international capital markets have sprung all over the globe such as in London. In international capital market, the availability of FC is assured under the four main systems viz:
  - Euro-currency market
  - Export credit facilities
  - Bonds issues
  - Financial Institutions.

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**Q.No.45. Name the various Financial Instruments dealt with in the International Market? (A)  
(NEW SM, OLD SM, PM) (M14 – 2M)**

**FINANCIAL INSTRUMENTS IN THE INTERNATIONAL MARKET:**

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

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

**Q.No.46. What are various “Financial Instruments” in International Markets? (A)  
(NEW SM, OLD SM, OLD PM, M14 - 2M)**

**FINANCIAL INSTRUMENTS:** Some of the various financial instruments dealt with in the international market are briefly described below:

**1. EXTERNAL COMMERCIAL BORROWINGS (ECB):**

- ECBs refer to commercial loans in the form of bank loans buyers credit, suppliers credit, securitised instruments (e.g. floating rate notes and fixed rate bonds) availed from non-resident lenders with minimum average maturity of 3 years.
- Borrowers can raise ECBs through internationally recognised sources like (i) international banks, (ii) international capital markets, (iii) multilateral financial institutions such as the IFC, ADB etc, (iv) export credit agencies, (v) suppliers of equipment, (vi) foreign collaborators and (vii) foreign equity holders.
- ECBs can be accessed through - (i) Automatic route (for companies registered under the companies Act, and NGOs engaged in micro finance activities) or (ii) Approval route (i.e after obtaining RBI or Government approval).

**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. These Bonds are attractive to investors seeking privacy. (N18 (N) - 1M)

**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. (N18 (N) - 1M)

**5. MEDIUM TERM NOTES:** Certain issuers need frequent financing through the Bond route including that of Euro bond. However, it may be costly and ineffective to go in for frequent issues. Instead, investors can follow the MTN programme. 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. (N18 (N) - 1M)

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. (N18 (N) - 1M)
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 Bond issues referred to above are known by different names e.g. Yankee Bonds in the US, Swiss Finance in Switzerland, Samurai Bonds in Tokyo and Bulldogs in UK.
11. **EURO CONVERTIBLE BONDS:** (M03, M04 - 3M)
  - a) It is a Euro-Bond, a debt instrument which gives the bond holders an option to convert them into a pre-determined number of equity shares of the company.
  - b) Usually the price of the equity shares at the time of conversion will have a premium element.
  - c) These bonds carry a fixed rate of interest.
  - d) These bonds may include a call option (where the issuer company has the option of calling / buying the bonds for redemption prior to the maturity date) or a Put Option (which gives the holder the option to put / sell his bonds to the issuer company at a pre-determined date and price).
12. **PLAIN EURO BONDS:** Plain Euro Bonds are mere debt instruments. These are not very attractive for an investor who desires to have valuable additions to his investment.
13. **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. Usually there is a five years maturity period and they are treated as a deferred equity issue.
14. **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 may like to invest for the purpose of earning regular income / cash flow.
15. **EURO-ISSUES BY INDIAN COMPANIES:** Indian companies are permitted to raise foreign currency resources through issue of ordinary equity shares through Global Depository Receipts (GDRs) / American Depository Receipts (ADRs).

**Note: You can expect a question in the exam on any one part / point.**

**Q.No.47. Write brief notes on Euro-Issues by Indian companies? (A)**

**(NEW SM, OLD SM)**

#### **EURO-ISSUES BY INDIAN COMPANIES:**

1. 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.
2. Such investment is treated as Foreign Direct investment.
3. The government guidelines on these issues are covered under the Foreign Currency Convertible Bonds and Ordinary Shares (Through depository receipt mechanism) scheme, 1993 and notifications issued after the implementation of the said scheme.

**Q.No.48. Write short notes on American Depository Receipts (ADRs) and Global Depository Receipts (GDRs)? (A)**

**(NEW SM TBQ-5, OLD SM, PM, PA, M17 – 4M, M14 – 4M)**

Indian companies are permitted to raise foreign currency resources through issue of ordinary equity shares through Global Depository Receipts (GDRs) / American Depository Receipts (ADRs)

**AMERICAN DEPOSITORY RECEIPTS (ADRS):**

1. ADRs are securities offered by non-us companies who want to list on any of the US exchange.
2. ADRs are issued as per conditions stipulated by Security Exchange Commission (SEC) of the USA, which is a regulatory body like the SEBI in India.
3. ADRs allow US investors to buy shares of these companies without the costs of investing directly in a foreign stock exchange.
4. ADRs are in the denomination of US dollars. The process of buying new, issued ADRs goes through US brokers, Helsinki Exchanges and DTC as well as Deutsche Bank. When transactions are made, the ADRS change hands, not the certificates. This eliminates the actual transfer of stock certificates between the US and foreign countries.

**GLOBAL DEPOSITORY RECEIPTS (GDRS):**

1. GDRs are negotiable certificate, denominated in US dollars held in the bank of one country representing a specific number of shares of a stock traded on the exchange of another country.
2. These financial instruments are used by companies to raise capital in either dollars or Euros. These are mainly traded in European countries and particularly in London.
3. 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.
4. These GDR's 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).

**Q.No.49. Brief out ADRs & GDRs in Indian Scenario? (A)**

**(NEW SM, OLD SM)**

**ADRS / GDRs IN INDIAN SCENARIO:**

Indian companies are shedding their reluctance to tap the US markets. Infosys Technologies was the first Indian company to be listed on Nasdaq in 1999. However, the first Indian firm to issue sponsored GDR or ADR was Reliance industries Limited. Beside, these two companies there are several other Indian firms are also listed in the overseas bourses. These are Wipro, MTNL, State Bank of India, Tata Motors, Dr. Reddy's Lab, Ranbaxy, Larsen & Toubro, ITC, ICICI Bank, Hindalco, HDFC Bank and Bajaj Auto.

**Q.No.50. Write short notes on Indian Depository Receipts (IDR's)? (A) (NEW SM, OLD SM, PM)**

1. **INDIAN DEPOSITORY RECEIPTS:** 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 (IDRs).
2. IDRs are similar to ADRS / GDRs in the sense that foreign companies can issue IDRs to raise funds from the Indian capital market in the same lines as an Indian company uses ADRs / GDRs to raise foreign capital.
3. The IDRs are listed and traded in India in the same way as other Indian securities are traded.

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**ADVANCED QUESTIONS**

**Q.No.51. Based on Purpose, Period, what are the various Sources of Finance available in India? (B)**  
(NEW SM, OLD SM)

TYPES OF NEEDS	MEANING	PERIOD	SOURCES
<b>Long Term Needs</b>	They are required to finance permanent or hardcore working capital like building, plant and furniture.	Exceeding 5 – 10 years	<ol style="list-style-type: none"> <li>1. Equity Shares</li> <li>2. Preference Shares</li> <li>3. Retained Profits</li> <li>4. Debentures</li> <li>5. Loans From Financial institutions</li> <li>6. Loans from commercial banks</li> <li>7. Venture capital funding</li> <li>8. Lease Financing</li> <li>9. Asset Securitization</li> <li>10. International Financing</li> <li>11. Loans from financial corporation</li> </ol>
<b>Medium Term Needs</b>	They are required to finance deferred revenue expenditure like advertisement expenses	Exceeding 1 year but not exceeding 5 years	<ol style="list-style-type: none"> <li>1. Commercial Banks</li> <li>2. Public Deposits</li> <li>3. State Financial Corporation</li> <li>4. Redeemable Debentures</li> <li>5. Redeemable Preference shares</li> <li>6. Loans from Financial Institutions</li> <li>7. Euro- Shares</li> <li>8. Foreign currency bonds</li> <li>9. Lease Financing / Hire purchase financing</li> <li>10. External Commercial Borrowings</li> </ol>
<b>Short Term Needs</b>	They are required to finance temporary working capital.	Normally not exceeding 1 year.	<ol style="list-style-type: none"> <li>1. Trade credit from suppliers</li> <li>2. Advances from Customers</li> <li>3. Bill Discounting facility</li> <li>4. Overdraft</li> <li>5. Cash Credit</li> <li>6. Factoring</li> <li>7. Public Deposits</li> <li>8. Accrued expenses and deferred income</li> <li>9. Commercial Banks</li> <li>10. Fixed Deposits for a period &lt; 1 year.</li> </ol>

**Q.No.52. What are the various types of Preference shares? (B)**  
(NEW SM) (FOR NEW SYLLABUS ONLY)

**TYPES OF PREFERENCE SHARES:** In addition to the aforesaid two preferential rights, a preference share may carry some other rights. On the basis of additional rights, preference shares can be classified into seven types as under:

1. **Cumulative Preference Share** is the share on which arrears of dividend are accumulated. Unless stated otherwise, a preference share is always deemed to be a cumulative share.
2. **Non-cumulative Preference Share** is the share on which, arrears of dividend do not accumulate as per the express provision in the Articles of Association.

3. **Redeemable Preference share** is the share, which is redeemable in accordance with the provisions of Sections 55 of the companies Act, 2013. A company limited by shares can't issue any irredeemable preference shares.
4. **Participating Preference Share** is that share, which, in addition to two basic preferential rights, also carries one or more of the following rights as per the Articles of Association:
  - a) a right to participate in the surplus profits left after paying dividend to equity shareholders; and
  - b) a right to participate in the surplus assets left after the repayment of capital to equity shareholders on the winding up of the company.
5. **Non-participating Preference Share** is the share, which is not a participating share. Unless stated otherwise, a preference share is always deemed to be a non-participating preference share.
6. **Convertible Preference Share** is the share, which gives its holder a right of conversion into equity share.
7. **Non-convertible preference share** is the share, which does not confer on its holder a right of conversion into equity share. Unless stated otherwise, a preference share is always deemed to be a non-convertible share.

Q.No.53. What are the various financial needs of a Business? (C) (NEW SM, OLD SM)

**FINANCIAL NEEDS OF A BUSINESS:** Business enterprises need funds to meet their different types of requirements. All the financial needs of a business may be grouped into the following three categories:

- a) **LONG TERM FINANCIAL NEEDS:** Such needs generally refer to those requirements of funds which are for a period exceeding 5-10 years. All investments in plant, machinery, land, buildings, etc., are considered as long term financial needs. Funds required to finance permanent or hard core working capital should also be procured from long term sources.
- b) **MEDIUM TERM FINANCIAL NEEDS:** Such requirements refer to those funds which are required for a period exceeding one year but not exceeding 5 years. For example, if a company resorts to extensive publicity and advertisement campaign then such type of expenses may be written off over a period of 3 to 5 years. These are called deferred revenue expenses and funds required for them are classified in the category of medium term financial needs.
- c) **SHORT TERM FINANCIAL NEEDS:** Such type of financial needs arise to finance current assets such as stock, debtors, cash, etc. Investment in these assets is known as meeting of working capital requirements of the concern. The main characteristic of short term financial needs is that they arise for a short period of time not exceeding the accounting period. i.e., one year.

Q.No.54. Write a short note on long term loans from Financial Institutions? (C)  
(NEW SM) (FOR NEW SYLLABUS STUDENTS ONLY)

**LOANS FROM FINANCIAL INSTITUTIONS:**

i) **FINANCIAL INSTITUTION: NATIONAL**

S. NO.	NAME OF THE FINANCIAL INSTITUTION	YEAR OF ESTABLISHMENT	REMARKS
1.	Industrial Finance Corporation of India (IFCI)	1918	Converted into a public Company
2.	State Financial Corporations (SFCs)	1951	-
3.	Industrial Development Bank of India (IDBI)	1954	Converted into Bank
4.	National Industrial Development Corporation (NIDC)	1954	-

5.	Industrial Credit and Investment Corporation of India (ICICI)	1955	Converted into Bank and Privatised)
6.	Life Insurance Corporation of India (LIC)	1956	-
7.	Unit Trust of India (UTI)	1964	-
8.	Industrial Reconstruction Bank of India (IRBI)	1971	-

## ii) FINANCIAL INSTITUTION: INTERNATIONAL

S. NO.	NAME OF THE FINANCIAL INSTITUTION	YEAR OF ESTABLISHMENT
1.	The World Bank/International Bank for Reconstruction and Development (IBRD)	1944
2.	The International Finance Corporation (IFC)	1956
3.	Asian Development Bank (ADB)	1966

**Q.No.55. Distinguish between Global Depository Receipts (GDR'S) and American Depository Receipts (ADR'S)? (C) (OLD SM, PM)**

**DIFFERENTIATION BETWEEN GLOBAL DEPOSITORY RECEIPTS (GDRS) AND AMERICAN DEPOSITORY RECEIPTS (ADRS):**

**GLOBAL DEPOSITORY RECEIPTS (GDRS)**

1. Global Depository Receipts (GDRs) is a negotiable certificate denominated in US dollars, which represents a-non-US companies publicly, traded local currency equity.
2. GDRs are created when the local currency shares of an Indian company are delivered to the depository's local custodian bank, against which depository bank issues depository receipts in US dollar.
3. GDR may be freely traded in the overseas market like any other dollar denominated security either on a foreign stock exchange or in the over the counter market of qualified institutional buyers (QIBs).
4. By issue of GDRs, Indian companies are able to tap global equity market to raise foreign currency funds by way of equity.

**AMERICAN DEPOSITORY RECEIPTS (ADRS):**

1. American Depository Receipts (ADRs) are depository receipts issued by non US companies who want to list on any of the USA Exchange, as governed by the provisions of Security and Exchange Commission of USA.
2. Each ADR represent a certain number of company regular shares.
3. ADRs allow US investors to buy shares of these companies without the costs of investing directly in a foreign stock exchange.
4. ADRs are costlier than GDR Legal fees are considerably high for US listing. Registration fee in USA is also substantial. Hence, ADRs are less popular than GDRs.

**MULTIPLE CHOICE QUESTIONS - FOR SELF STUDY**

1. Equity shares:
  - a) Have an unlimited life, and voting rights and receive dividends
  - b) Have a limited life, with no voting rights but receive dividends
  - c) Have a limited life, and voting rights and receive dividends
  - d) Have an unlimited life, and voting rights but receive no dividends
2. External sources of finance do not include:
  - a) Debentures
  - b) Retained earnings
  - c) Overdrafts
  - d) Leasing

3. Internal sources of finance do not include:  
 a) Better management of working capital  
 b) Ordinary shares  
 c) Retained earnings                      d) Trade credit
4. Preference shares:  
 a) Do not get dividends  
 b) Have no voting rights  
 c) Are not part of a company's share capital  
 d) Receive dividends
5. A debenture:  
 a) Is a long-term loan  
 b) Does not require security  
 c) Is a short-term loan  
 d) Receives dividend payments
6. Debt capital refers to:  
 a) Money raised through the sale of shares.  
 b) Funds raised by borrowing that must be repaid.  
 c) Factoring accounts receivable.  
 d) Inventory loans.
7. The most popular source of short-term funding is:  
 a) Factoring.  
 b) Trade credit.  
 c) Family and friends.  
 d) Commercial Banks.

**KEY:**

1.	A	2.	B	3.	B	4.	B	5	A	6	B	7.	B
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**THE END**



### 3. WORKING CAPITAL MANAGEMENT

#### MODEL 1: MEANING AND CONCEPT OF WORKING CAPITAL

Q.No.1. Explain the meaning & concept of working capital?

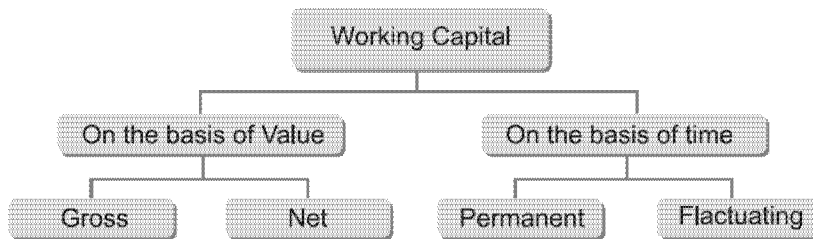
(C) (NEW SM, OLD SM)

#### MEANING:

- a) Working capital refers to funds required to be invested in the business for a short period usually upto one year. It is also known as short-term capital or circulating capital.
- b) In accounting term, it is the difference between the current assets and current liabilities.

$$\text{Working Capital} = \text{Current Assets} - \text{Current Liabilities}$$

The concept of working capital can also be explained through two angles.



#### i) VALUE POINT OF VIEW:

- a) **Gross Working Capital:** It refers to the firm's investment in Current Assets.
- b) **Net Working Capital:** It refers to the difference between current assets and current liabilities.  
 A positive working capital means that the company is able to pay off its short term liabilities.  
 A negative working capital means that the company currently is unable to meet its short-term liabilities.

#### ii) TIME POINT OF VIEW:

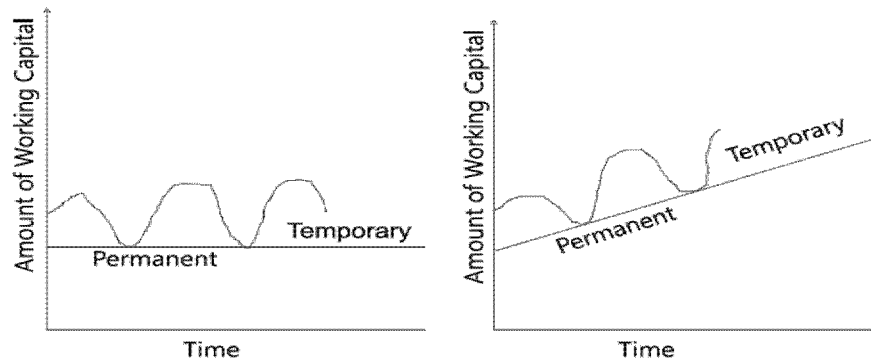
- a) **Permanent Working Capital:** It refers to the hard core working capital. It is that minimum level of investment in the current assets that is carried by the business at all times to carry out minimum level of its activities.
- b) **Temporary Working Capital:** It refers to that part of total working capital, which is required by a business over and above permanent working capital. It is also called variable working capital.

Q.No.2. Write a short note on Permanent Working Capital vs Temporary Working Capital

(C) (NEW SM, OLD SM, PA)

#### PERMANENT WORKING CAPITAL VS TEMPORARY WORKING CAPITAL:

PARTICULARS	PERMANENT WORKING CAPITAL	TEMPORARY WORKING CAPITAL
1. Meaning	It is the <u>minimum</u> level of investment required in the Working Capital of the business at any point of time and hence at all points of time.	It represents Working Capital requirements <u>over and above</u> Permanent Working Capital.
2. Nature	It represents a long-term investment.	It represents a short-term investment.
3. Also called	It is also called <u>Fixed (or) Core (or) Hard core Working Capital</u> .	It is also called <u>Fluctuating (or) Variable Working Capital</u> .
4. Amount	Generally, the amount of Permanent Working Capital increases along with sales and activity levels in the long-run.	The amount of Temporary Working Capital fluctuates (i.e. moves up and down) due to factors like peak season, trade cycle boom, etc.



**Q.No.3. What is working capital? Explain the importance of working capital to Business?**  
(C) (NEW SM, OLD SM, PA)

*First briefly write what is working capital.*

**IMPORTANCE OF WORKING CAPITAL:**

- i) Working Capital is required to use Fixed Assets profitably. For example, a machine cannot be used productively without Raw Materials.
- ii) Funds are required for day-to-day operations and transactions. These are provided by Cash and Cash Equivalents, forming part of Current Assets.
- iii) Adequate Working Capital determines the short-term solvency of the Firm. Inadequate Working Capital means that the Firm will be unable to meet its immediate payment commitments.
- iv) Funds are procured from long-term and short-term sources. Hence, they should be invested appropriately in a proper mix of long-term and short-term assets, in order to maintain and improve the structural health of the business.
- v) Increase in activity levels and sales should be backed up by suitable investment in Working Capital. Otherwise, it will result in under-capitalization and over-trading.
- vi) The aspects of liquidity and profitability are inversely related. Higher the profitability, lower the liquidity, and vice-versa. Hence a proper balance between the two is required.
- vii) The need for Working Capital is directly related to the Firm's growth.

**Q.No.4. Explain the importance of maintaining adequate working capital?**

(C) (NEW SM, OLD SM)

*First briefly write what is working capital.*

**IMPORTANCE OF ADEQUATE WORKING CAPITAL:**

1. Management of working capital is an essential task of the finance manager. He has to ensure that the amount of working capital available with his concern is neither too large nor too small for its requirements.
2. A large amount of working capital would mean that the company has idle funds. Since funds have a cost, the company has to pay huge amount as interest on such funds.
3. If the firms have inadequate working capital, such firms run the risk of insolvency. Paucity of working capital may lead to a situation where the firm may not be able to meet its liabilities.
4. Various studies conducted by the Bureau of Public Enterprises have shown that one of the reasons for poor performance of public sector undertakings in our country has been the large amount of funds locked up in working capital. This results in over capitalization. Over capitalization results into lower rate of return. This implies a less than optimal use of resources. Therefore, a firm has to be very careful in estimating its working capital requirements.

5. Maintaining adequate working capital is not just important in the short-term. Sufficient liquidity must be maintained in order to ensure the survival of the business in the long-term as well.

**Q.No.5. What are the determinants of Working Capital Requirement?**

**(B) (NEW SM, OLD SM, M18 (O) - 4M)**

**SOME OF THE ITEMS/FACTORS WHICH NEEDS TO BE CONSIDERED WHILE PLANNING FOR WORKING CAPITAL REQUIREMENT ARE:**

- a) **CASH:** Identify the cash balance which allows for the business to meet its day to day expenses, but reducing cash holding costs.
- b) **INVENTORY:** Identify the level of inventory which allows for uninterrupted production but reduces the investment in raw materials. The techniques Like Just In Time Inventory (JIT) and Economic Order Quantity (EOQ) are used for this.
- c) **RECEIVABLES:** 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. Depending on 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) **OPERATING EFFICIENCY:** A company can reduce the working capital requirement by eliminating waste, improving coordination etc.
- f) **NATURE OF BUSINESS:** For e.g. in a business of restaurant, most of the sales are on Cash basis. Therefore, need for working capital is very less. So working capital requirement also depends upon the nature of business.
- g) **MARKET AND DEMAND CONDITIONS:** For e.g. if the demand of an item far exceeds its production, the working capital requirement would be less since the investment in finished goods inventory will be very less.
- h) **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 the whole year or instead may choose policy of production only during demand season.
- 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.
- j) **OTHER FACTORS:**
- |                                  |                                  |
|----------------------------------|----------------------------------|
| i) <u>Production Policies.</u>   | v) <u>Business Cycle.</u>        |
| ii) <u>Credit Policy.</u>        | vi) <u>Growth And Expansion.</u> |
| iii) <u>Abnormal Factors.</u>    | vii) <u>Level Of Taxes.</u>      |
| iv) <u>Conditions Of Supply.</u> | viii) <u>Dividend Policy</u>     |

**SIMILAR QUESTION:**

1. Discuss the factors to be taken into consideration while determining the requirement of working capital?  
(NEW SM-TBQ 1, M18 (O) - 4M)
- A. Same as above.

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**MODEL 2: MANAGEMENT OF WORKING CAPITAL**

**Q.No.6. What is working capital management? Discuss the liquidity vs. Profitability issue in Management of Working Capital. (A) (NEW SM-TBQ 2, OLD SM, OLD PM, MTP N16 - 4M, N10 - 4M)**

**WORKING CAPITAL MANAGEMENT:**

- Working Capital Management means planning, organizing, directing and controlling of working capital. It involves managing the balance between firm's short-term assets and its short-term liabilities.
- Its scope can be grouped into two broad areas (i) Profitability and Liquidity and (ii) Investment and Financing Decision.

**LIQUIDITY AND PROFITABILITY:**

- For uninterrupted and smooth functioning of the day to day business of an entity it is important to maintain liquidity of funds evenly while considering the cost aspect.
- Unnecessary tying up of funds in idle assets not only reduces the liquidity but also reduces the opportunity to earn better returns from a productive asset.
- Hence, a trade-off is required between the liquidity and profitability which increases the profitability without disturbing the day to day functioning.
- This requires 3Es i.e. Economy in financing, Efficiency in utilisation and Effectiveness in achieving the intended objectives.

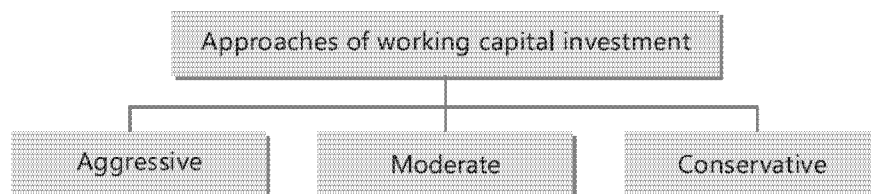
**INVESTMENT AND FINANCING:** Working capital policy is a function of two decisions.

- Investment in working capital:** It is concerned with the level of investment in the current assets. It gives the answer of 'How much' funds to be tied in to achieve the organisation objectives (i.e. Effectiveness of funds).
- Financing decision:** It is concerned with the arrangement of funds to finance the working capital. It gives the answer 'Where from' fund to be sourced' at lowest cost as possible (i.e. Economy).

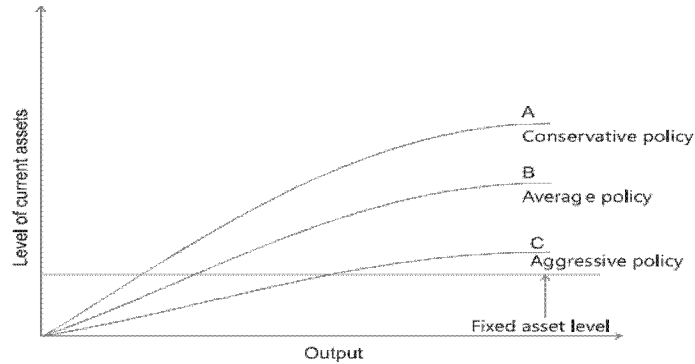
**Q.No.7. What are the various approaches of working capital investment?**

**(C) (NEW SM, OLD SM)**

**APPROACHES OF WORKING CAPITAL INVESTMENT:** Based on organisational policy and risk-return trade off, working capital investment decisions are categorised into three approaches i.e. aggressive, conservative and moderate.



- AGGRESSIVE:** Here investment in working capital is kept at minimal investment in current assets which means the entity does hold lower level of inventory, follow strict credit policy, keeps less cash balance etc. The advantage of this approach is lower financial costs.
- CONSERVATIVE:**
  - Here investment in current assets higher and it keeps inventory level higher, follows liberal credit policies, and cash balance as high as to meet any current liabilities immediately.
  - It facilitates higher sales volume, due to liberal credit policy and increase goodwill among the suppliers due to payment in short time.
- MODERATE:** This approach is in between the above two approaches. Under this approach a balance between Risk and Return is maintained to gain more by using the funds in a very efficient manner.



**Q.No.8. Write a short note on Current Assets to Fixed Assets Ratio? (B) (NEW SM, OLD SM)**

### CURRENT ASSETS TO FIXED ASSETS RATIO:

- i) The finance manager is required to determine the optimum level of current assets so that the shareholders' value is maximized.
- ii) A firm needs fixed and current assets to support a particular level of output. As the firm's output and sales increases, the need for current assets also increases.
- iii) Generally, current assets do not increase in direct proportion to output. Current assets may increase at a decreasing rate with output. As the output increases, the firm starts using its current assets more efficiently.
- iv) The level of current assets can be measured by creating a relationship between current assets and fixed assets.

### FORMULA:

Current assets to fixed assets ratio =  $\frac{\text{Current assets}}{\text{Fixed assets}}$ .

### OBSERVATION:

- i) A higher current assets/fixed assets ratio indicates a conservative policy which implies greater liquidity and lower risk.
- ii) Lower current assets/fixed assets ratio means an aggressive policy which indicates Higher risk and poor liquidity.
- iii) Moderate current assets policy will fall in the middle of conservative and aggressive policies. The current assets policy of most of the firms may fall between these two extreme policies.

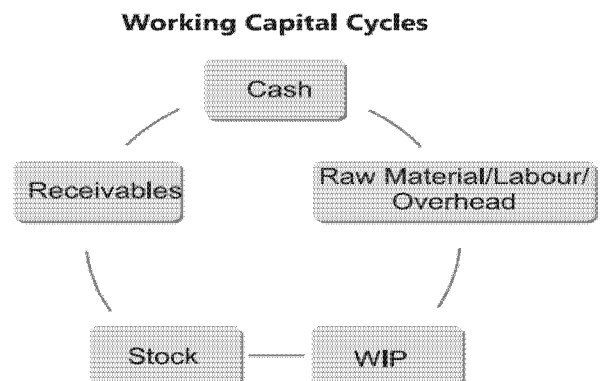
### **MODEL 3: OPERATING OR WORKING CAPITAL CYCLE**

**Q.No.9. Write a short notes on operating or working capital cycle?**

**(B) (NEW SM, OLD SM, PM) (N 10 - 4M)**

### OPERATING CYCLE:

- i) Working Capital Cycle or Cash Cycle or Operating Cycle is the time duration for conversion of cash into cash equivalents like Raw Materials, Work-in Progress, Finished Goods, Sundry Debtors and thereafter back into cash.
- ii) It helps in the forecast, control and management of working capital.
- iii) The duration of working capital cycle may vary depending on the nature of business.



**SEGMENTS:** The operating cycle has following phases or segments -

- Conversion of Cash into Raw Materials.
- Conversion of Raw Materials, into WIP and then into Finished Goods.
- Conversion of Finished Goods into Debtors through Sales.
- Conversion of Receivables into Cash.

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

$$\text{Operating Cycle} = R + W + F + D - C.$$

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.

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### **MODEL 4: TREASURY MANAGEMENT**

**Q.No.10. What is the meaning of Treasury Management?**

**(A) (NEW SM, OLD SM)**

#### **TREASURY MANAGEMENT:**

- Treasury Management refers to the efficient management of liquidity and financial risk in business.
- 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.'

#### **1. THE TREASURY MANAGEMENT MAINLY DEALS WITH:**

- Working capital management, and
- Financial risk management (It includes forex and interest rate management).

#### **2. THE KEY GOALS OF TREASURY MANAGEMENT ARE:**

- Maximize the return on the available cash,
- Minimize interest cost on borrowings,
- Mobilise as much cash as possible for corporate ventures (in case of need), and
- 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.

**Q.No.11. Define Treasury Management? What are the functions of Treasury Management?**

**(A) (NEW SM-TBQ 4, OLD SM, PM) (N16 - 4M, M09 - 2M)**

*First briefly write what is Treasury Management.*

#### **FUNCTIONS OF TREASURY MANAGEMENT:**

- 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.
- 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.

### **MODEL 5: MANAGEMENT OF CASH**

**Q.No.12. What is Cash Management? What are the objectives of Cash Management?**

**(C) (NEW SM, OLD SM)**

**CASH MANAGEMENT:** It is an important function of the finance manager. It is concerned with the managing of:

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

**OBJECTIVES OF CASH MANAGEMENT:**

- Provide adequate cash to each of its units,
- No funds are blocked in idle cash, and
- 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.13. Write Basic Needs or Considerations for holding Cash? (B) (NEW SM, OLD SM, PA)**

**BASIC NEEDS OR CONSIDERATIONS FOR HOLDING CASH:**

- TRANSACTION OR OPERATION NEEDS:** Cash may be held sufficiently in order to meet day-to-day expenses, repayments, commitments, etc. If the forecast receipts or inflows do not arise as planned, the reserve cash balance will be available for meeting payment commitments.
- SPECULATIVE OR INVESTMENT NEEDS:** Cash may be held in order to take advantage of profitable opportunities that may crop up, e.g. purchase of materials in bulk in case of temporary fall in price. Otherwise, such opportunities may be lost for want of ready cash.
- PRECAUTIONARY OR SAFETY NEEDS:** Cash may be held in order to provide safety against unexpected events and payments. Sufficient cash holding gives a sense of security or safety to the Firm.

**SIMILAR QUESTION:**

- What are the Needs for Cash?

A. Same as above.

**Q.No.14. What is Cash Budget? What are the various purposes of Cash Budgets?**

**(A) (NEW SM, OLD SM) (N15 - 4M)**

**CASH BUDGET:** It is the most significant 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 coordinates 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.

**SIMILAR QUESTION:**

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

A. Same as above.

**Q.No.15. What is cash Budget? Explain advantages and disadvantage of cash budget? (C) (NEW SM, OLD SM)**

*First briefly write what is cash Budget.*

1. **ADVANTAGES:**

- a) Complete picture of all items of expected Cash Flows.
- b) Sound tool of managing daily cash operations.
- c) Determination of Net Cash inflow so as to arrange finance, when required.
- d) Identification of better ways to utilize funds, e.g. investing surplus cash in marketable securities and earn profits.

2. **DISADVANTAGES:**

- a) Reliability is reduced due to uncertainty of cash forecasts. For example, collections may be delayed, or unanticipated demands may cause large disbursements.
- b) Fails to highlight the significant movements in Working Capital items.

**Q.No.16. What are the methods used for preparation of Cash Budgets? (C) (NEW SM, OLD SM)**

**METHODS OF PREPARATION OF CASH BUDGETS:**

- 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 long-term liabilities and the balance sheet will then show if additional finance is needed.

**SIMILAR QUESTION:**

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

A. Same as above.



Q.No.17. Explain the following 1. Concentration Banking 2. Lock Box System.

(A) (NEW SM, OLD SM)

1. **CONCENTRATION BANKING:** (MTP M18 (O) - 2M, N17 - 2M, M17 - 2M, M14 - 2M)
  - 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 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:** (N17 - 2M, M14 - 2M)
  - 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.

**SIMILAR QUESTION:**

1. What are the various localised cash collection systems?

A. Same as above.

Note: You can expect a question in the exam on any one part / point.

Q.No.18. Write a short note on Different kinds of float with reference to management of cash.

(A) (NEW SM, OLD SM, OLD PM, MTP2 N18 (O) - 4M, 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) **MAILING 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.

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**Q.No.19. What is Baumol's Economic Order Quantity model?**

**(A) (NEW SM, OLD SM, PM, PA, M 04, N 05 - 3M)**

- i) **PROPOSED:** This model was proposed by William J. Baumol's in the year 1952, It also called W.J. Boaumol's Economic order quantity model.
- ii) **PRINCIPLE:** According to this model, optimum cash level is that level of cash where the carrying costs and transactions costs are the minimum and at that point where these two costs are equal.
- The carrying cost refers 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 fails short of cash and has to sell the securities resulting in clerical, brokerage, registration and other costs.
  - The optimum cash balance according to this model will be that point where these two costs are equal.
- iii) **ASSUMPTIONS:**
- Cash needs of the firm are known with certainty.
  - The cash is used uniformly over a period of time and it is also known with certainty.
  - The holding cost is known and it is constant.
  - The transaction cost also remains constant.

- iv) **COMPUTATION:** The formula for determining optimum cash balance is:  $C = \sqrt{\frac{2U \times P}{S}}$

Where, C = Optimum cash balance,

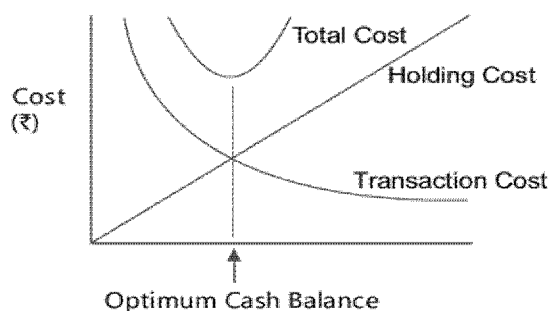
U = Annual (or monthly) cash disbursement,

P = Fixed cost per transaction,

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

This can be explained with the following diagram:

**DIAGRAMMATIC REPRESENTATION:**



**SIMILAR QUESTION:**

1. Explain Baumol's Model of Cash Management.

(NEW SM-TBQ 5)

A. Same as above.

**Q.No.20. Discuss Miller-Orr Cash Management model.**

**(A) (NEW SM-TBQ 8, OLD SM, PM, PA) (N 05 - 3M, M11 - 4M, M15 - 4M)**

- a) **PROPOSED:** This model was proposed by Miller-Orr in the year 1952, It also called Stockstic Model.
- b) **THEORY:** This model operates as under-

- i) Cash Outflows / Payments are not uniform during the year.
- ii) Upper and lower limits can be fixed for cash balances, as outflows do not exceed a certain limit on any day. These limits are determined based on fixed transaction costs, interest foregone on marketable securities and the degree of likely fluctuations in cash balances.
- iii) When cash balance reaches the upper limit, surplus cash is invested in marketable securities, to bring down the cash balance to the average limit or return point.
- iv) When cash balance touches the lower limit, investments (marketable securities) are disposed off so that cash balances goes up to the average limit or return point.
- v) During the period when Cash Balance stays between high and low limits, there are no transactions between cash and marketable securities.

c) **ASSUMPTIONS:**

- a) Under this model, cash payments are presumed at different amounts on different days, i.e. variable or stochastic, e.g. Wage and Salary payment arises in the first week, Telephone Bills fall due for payment once in a month, etc.
- b) With this assumption, this model is designed to determine the time and size of transfers between an Investment Account and Cash Account.

d) **FORMULA:**

$$Z = \sqrt[3]{\frac{3TV}{4i}}$$

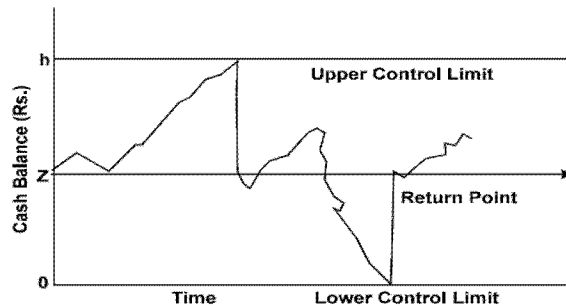
$$\text{Upper limit} = 3Z + L$$

$$\text{Return level } R = L + Z$$

$$\text{Spread} = H - L$$

$$\text{Average Cash Balance} = \frac{4R - L}{3}$$

**DIAGRAMMATIC REPRESENTATION:**



MILLER-ORR CASH MANAGEMENT MODEL

The MO Model is more realistic since it allows variations in cash balance within lower and upper limits. The finance manager can set the limits according to the firm's liquidity requirements i.e., maintaining minimum and maximum cash balance.

**Q.No.21. Write a short note on Management of Marketable Securities?**

**(A) (NEW SM, OLD SM, PM, PA) (M16 - 4M, N13 - 4M)**

**MARKETABLE SECURITIES:**

- a) Marketable securities are short period, interest earning, high quality debt instruments that can be easily converted into cash.
- b) Some examples are Government Treasury Bills (T-Bills), Short-term Deposits with Banks (Certificate of Deposits and Money at Call and at Short Notice), Inter-Corporate Deposits (ICD's), Commercial Papers (CP's), Money Market Mutual Funds (MMMF5), etc.

**SELECTION CRITERIA:** The selection of securities for short-term investment purposes, depends on-

- a) **SAFETY:** Investment should be safe, i.e. guaranteed income and return of principal, when disposed off. Since short-term funds are to be parked in marketable securities, minimum risk is the criterion of selection, for ensuring liquidity.
- b) **MATURITY:** Matching maturity of investments with 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 said to be highly liquid or marketable.

**SIMILAR QUESTIONS:**

1. Describe the three principles relating to selection of marketable securities. (M16 - 4M)  
A. Same as above.
2. What are the principles involved in selection of marketable securities? (OLD PM)  
A. Same as above.

**Q.No.22. 'Management of marketable securities is an integral part of investment of cash'**  
Comment. (A) (NEW SM, OLD SM, 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.

**MODEL 6: RECENT DEVELOPMENTS IN CASH MANAGEMENT**

**Q.No.23. Write a short note on Electronic Cash Management System.**  
(A) (NEW SM-TBQ 6, OLD SM, 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.

**Q.No.24. State the advantages of Electronic Cash Management System.**  
(A) (NEW SM-TBQ 6, OLD SM, PM) (M 13-4M)

*First briefly write what is Electronic Cash Management System.*

**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.

**Q.No.25. Explain recent developments in cash Management?**

**(A) (NEW SM, OLD SM) (N 13 – 4M)**

**ELECTRONIC FUNDS TRANSFER:**

- a) By using information technology in the Banking Services, the electronic network will be linked to different branches and banks. Funds and Data can be transferred electronically from one account / place / branch / bank to another.
- b) The advantages of Electronic Fund Transfer System are (i) Instant updation of accounts, (ii) Quick transfer of funds, and (iii) Instant information about foreign exchange rates.

**ZERO BALANCE ACCOUNT:**

- a) For efficient Cash Management, Firms can employ an extensive policy if substituting marketable securities for cash by the use of Zero Balance Accounts.
- b) Every day, the Firm totals the cheques presented for payment against the account.
- c) The firm transfers the balance amount of cash in the account of any, for buying marketable securities. In case of shortage of cash, the Firm sells the marketable securities.
- d) This method seeks to ensure optimum liquidity as well as profitability.

**MONEY MARKET OPERATIONS:**

- a) One of the tasks of 'treasury function' of larger companies is the investment of surplus funds in the money market.
- b) The chief characteristic of money market banking is one of size. Banks obtain funds by competing in the money market for the deposits by the companies, public authorities, High Net Worth Investors (HNI), and other banks.
- c) Deposits are made for specific periods ranging from overnight to one year; highly competitive rates which reflect supply and demand on a daily, even hourly basis are quoted.

- d) Consequently, the rates can fluctuate quite dramatically, especially for the shorter-term deposits. Surplus funds can thus be invested in money market easily.

#### **PETTY CASH IMPREST SYSTEM:**

- a) Under this system, the day-to-day petty cash expenses are estimated taking into account past experience and future needs.
- b) Generally, a week's requirement of cash will be kept separately for making petty cash expenses. Again, the next week will commence with the pre-determined balance. This will reduce the strain of the management in managing petty cash expenses and help in managing overall cash efficiently.

#### **MANAGEMENT OF TEMPORARY CASH SURPLUS:**

Temporary cash surpluses can be profitably invested in the following:

- a) Short-term deposits in Banks and financial institutions.
- b) Short-term debt market instruments.
- c) Long-term debt instruments.
- d) Shares of Blue chip listed companies.

**Note: You can expect a question in the exam on any one part / point.**

**Q.No.26. What is Virtual Banking? State its advantages.**

**(A) (NEW SM, OLD SM, OLD PM, MTP N16 - 4M, MTP N15 - 4M, N 13 - 4M)**

#### **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.

#### **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.

#### **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).*

**SIMILAR QUESTION:**

1. "Sophisticated cash management system can be achieved through Virtual banking." Discuss.
- A. Same as above.

**MODEL 7: MANAGEMENT OF RECEIVABLES**

**Q.No.27. Meaning and Objective of Management Of Receivables? (C) (NEW SM, OLD SM)**

1. **MANAGEMENT OF RECEIVABLES:**

It refers to planning and controlling of 'debt' owed to the firm from customer on account of credit sales. It is also known as trade credit management.

2. **OBJECTIVE OF MANAGEMENT OF RECEIVABLES (DEBTORS):**

- a) The basic objective of management of receivables (debtors) is to optimise the return on investment on these assets.
- b) Large amounts are tied up in receivables, there are chances of bad debts and there will be cost of collection of debts.
- c) On the contrary, if the investment in receivables is low, the sales may be restricted, since the competitors may offer more liberal terms.

Therefore, management of receivables is an important issue and requires proper policies and their implementation.

**Q.No.28. What are the 3 aspects of management of sundry debtors? (B) (NEW SM, OLD SM) (M 02, 10 - 4M)**

There are basically 3 aspects of management of sundry debtors.

1. **CREDIT POLICY:** The credit policy of a firm involves decisions relating to length of the credit period, cash discount and other special terms. These decisions in turn determine investments in sundry debtors, average collection period and bad debt losses. Credit policy involves the following considerations:

- a) **CREDIT PERIOD:** If the demand of a product is inelastic, the credit period may be small. However, if product has an elastic demand, the credit period will determine the quantum of sales. The credit period is also dependent on the custom in the industry and the practice followed by various competitors.
- b) **DISCOUNT POLICY:** Discounts are normally given to speed up the collection of debts. The rate of discount to be given should depend upon the costs of carrying debts.

2. **CREDIT ANALYSIS:** This requires the finance manager to determine as to how risky it is to advance credit to a particular party.

3. **CONTROL OF RECEIVABLES:**

This requires finance manager to follow up debtors and decide about a suitable credit collection policy. It involves both laying down of credit policies and execution of such policies.

There is always cost of maintaining receivables which comprises of following costs:

- a) The company requires additional funds as resources are blocked in receivables which involves a cost in the form of interest (loan funds) or opportunity cost (own funds).
- b) Administrative costs which include record keeping, investigation of credit worthiness etc.
- c) Collection costs.
- d) Defaulting costs.

**Q.No.29. Is it worth offering discounts to debtors to encourage prompt payment? (B) (NEW SM, OLD SM) (RTP: M15)**

- i) Proposed changes to credit policy should be evaluated in the light of the additional costs and benefits that will result from their being undertaken.
- ii) 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.30. What is credit policy? Explain briefly types of credit policies? (B) (NEW SM, OLD SM)**

1. **CREDIT POLICY:** The credit policy of a firm involves decisions relating to length of the credit period, cash discount and other special items. These decisions in turn determine investments in sundry debtors, average collection period and bad debt losses. Credit policy involves the following considerations:

2. **TYPES OF CREDIT POLICIES:**

**Lenient / Loose / Expansive credit policy:**

- i) Under this policy, firms sell on credit to customers on very liberal terms and standards.
- ii) Because of this policy company able increase in accounts receivables that is, additional extension of trade credit not only results in higher sales but also requires additional financing to support the increased investment in accounts receivables.
- iii) The costs of credit investigations and collection efforts and the chances of bad debts are also increased.

**Stringent / Tight / Restrictive credit policy:**

- i) Under this policy the firm is very selective in extending credit. It mix credit sales to only to those customers who have proven to be business.
- ii) Because of tight credit standards, chances of bad debts and other credit costs are minimized but at the same time sales and profits are restricted.

### **MODEL 8: FINANCING RECEIVABLES**

**Q.No.31. Write about various methods of Financing Receivables? (A) (NEW SM, OLD SM)**

Pledging of accounts receivables and Factoring have emerged as the important sources of financing of accounts receivables now-a-days.

**PLEDGING:**

- a) Pledging refers to the use of a firm's receivable to secure a short term loan which serve as prime collateral for a secured loan.
- b) The lender scrutinizes the quality of the accounts receivables, selects acceptable accounts, creates a lien on the collateral and fixes the percentage of financing receivables which ranges around 50 to 90%.
- c) The major advantage of pledging accounts receivables is the ease and flexibility it provides to the borrower. Moreover, financing is done regularly. This, however, suffers on account of high cost of financing.

**FACTORING:**

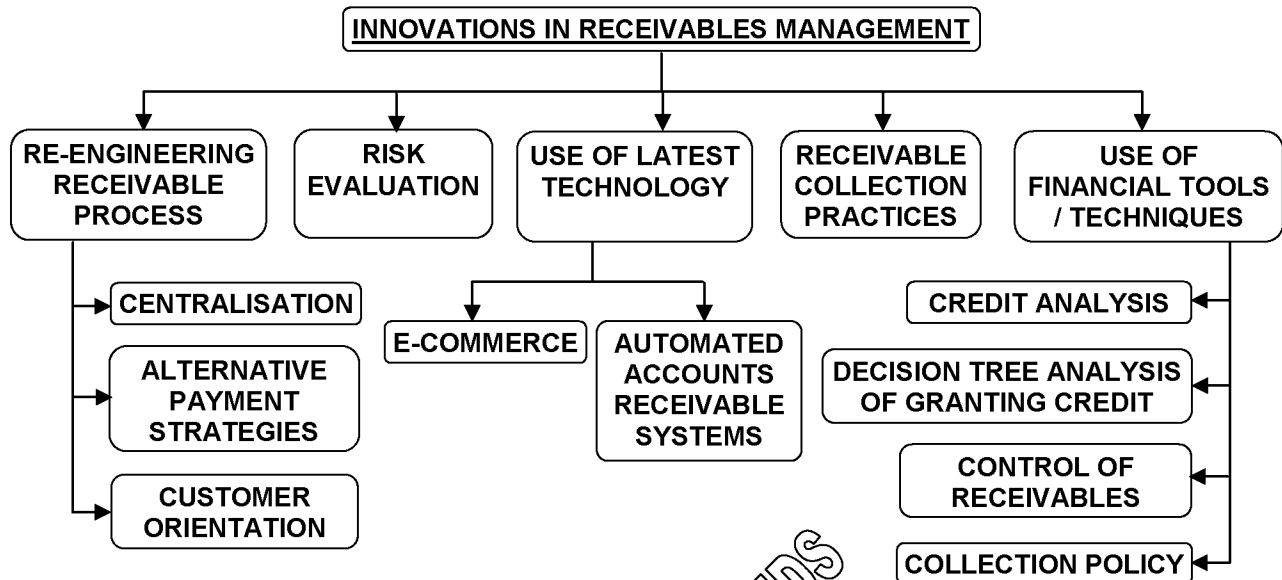
- a) Factoring is a relatively new concept in financing of accounts receivables, which refers to outright sale of accounts receivables to a factor or a financial agency.



- b) A factor is a firm that acquires the receivables of other firms. The factoring lays down the conditions of the sale in a factoring agreement.
- c) The factoring agency bears the right of collection and services the accounts for a fee.
- d) Normally, factoring is the arrangement on a non-recourse basis where in the event of default the loss is borne by this factor.

However, in a factoring arrangement with recourse, in such situation, the accounts receivables will be turned back to the firm by the factor for resolution.

### MODEL 9: INNOVATIONS IN RECEIVABLES MANAGEMENT



**Q.No.32. Brief out various innovations in Receivable Management? (A) (NEW SM, OLD SM)**

- RE-ENGINEERING RECEIVABLE PROCESS:** Re-engineering is a fundamental re-think and re-design of business processes by incorporating modern business approaches. The nature of accounts receivables is such that decisions made elsewhere in the organization are likely to affect the level of resources that are expended on the management of accounts receivables.
  - Centralisation:** Centralisation of high nature transactions of Accounts Receivables and Payable increases operating efficiency, since this process focuses attention on specialized group for speedy recovery.
  - Alternative Payment Strategies:** Collection from Debtors Payment is likely to be quicker where a number of payment alternatives are made available to customers. Also, convenient payment methods are a marketing tool in attracting and retaining customers.
  - Customer Orientation / Case Study:** Where individual customers or a group of customers have some strategic importance to the Firm, a case study of this customer(s) may lead to formation of an appropriate strategy for prompt settlement of debt.
- RISK EVALUATION:** Risk Evaluation creates an effective control mechanism. Once risks have been properly assessed, control can be introduced to either contain the risk to an acceptable level or to eliminate them entirely.
- USE OF LATEST TECHNOLOGY:** Technological developments now-a-days provides an opportunity for improvement in accounts receivables process. The major innovations available are the integration of systems used in the management of accounts receivables, the automation and the use of e-commerce.
- RECEIVABLE COLLECTION PRACTICES:** The aim of debtors' collection should be to reduce, monitor and control the accounts receivable at the same time maintain customer goodwill. The fundamental rule of sound receivable management should be to reduce the time lag between the sale and collection. Any delays that lengthen this span causes receivables to unnecessary build up and increase the risk of bad debts.

5. **USE OF FINANCIAL TOOLS/TECHNIQUES:** The finance manager while managing accounts receivables uses a number of financial tools and techniques. Some of them have been described hereby as follows:
- i) **Credit Analysis:** While determining the credit terms, the firm has to evaluate individual customers in respect of their credit worthiness and the possibility of bad debts. For this purpose, the firm has to ascertain credit rating of prospective customers.
  - ii) **Decision Tree Analysis of Granting Credit:** The decision whether to grant credit or not is a decision involving costs and benefits. When a customer pays, the seller makes profit but when he fails to pay the amount of cost going into the product is also gone.

**Note:** You can expect a question in the exam on any one part / point.

**Q.No.33. Explain the concept of Re-Engineering Receivable Process?**

**(A) (NEW SM, OLD SM, PA)**

**RE-ENGINEERING RECEIVABLE PROCESS:**

1. In some of the organizations real cost reductions and performance improvements have been achieved by re-engineering in accounts receivable process.
2. Re-engineering is a fundamental re-think and re-design of business processes by incorporating modern business approaches.
3. The nature of accounts receivables is such that decisions made elsewhere in the organization are likely to affect the level of resources that are expended on the management of accounts receivables.

The following aspects provide an opportunity to improve the management of accounts receivables:

- a) **CENTRALISATION:** Centralisation of high nature transactions of Accounts Receivables and Payable increases operating efficiency. Since this process focuses attention on specialized group for speedy recovery.
- b) **ALTERNATIVE PAYMENT STRATEGIES:** Collection from Debtors Payment is likely to be quicker where a number of payment alternatives are made available to customers. Also, convenient payment methods are a marketing tool in attracting and retaining customers.
  - i) **Direct Debit:** It is an authorization for the transfer of funds from the Purchasers Bank Account.
  - ii) **Integrated Voice Response System (IVRS):** This system uses human operators and a computer based system to allow customers to make payment over phone, generally by credit card. This system has proved to be beneficial in the organizations processing a large number of payments regularly.
  - iii) **Collection by Third Party:** The payment can be collected by an authorized external Firm. The payments can be made by Cash, Cheque, Credit Card or Electronic Fund Transfer. Banks may also act as Collecting Agents of their customers and directly depositing the collections in Seller's / Customers' Bank Accounts.
  - iv) **Lock Box Processing:** Under this system, an outsourced Partner captures cheques and invoice data and transmits the file to the client Firm for processing in that Firm's systems.
  - v) **Payments via Internet:** Payment Gateways can be established on the internet, through which collections can be made faster, sometimes even before dispatch of goods.
- c) **CUSTOMER ORIENTATION:** Where individual customers or a group of customers have some strategic importance to the Firm, a case study of this customer(s) may lead to formation of an appropriate strategy for prompt settlement of debt.

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To **MASTER MINDS**, Guntur

**Q.No.34. Explain briefly about Automated Accounts Receivables Systems?**

**(A) (NEW SM, OLD SM, PM, PA) (M 10 - 2M)**

**AUTOMATED ACCOUNTS RECEIVABLE SYSTEMS:**

- i) Manual systems of recording the transactions and managing receivables are cumbersome and costly.
- ii) Integrated Receivable Management Systems automatically update all the accounting records affected by a transaction.
- iii) This system allows the application and tracking of receivables and collections, and permits the Company to store important information for an unlimited number of customer payments and adjustments.

**Q.No.35. What are the major Receivables Collection Practices?**

**(A) (NEW SM, OLD SM, PA)**

**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 in order to reduce risk and bad debts.

**THE FOLLOWING ARE MAJOR RECEIVABLE COLLECTION PROCEDURES AND PRACTICES:**

- i) Issue of Invoice.
- ii) pen account or open-end credit.
- iii) Credit terms or time limits.
- iv) Periodic statements.
- v) Use of payment incentives and penalties.
- vi) Record keeping and Continuous Audit.
- vii) **Export Factoring:** Factors provide comprehensive credit management, loss protection collection services and provision of working capital to the firms exporting internationally.
- viii) **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.36. Explain the concept of Credit Analysis?**

**(A) (NEW SM, OLD SM, PA) (M 02 - 4M)**

**CREDIT ANALYSIS / CREDIT RATING:**

- a) When firm wants to give credit to a new customer or increase credit to existing customers, it wants to evaluate individual customers in respect of their credit worthiness and the possibility of bad debts,
- b) Credit rating of a customer involves finding answers to two broad questions regarding the customer, viz., (i) Can he pay and (ii) Will he pay?
- c) The former question is regarding the ability or financial soundness while the latter is a question of attitude of customer to his payment obligations.
- d) Broadly speaking, the steps involved in credit rating are: (i) analysis of customer's financial statements and (ii) obtaining reference reports from customer's bank and business associates, Past experience, Published financial statements, and Salesman's interview and reports.
- e) There are two broad ways of doing an exercise in credit rating, viz. (i) doing it internally by a team within the firm, (ii) doing it through external specialised agencies.

- f) In foreign countries specialised agencies are engaged in the task of providing rating information regarding individual parties. Dun and Bradstreet is one such agency, which reports on the creditworthiness of various businessmen.

**Q.No.37. Define the term Collection Policy?**

**(A) (NEW SM, OLD SM, PA)**

**COLLECTION POLICY:** Efficient and timely collection of debtors ensures that the bad debt losses are reduced to the minimum and the average collection period is shorter. It is important that clear-cut procedures regarding credit collection are set up like:

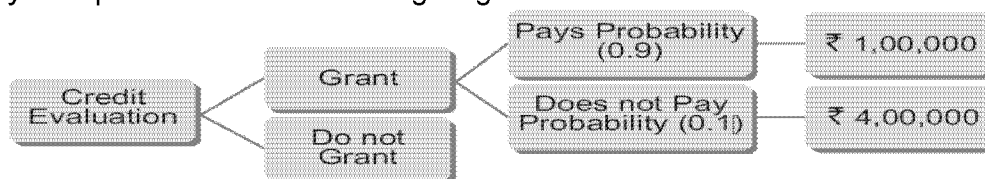
- How long should a debtor balance be allowed to exist before collection process is started?
- What should be the procedure of follow up with defaulting customer? How reminders are to be sent and how should each successive reminder be drafted?
- Should there be collection machinery whereby personal calls by company's representatives are made?
- What should be the procedure for dealing with doubtful accounts? Is legal action to be instituted? How should account be handled?

**Q.No.38. Write a short note on Decision Tree Analysis of Granting Credit?**

**(A) (NEW SM, OLD SM, PA)**

**DECISION TREE ANALYSIS OF GRANTING CREDIT:**

- The decision whether to grant credit or not is a decision involving costs and benefits. When a customer pays, the seller makes profit but when he fails to pay the amount of cost going into the product is also gone.
- If the relative chances of recovering the dues can be decided it can form a probability distribution of payment or non-payment.
- If the chances of recovery are 9 out of 10 then probability of recovery is 0.9 and that of default is 0.1.
- Credit evaluation of a customer shows that the probability of recovery is 0.9 and that of default is 0.1. the revenue from the order is Rs. 5 lakhs and cost is Rs. 4 lakhs. The decision is whether credit should be granted or not.
- The analysis is presented in the following diagram.



The weighted net benefit is Rs.  $[1,00,000 \times 0.9 \text{ i.e. } 90,000 - 0.1 \times 4,00,000 \text{ i.e. } 40,000] = 50,000$ . So credit should be granted.

### MODEL 10: MONITORING OF RECEIVABLES

**Q.No.39. What are the measures for monitoring receivables?**

**(A) (NEW SM, OLD SM, N04 - 3M)**

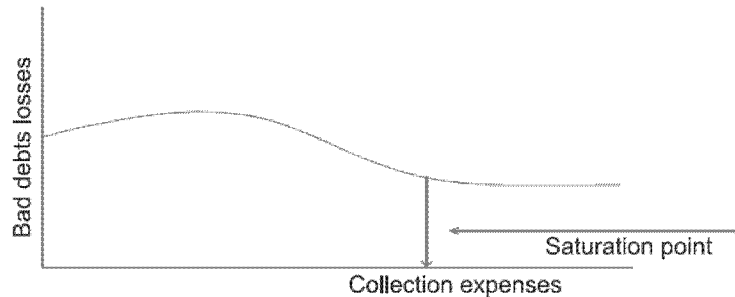
Monitoring of receivables involves the following:

- COMPUTATION OF AVERAGE AGE OF RECEIVABLES:** It involves computation of average collection period.
- AGEING SCHEDULE:** The pattern of out standings / receivables is determined by preparing the Ageing Schedule. If the receivables denote old out standings due for longer periods, suitable action should be taken to collect them immediately.

c) **COLLECTION PROGRAMME:**

- i) Monitoring the state of receivables.
- ii) Intimation to customers when due date approaches.
- iii) Telegraphic and telephonic advice to customers on the due date.
- iv) Threat of legal action on overdue A/cs.
- v) Legal action on overdue A/cs.

The following diagram shows the relationship between collection expenses and bad debt losses which have to be established as initial increase in collection expenses may have only a small impact on bad debt losses.

**Q.No.40. Write a short note on ageing schedule?**

(A) (NEW SM, OLD SM, OLD PM, PA, MTP M18 (O) - 4M, N18 (O) - 4M)

**AGEING SCHEDULE:** In a 'Ageing Schedule', the receivables are classified according to their age, i.e. period for which they have been outstanding. e.g. less than 30 days, 30-45 days, 45-60 days, above 60 days, etc.

**ROLE:** Preparation of Ageing Schedule helps management in the following ways -

- i) Analysis of quality of individual accounts,
- ii) Intra-Firm and Inter-Firm comparison, i.e. comparing liquidity of present receivables with the past periods and also comparing current liquidity of receivables of one Firm with that of other Firms,
- iii) Trend analysis of Debtors,
- iv) Supplement to average collection period of receivables / sales analysis, and
- v) Recognition of recent increase and slump in sales.

**SIMILAR QUESTION:**

1. Explain the 'Ageing Schedule' in the context of monitoring of receivables?

A. Same as above.

(MTP M18 (O) - 4M)

**MODEL 11: MANAGEMENT OF PAYABLES****Q.No.41. What is meant by Management of Payables?**

(B) (NEW SM, OLD SM)

- a) There is an old age saying in business that if you can buy well then you can sell well. Management of your creditors and suppliers is just as important as the management of your debtors.
- b) Trade creditor is a spontaneous source of finance in the sense that it arises from ordinary business transaction. But it is also important to look after your creditors – slow payment by you may create ill-feeling and your supplies could be disrupted and also create a bad image for your company.
- c) Creditors are a vital part of effective cash management and should be managed carefully to enhance the cash position.

## Q.No.42. Cost and benefits of Trade Credit.

(B) (NEW SM, OLD SM)

**INTRODUCTION:** Creditors are a vital part of effective cash management and should be managed carefully to enhance the cash position.

1. **COST OF AVAILING TRADE CREDIT:** Normally it is considered that the trade credit does not carry any cost. However, it carries 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. Regarding 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 levles 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.

## Q.No.43. How can we compute Cost of Payables?

(B) (NEW SM, OLD SM)

- i) By using the trade credit judiciously, a firm can reduce the effect of growth or burden on investments in Working Capital.
- ii) Now question arises how to calculate the cost of not taking the discount.
- iii) The following equation can be used to calculate nominal cost, on an annual basis of not taking the discount:

$$\frac{d}{100-d} \times \frac{365 \text{ days}}{t}$$

- iv) However, the above formula does not take into account the compounding effect and therefore, the cost of credit shall be even higher. The cost of lost cash discount can be estimated by the formula:

$$\left( \frac{100}{100-d} \right)^{\frac{365}{t}} - 1$$

- v) Where,

d = Size of discount i.e. for 6% discount, d=6

t = The reduction in the payment period in days, necessary to obtain the early discount or Days Credit Outstanding – Discount Period.

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**MODEL 12: FINANCING OF WORKING CAPITAL**

**Q.No.44. What are various Sources of Financing Working Capital? (B) (NEW SM, OLD SM)**

**THE WORKING CAPITAL FINANCE MAY BE CLASSIFIED BETWEEN THE TWO CATEGORIES:**

- i) Spontaneous sources; and
  - ii) Negotiable sources.
- i) **SPONTANEOUS SOURCES:** Spontaneous sources of finance are those which naturally arise in the course of business operations. Trade credit, credit from employees, credit from suppliers of services, etc. are some of the examples which may be quoted in this respect.
  - ii) **NEGOTIATED SOURCES:** On the other hand the negotiated sources, as the name implies, are those which have to be specifically negotiated with lenders say, commercial banks, financial institutions, general public etc.

The finance manager has to be very careful while selecting a particular source, or a combination thereof for financing of working capital. Generally, the following parameters will guide his decisions in this respect:

- a) Cost factor,
- b) Impact on credit rating,
- c) Feasibility,
- d) Reliability,
- e) Restrictions,
- f) Hedging approach or matching approach i.e., Financing of assets with the same maturity as of assets.

**Q.No.45. Explain the importance of trade credit and accruals as source of working capital. What is the cost of these sources? (A) (NEW SM, OLD SM, PM) (MTP: M18 (O) - 4M, M17 - 4M)**

**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.

**MODEL 13: FORMS OF BANK CREDIT**

**Q.No.46. Enumerate various forms of bank credit in financing the working capital of a business organization. (A) (NEW SM-TBQ 11, OLD SM, OLD PM, M10 - 2M, N12 - 4M, MTP M15 - 4M)**

The bank credit will generally be in the following forms:

- i) **CASH CREDIT:** This facility will be given by the banker to the customers by giving certain amount of credit facility on continuous basis. The borrower will not be allowed to exceed the limits sanctioned by the bank.

- ii) **BANK OVERDRAFT:** It is a short-term borrowing facility made available to the companies in case of urgent need of funds. The banks will impose limits on the amount they can lend. When the borrowed funds are no longer required they can quickly and easily be repaid. The banks issue overdrafts with a right to call them in at short notice.
- iii) **BILLS DISCOUNTING:** The Company which sells goods on credit will normally draw a bill on the buyer who will accept it and sends it to the seller of goods. The seller, in turn discounts the bill with his banker. The banker will generally earmark the discounting bill limit.
- iv) **BILLS ACCEPTANCE:** To obtain finance under this type of arrangement a company draws a bill of exchange on bank. The bank accepts the bill thereby promising to pay out the amount of the bill at some specified future date.
- v) **LINE OF CREDIT:** Line of Credit is a commitment by a bank to lend a certain amount of funds on demand specifying the maximum amount.
- vi) **LETTER OF CREDIT:** It is an arrangement by which the issuing bank on the instructions of a customer or on its own behalf undertakes to pay or accept or negotiate or authorizes another bank to do so against stipulated documents subject to compliance with specified terms and conditions.
- vii) **BANK GUARANTEES:** Bank guarantee is one of the facilities that the commercial banks extend on behalf of their clients in favour of third parties who will be the beneficiaries of the guarantees.

**SIMILAR QUESTION:**

1. What are the forms of Bank Credit?

(MTP M15 - 4M)

A. Same as above.

**MODEL 14: MAXIMUM PERMISSIBLE BANK FINANCE (MPBF) - TANDON COMMITTEE****(FOR NEW SYLLABUS ONLY)**

Q.No.47. write a short note on recommendations of Tandon committee?

(B) (NEW SM)

**MAXIMUM PERMISSIBLE BANK FINANCE (MPBF):** The Reserve Bank of India set up in 1974 a study group under the chairmanship of Mr. P.L. Tandon, popularly referred to as The Tandon committee.

**RECOMMENDATIONS OF THE COMMITTEE:**

1. A proper fund discipline has to be observed by the borrowers. They should supply to the banker information regarding his operational plans well in advance. The banker must carry out a realistic appraisal of such plans.
2. The main function of the banker as a lender is to supplement the borrower's resources to carry on acceptable level of current assets. This has two implications: (a) current assets must be reasonable and based on norms, and (b) a part of funds requirement for carrying out current assets must be financed from long term funds.
3. The bank should know the end use of bank credit so that it is used only for purposes for which it was made available.
4. The bank should follow inventory and receivable norms and also leading norms. It has suggested inventory and receivable norms for fifteen major industries.

Q.No.48. Explain lending norms of Maximum permissible bank finance as suggested by Tandon committee?

(B) (NEW SM)

**LENDING NORMS SUGGESTED BY TANDON COMMITTEE:****Method I:**

MPBF = 75% of [Current Assets Less Current Liabilities] i.e. 75% of Net Working Capital



\*The borrower has to contribute a minimum of 25% of working capital gap from long term funds.

**Method II:**

MPBF = [75% of Current Assets] Less Current Liabilities.

\* The borrower has to contribute a minimum of 25% of the total current assets from long term funds.

**Method III:**

MPBF = [75% of Soft Core Current Assets] Less Current Liabilities.

\* The borrower has to contribute the entire hard core current assets and a minimum of 25% of the balance of the current assets from long term funds.

The RBI vide its credit policy (beginning of 1997) scrapped the concept of MPBF. The salient features of new credit system were:

- For borrowers with requirements of upto Rs.25 Lakhs credit limit will be computed after detailed discussion with the borrower, without going into detailed evaluation.
- For borrowers with requirements above Rs.25 Lakhs, but upto Rs. 5 crore, credit limit can be offered upto 20% of the projected gross sales of the borrower.
- For large borrowers not falling in the above categories, the cash budget systems may be used to identify the working capital needs.

**Q.No.49. Define the term Core current assets?**

**(A) (NEW SM)**

**CORE CURRENT ASSETS:**

- Core current assets are permanent components of current assets which are required throughout the year for a company to run continuously and to stay viable.
- The term "Core Current Assets" was framed by Tandon Committee while explaining the amount of stock a company can hold in its current assets. Generally, such assets are financed by long term funds. Sometimes core current assets are also referred to as "Hardcore Working Capital".
- These assets are not liquid and so when companies are in need of money, they initially sell off non-core assets (assets which are not important for continuous functioning of a business) to raise money. If a company is ready to raise cash by selling its core current assets, then this implies that the company is in dire situation or close to bankruptcy.
- Examples of Core Current Assets are Raw materials, Work in Progress, Finished Goods, Cash in Hand and at Bank etc.

**QUESTIONS FOR ACADEMIC INTEREST ONLY – FOR STUDENTS SELF STUDY**

**Q.No.50. What are the factors to be considered while investing in working capital?**

**(C) (NEW SM, OLD SM)**

**INVESTMENT IN WORKING CAPITAL:**

- Investment in working capital is a matter of policy decision by an entity. It has to be decided in the light of organisational objectives, trade policies and financial (cost-benefit) considerations.
- There are no standard rules for deciding the level of investment in working capital.

Hence, level of investment depends on various factors listed below:

- NATURE OF INDUSTRY:** Construction companies, breweries etc. requires large investment in working capital due long gestation period.
- TYPES OF PRODUCTS:** Consumer durable has large inventory as compared to perishable products.

- c) **MANUFACTURING VS TRADING VS SERVICE:** A manufacturing entity has to maintain three levels of inventory i.e. raw material, work-in-process and finished goods whereas a trading and a service entity has to maintain inventory only in the form of trading stock and consumables respectively.
- d) **VOLUME OF SALES:** Where the sales are high, there is a possibility of high receivables as well.
- e) **CREDIT POLICY:** An entity whose credit policy is liberal has not only high level of receivables but requires more capital to fund raw material purchases.

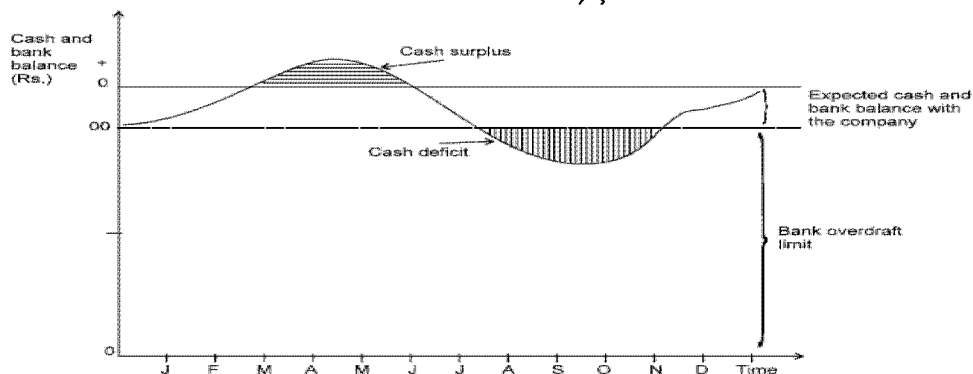
**Q.No.51. What are the main components involved in preparation of Cash budget?**

(C) (NEW SM, OLD SM)

**MAIN COMPONENTS INVOLVE 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:
- Operating (cash flows generated by operations of the firm), and
  - 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.52. Write a short note on Controlling Payments as a part of Cash Management.**

(C) (NEW SM, OLD SM)

**CONTROLLING PAYMENTS:**

- a) An effective control over payments can also cause faster turnover of cash. This is possible only by making payments on the due date, making excessive use of draft (bill of exchange) instead of cheques.
- b) Availability of cash can be maximized by playing the float. In this, a firm estimates accurately the time when the cheques issued will be presented for encashment and thus utilizes the float period to its advantage by issuing more cheques but having in the bank account only so much cash balance as will be sufficient to honour those cheques which are actually expected to be presented on a particular date.
- c) Also company may make payment to its outstation suppliers by a cheque and send it through mail. The delay in transit and collection of the cheque, will be used to increase the float.

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**Q.No.53. Discuss the Effect of Double Shift Working on Working Capital Requirements.**  
(C) (NEW SM, OLD SM, OLD PM, PA) (N10 - 4M)

**IMPACT OF DOUBLE SHIFT WORKING ON WC REQUIREMENTS:**

Working Double Shift leads to economies of scale due to greater use of Fixed Assets. As a Firm increases the number of production hours, Working Capital requirements also increase. But the increase in the Working Capital amount may not be directly proportional.

The impact of double shift working on various components of Working Capital is as under –

<u>ITEM</u>	<u>EFFECT ON QUANTITY</u>	<u>EFFECT ON RATE</u>
<b>Raw Materials</b>	Stock requirements may double since consumption per day will be <u>twice as earlier</u> .	Due to <u>bulk purchasing</u> , the Firm may be able to avail <u>quantity discounts</u> . Hence, <u>average cost</u> per unit of Raw Material may be <u>reduced</u> .
<b>Work-in-Progress</b>	There will be <u>no change in the quantity of WIP</u> , since work commenced in the first shift will be completed in the second shift. Hence, at the end of any day, the quantity of WIP will remain the same as it was in single shift working.	Due to reduction in Raw Material cost and economies of fixed costs, the average cost per unit of <u>WIP may be reduced</u> .
<b>Finished Goods</b>	Due to greater production, Finished Goods Stocks may <u>double</u> in quantity.	Cost of production per unit will be <u>reduced</u> , due to lower cost of materials and economies of fixed costs per unit.
<b>Sundry Debtors</b>	increase in demand and increased sales will lead to <u>higher amount</u> of Debtors, for the same credit period. In case of reduction in credit period, the increase may not be proportional or double.	Selling Price per unit may be <u>reduced</u> on account of price elasticity of demand. Additional quantities could be sold only by reducing the price.
<b>Sundry Creditors</b>	Raw Materials purchase quantity and Creditors bill quantity may <u>double</u> subject to, credit period remaining constant. In case of extended credit periods, Creditors may increase more than proportionately or double.	Due to bulk purchasing and better bargaining power, the Firm may obtain discounts. Hence, amount payable per unit of purchase stands <u>reduced</u> .

**ADVANCED QUESTIONS**

**Q.No.54. What are the various methods available for estimating Working Capital Needs?**  
(C) (NEW SM, OLD SM, OLD 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:

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

**Q.No.55. What do you mean by Cash Planning?**

**(B) (NEW SM, OLD SM, PA)**

1. 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 periodically either on daily, weekly or monthly basis.
2. For estimating and monitoring the future requirements of Cash, Cash Flow Statements, and Cash Budgets can be prepared, for both short-term and long-term periods.
3. The period and frequency of cash planning generally depends upon the size of the Firm and philosophy of management. Cash Planning is inevitable for ensuring success of operations.

**Alternative Question:**

1. Write short note on cash planning.

**(MTP1 N18 (O) - 2M)**

- A. Refer above answer.

**Q.No.56. What are the factors to be considered for determining the credit policy?**

**(B) (NEW SM, OLD SM)**

*First briefly write what is credit policy.*

**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.,

**Q.No.57. What is the significance of Operating Cycle?**

**(C) (NEW SM, OLD SM)**

*First briefly write what is Operating Cycle.*

**SIGNIFICANCE OF OPERATING CYCLE:**

- i) **SURPLUS GENERATION**: It represents the activity cycle of the business, i.e. purchase, manufacture, sales and collection thereof. Hence, the Operating Cycle represents the process that creates surplus or profit for the business.
- ii) **FUNDS ROTATION**: Operating Cycle indicates the total time required for rotation of funds. The faster the funds rotate, better it is for the Firm.
- iii) **GOING CONCERN**: Cash Cycle lends meaning to the Going Concern concept. If the cycle stops in between, the going concern assumption may be lost.

Hence, Working Capital Cycle should be on par with the industry average. A long cycle indicates overstocking of inventories or delayed collection of receivables and is considered unsatisfactory.

Using the Operating Cycle, the Working Capital Turnover can be computed as:  $365/\text{Operating cycle}$ .

Generally, the higher the Operating Cycle Ratio is better for the business.

**Q.No.58. What are Factors under the control of finance manager with respect to receivables management? (C) (NEW SM, OLD SM)**

The finance manager has operating responsibility for the management of the investment in receivables. His involvement includes: -

- a) Supervising the administration of credit,
- b) Contribute to top management decisions relating to the best credit policies of the firm,
- c) Deciding the criteria for selection of credit applications, and
- d) Speed up the conversion of receivables into cash by aggressive collection policy,

In summary the finance manager has to strike a balance between the cost of increased investment in receivables and profits from the higher levels of sales.

**Q.No.59. Discuss the risk-return considerations in financing of current assets. (C) (NEW SM, OLD SM, PM) (N15 – 4M)**

- i) 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.
- ii) 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.
- iii) 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. 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.
- iv) 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.

### MULTIPLE CHOICE QUESTIONS - FOR SELF STUDY

1. The credit terms may be expressed as "3/15 net 60". This means that a 3% discount will be granted if the customer pays within 15 days, if he does not avail the offer he must make payment within 60 days.
  - a) I agree with the statement
  - b) I do not agree with the statement
  - c) I cannot say.
2. The term 'net 50' implies that the customer will make payment.
  - a) Exactly on 50th day
  - b) Before 50th day
  - c) Not later than 50th day
  - d) None of the above.
3. Trade credit is a source of:
  - a) Long-term finance
  - b) Medium term finance
  - c) Spontaneous source of finance
  - d) None of the above.
4. The term float is used in
  - a) Inventory Management
  - b) Receivable Management
  - c) Cash Management
  - d) Marketable securities.

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5. William J Baumol's model of Cash Management determines optimum cash level where the carrying cost and transaction cost are:
- Maximum
  - Minimum
  - Medium
  - None of the above.
6. In Miller - ORR Model of Cash Management:
- The lower, upper limit, and return point of Cash Balances are set out
  - Only upper limit and return point are decided
  - Only lower limit and return point are decided
  - None of the above are decided.
7. Working Capital is defined as
- Excess of current assets over current liabilities
  - Excess of current liabilities over current assets
  - Excess of Fixed Assets over long-term liabilities
  - None of the above.
8. Working Capital is also known as "Circulating Capital, fluctuating Capital and revolving capital". The aforesaid statement is;
- Correct
  - Incorrect
  - Cannot say.
9. The basic objectives of Working Capital Management are:
- Optimum utilization of resources for profitability
  - To meet day-to-day current obligations
  - Ensuring marginal return on current assets is always more than cost of capital
  - Select any one of the above statement.
10. The term Gross Working Capital is known as:
- The investment in current liabilities
  - The investment in long-term liability
  - The investment in current assets
  - None of the above.
11. The term net working capital refers to the difference between the current assets minus current liabilities.
- The statement is correct
  - The statement is incorrect
  - I cannot say.
12. The term "Core current assets' was coined by
- Chore Committee
  - Tandon Committee
  - Jilani Committee
  - None of the above.
13. The concept operating cycle refers to the average time which elapses between the acquisition of raw materials and the final cash realization. This statement is
- Correct
  - Incorrect
  - Partially True
  - I cannot say.
14. As a matter of self-imposed financial discipline can there be a situation of zero working capital now-a-days in some of the professionally managed organizations.
- Yes
  - No
  - Impossible
  - Cannot say.
15. Over trading arises when a business expands beyond the level of funds available. The statement is
- Incorrect
  - Correct
  - Partially correct
  - I cannot say.
16. Conservative Working Capital strategy calls for high levels of current assets in relation to sales.
- I agree
  - Do not agree
  - I cannot say.
17. The term Working Capital leverage refer to the impact of level of working capital on company's profitability. This measures the responsiveness of ROCE for changes in current assets.
- I agree
  - Do not agree
  - The statement is partially true.
18. The term spontaneous source of finance refers to the finance which naturally arise in the course of business operations. The statement is
- Correct
  - Incorrect
  - Partially Correct
  - I cannot say.
19. Under hedging approach to financing of working capital requirements of a firm, each asset in the balance sheet assets side would be offset with a financing instrument of the same approximate maturity. This statement is
- Incorrect
  - Correct
  - Partially correct
  - I cannot say.

20. Trade credit is a  
 a) Negotiated source of finance  
 b) Hybrid source of finance  
 c) Spontaneous source of finance  
 d) None of the above.
21. Factoring is a method of financing whereby a firm sells its trade debts at a discount to a financial institution. The statement is  
 a) Correct                      b) Incorrect  
 c) Partially correct        d) I cannot say.
22. A factoring arrangement can be both with recourse as well as without recourse:  
 a) True                              b) False  
 c) Partially correct        d) Cannot say.
23. The Bank financing of working capital will generally be in the following form. Cash Credit, Overdraft, bills discounting, bills acceptance, line of credit; Letter of credit and bank guarantee.  
 a) I agree  
 b) I do not agree  
 c) I cannot say.
24. When the items of inventory are classified according to value of usage, the technique is known as:  
 a) XYZ Analysis    b) ABC Analysis  
 c) DEF Analysis    d) None of the above.
25. When a firm advises its customers to mail their payments to special Post Office collection centers, the system is known as.  
 a) Concentration banking  
 b) Lock Box system  
 c) Playing the float  
 d) None of the above.

**KEY:**

1.	A	2.	C	3.	C	4.	C	5.	B	6.	A	7.	A	8.	A	9.	B	10.	C
11.	A	12.	B	13.	A	14.	A	15.	B	16.	A	17.	A	18.	A	19.	B	20.	C
21.	A	22.	A	23.	A	24.	B	25.	B										

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**THE END**

## 4. RISK ANALYSIS IN CAPITAL BUDGETING

**Q. No.1. Define the term Risk & Uncertainty. (A)**

**(NEW SM, PR)**

- The term risk in capital budgeting refers to the difference between actual and expected cash flows.
- It may be noted that there is a difference between risk & uncertainty.

### MEANING OF RISK:

Risk is a situation where

- Several outcomes (also called as range of outcomes), are possible
- Within this range, any one outcome can occur
- Each possible outcome has a known probability
- Such probabilities are assessed by reference to past information about relative frequencies of outcome

Risk can be measured; uncertainty cannot be measured. Risk applies where the decision – maker is willing to act on probabilities.

### MEANING OF UNCERTAINTY:

Uncertainty is a situation where

- The range of outcomes is unknown
- The probability of outcomes is known
- Or, both are known

*Let us explain with an example. You come out of an examination hall saying, "There is a 60% chance that I will get 80 marks and a 40% chance that I will score 50 marks." Your friend, **Doraemon** comes out of the hall saying, "God only knows how I have done." Yours is a case of risk. **Doraemon's** is a case of uncertainty.*

**Q. No.2. Discuss various sources of Risks. (A)**

**(NEW SM, MTP MAR.18 – 4M)**

Risk arises from different sources, depending on the type of investment being considered, as well as the circumstances and the industry in which the organisation is operating. Some of the sources of risk are as follows:

1. **Project-specific risk:** Risks which are related to a particular project and affects the project's cash flows, it includes completion of the project in scheduled time, error of estimation in resources and allocation, estimation of cash flows etc. For example, a nuclear power project of a power generation company has different risks than hydel projects.
2. **Company specific risk:** Risk which arise due to company specific factors like downgrading of credit rating, changes in key managerial persons, cases for violation of Intellectual Property Rights (IPR) and other laws and regulations, dispute with workers etc. All these factors affect the cash flows of an entity and access to funds for capital investments. For example, two banks have different exposure to default risk.
3. **Industry-specific risk:** These are the risks which effect the whole industry in which the company operates. These risks include regulatory restrictions on industry, changes in technologies, etc.
4. **Market risk:** The risk which arise due to market related conditions like entry of substitute, changes in demand conditions, availability and access to resources etc. *For example, a thermal power project gets affected if the coal mines are unable to supply coal requirements of a thermal power company, etc.*



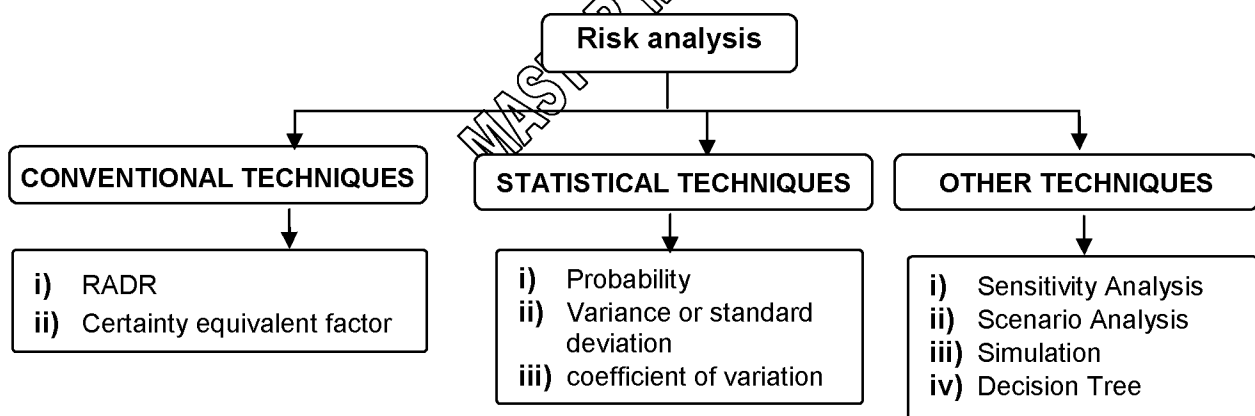
5. **Competition risk:** These are risks related with competition in the market in which a company operates. These risks are risk of entry of rival, product dynamism and change in tastes and preferences of consumers, etc.
6. **Risk due to Economic conditions:** These are the risks which are related with macro-economic conditions like changes in monetary policies by central banks, changes in fiscal policies like introduction of new taxes and cess, inflation, changes in GDP, changes in savings and net disposable income, etc.
7. **International risk:** These are risks which are related with conditions which are caused by global economic conditions like restriction on free trade, restrictions on market access, recessions, bilateral agreements, political and geographical conditions etc. *For example, restriction on outsourcing of jobs to overseas markets.*

**Q.No.3. State the reasons for adjustment of risk in Capital Budgeting Decisions. (C)**  
(NEW SM, N18 (N) - 2M)

Main reasons for considering risk in capital budgeting decisions are as follows

1. 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 other investment options available.
2. Risk adjustment is required to know the real value of the Cash Inflows.

**Q. No.4. List out various Risk Evaluation Techniques in Capital Budgeting? (C)** (NEW SM)



**Q. No.5. Write a short note on Risk Adjusted Discount Rate. (A)** (NEW SM, RI)

1. Every firm is basically risk averse and tries to avoid risk. However, it may be ready to take risk provided it is rewarded for undertaking risk by higher returns.
2. So, more risky the investment is, the greater would be the expected return.
3. The expected return is expressed in terms of discount rate which is also termed as the minimum required rate of return generated by a proposal if it is to be accepted.
4. Therefore, there is a positive correlation between risk of a proposal and the discount rate.
5. RADR attempts to incorporate risk by modifying the discount rate. A risk premium is added to the riskless discount rate, to reflect the risk inherent in the project.
6. The RADR is based on the premise that riskiness of a proposal may be taken care of, by adjusting the discount rate.

The RADR may be expressed in terms of Equation.

$$k_a = k + \alpha$$

where,  $k_a$  = Risk Adjusted Discount Rate

$k$  = Risk Free Discount Rate

$\alpha$  = Risk Adjustment Premium

A Risk Adjusted Discount Rate is a sum of risk free rate and risk premium. The Risk Premium depends on the perception of risk by the investor of a particular investment and risk aversion of the Investor.

So Risk Adjusted Discount Rate = Risk free rate+ Risk premium.

#### **ADVANTAGES OF RISK-ADJUSTED DISCOUNT RATE:**

1. It is easy to understand.
2. It incorporates risk premium in the discounting factor.

#### **LIMITATIONS OF RISK-ADJUSTED DISCOUNT RATE:**

1. Difficulty in finding risk premium and risk-adjusted discount rate.
2. Assumption that investors are risk averse is always not true.

#### **Q.No.6. Write a short note on Certainty Equivalent (CE) Approach. (A) (NEW SM, M18 (N) - 4M, RI)**

- a) The CE approach to incorporate the risk to adjust the cash flows of a proposal to reflect the riskiness.
- b) The CE approach attempts at adjusting the future cash flows instead of adjusting the discount rates.
- c) The expected future cash flows which are taken as risky and uncertain are converted into certainty risk less cash flows.
- d) Higher the Risk involved in cash flows lower will be the adjustment factor & Vice versa.
- e) Since Risk is already adjusted, these adjusted cash flows are then discounted at risk free discount rate to find out the NPV of the proposal.

#### **ADVANTAGES OF CERTAINTY EQUIVALENT METHOD:**

1. The certainty equivalent method is simple and easy to understand and apply.
2. It can easily be calculated for different risk levels applicable to different cash flows.

*For example, if in a particular year, a higher risk is associated with the Cash Flow, it can be easily adjusted and the NPV can be recalculated accordingly.*

#### **DISADVANTAGES OF CERTAINTY EQUIVALENT METHOD:**

1. There is no Statistical or Mathematical model available to estimate certainty Equivalent. Assumption of risk being subjective, it varies on the perception of the risk by the management because of bias and individual opinions involved.
2. There is no objective or mathematical method to estimate certainty equivalents. Certainty Equivalents are subjective and vary as per each individual's estimate.
3. Certainty equivalents are decided by the management based on their perception of risk. However, the risk perception of the shareholders who are the money lenders for the project is ignored. Hence it is not used often in corporate decision making.

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**Q. No.7. Distinguish between Certainty Equivalent Method and Risk Adjusted Discount Rate Method? (C)** **(NEW SM, PD)**

1. Certainty Equivalent Method is superior to Risk Adjusted Discount Rate Method as it does not assume that risk increases with time at constant rate.
2. Each year's Certainty Equivalent Coefficient is based on level of risk impacting its cash flow. Despite its soundness, it is not preferable like Risk Adjusted Discount Rate Method.
3. It is difficult to specify a series of Certainty Equivalent Coefficients but simple to adjust discount rates.

Point	Certainty Equivalent Method	Risk Adjusted Discount Rate Method
a) Factor Adjusted	This method adjusts the cash flows of a project for risk.	This method adjusts the discount rate (WACC) for risk.
b) Time effect	Cash flows are adjusted for Risk over time under this method.	This method assumes that risk increases with at a constant rate.
c) Ease	It is difficult to specify a series of CE Co- efficient.	It is comparatively easier to adjust discount rates.
d) Accuracy	This is superior to the RADR Approach, as it can measure risk more accurately.	Risk is adjusted only in the discount rates and is not recognised in the cash flows. However, cash flows are more uncertain than the cost of capital.

**Q. No.8. Write a short note on Sensitivity Analysis (A)**

**(NEW SM, RI)**

1. The NPV of a project is based upon the series of cash flows and the discount factor.
2. Both these determinants depend upon so many variables such as sales revenue, input cost, competition etc.
3. Given the level of all these variables, there will be a series of cash flows and there will be NPV of the proposal.
4. If any of these variables change, the value of NPV will also change.
5. It means that the value of NPV is sensitive to all these variables. However, the value of NPV will not change in the same proportion for a given change in any one of these variables. For some variables, the NPV may be less sensitive while for others, the NPV may be more sensitive.
6. The Sensitivity Analysis (SA) deals with the cooperation of sensitivity of the NPV in relation to different variables contributing to the NPV.

**STEPS INVOLVED IN SENSITIVITY ANALYSIS:**

Sensitivity Analysis is conducted by following the steps stated below:

- a) Finding variables, which have an influence on the NPV (or IRR) of the project.
- b) Establishing mathematical relationship between the variables.
- c) Analysing the effect of the change in each of the variables on the NPV (or IRR) of the project.

**ADVANTAGES OF SENSITIVITY ANALYSIS:**

1. **Critical Issues:** This analysis identifies critical factors that impinge on a project's success or failure.
2. **Simplicity:** This analysis is quite simple.

**DISADVANTAGE OF SENSITIVITY ANALYSIS:**

1. **Assumption of Independence:** This analysis assumes that all variables are independent i.e. they are not related to each other, which is unlikely in real life.
2. **Ignore probability:** This analysis does not look to the probability of changes in the variables.
3. **Not so reliable:** This analysis provides information on the basis of which decisions can be made but does not point directly to the correct decision.

**Q. No.9. Write a short note on Scenario Analysis. (B)****(NEW SM)**

- a) Although sensitivity analysis is probably the most widely used risk analysis technique, it does have limitations. Therefore, we need to extend sensitivity analysis to deal with the probability distributions of the inputs.
- b) In addition, it would be useful to vary more than one variable at a time so we could see the combined effects of changes in the variables.
- c) Scenario analysis provides answer to these situations of extensions. This analysis brings in the probabilities of changes in key variables and also allows us to change more than one variable at a time.
- d) This analysis begins with base case or most likely set of values for the input variables. Then, go for worst case scenario (low unit sales, low sale price, high variable cost and so on) and best case scenario.
- e) So, in a nutshell Scenario analysis examines the risk of investment, so as to analyse the impact of alternative combinations of variables, on the project's NPV or IRR

**Q. No.10. Distinguish between Scenario Analysis and Sensitivity Analysis. (C)****(NEW SM)**

- a) Sensitivity analysis and Scenario analysis both help to understand the impact of change in input variable on the outcome of the project  
However, there are certain basic differences between the two:
- b) Sensitivity analysis calculates the impact of the change of a single input variable on the outcome of the project viz., NPV or IRR. The sensitivity analysis thus enables to identify that single critical variable that can impact the outcome in a huge way and the range of outcomes of the project given the change in the input variable.
- c) Scenario analysis, on the other hand, is based on a scenario. The scenario may be recession or a boom wherein depending on the scenario, all input variables change. Scenario Analysis calculates the outcome of the project considering this scenario where the variables have changed simultaneously. Similarly, the outcome of the project would also be considered for the normal and recessionary situation. The variability in the outcome under the three different scenarios would help the management to assess the risk a project carries. Higher deviation in the outcome can be assessed as higher risk and lower to medium deviation can be assessed accordingly.
- d) Scenario analysis is far more complex than sensitivity analysis because in scenario analysis all inputs are changed simultaneously considering the situation in hand while in sensitivity analysis only one input is changed and others are kept constant.

**Q.No.11. Write a short note on Monte Carlo Simulation. (A)****(NEW SM)**

- a) Monte Carlo simulation ties together sensitivities and probability distributions.
- b) This analysis starts with carrying out a simulation exercise to model the investment project.
- c) It involves identifying the key factors affecting the project and their inter relationships.

- d) This analysis specifies a range for a probability distribution of potential outcomes for each of model's assumptions.
- e) Monte Carlo simulation is a computerized mathematical technique that allows decision makers to calculate risk and uncertainty in decision making.
- f) Monte Carlo simulation generates a range of possible outcomes and their probabilities associated with those outcomes.
- g) It also shows the probabilities of extreme possibilities like the probability of best case and the worst case along with the probabilities of a range of outcomes.
- h) The technique is widely used in fields as finance, project management, Portfolio Management, Stock Return Analysis etc.

#### **STEPS FOR SIMULATION ANALYSIS:**

1. Identification of variables that influence cash inflows and outflows.
2. Specify values of parameters and probability distributions of variables.
3. Select a value at random from probability distribution of each of the variables.
4. Determine NPV corresponding to the randomly generated value of variables.
5. Repeat steps (3) & (4) a large number of times to get a large number of simulated NPVs.
6. Plot probability distribution of NPVs.

#### **APPLICATION OF SIMULATION ANALYSIS:**

1. It is used in Project Finance to model the random variables with which uncertainty is associated viz., Cash flows, Variable expenses.
2. It is used for Options Pricing where the various factors like implied volatility, price of the underlying asset are the random variables and the different ranges of these individual random variables can be calculated using Monte Carlo Simulation.
3. It is used for making a judgment of the return out of a Stock or a Stock Portfolio. Thus it is of significant importance in Portfolio Management and Retirement Planning.

#### **ADVANTAGES OF SIMULATION ANALYSIS:**

1. Monte Carlo simulation provides useful inputs for Sensitivity Analysis by helping to understand variability in which inputs affects the outcome to the biggest extent.
2. Using Monte Carlo simulation, a judgment can be made as to the range in which the input lied under a particular scenario. Thus using the results of Monte Carlo Simulation, different scenarios can be studied.
3. The results produced by Monte Carlo Simulation also show the associated probability of the results occurring. Thus it simplifies the decision making process of the management.
4. In a complex decision making environment, different variables are interdependent on each other and that impacts the end result out of a project. Monte Carlo simulation, helps to understand the interdependency between input variables. Understanding this inter dependability, enables to reduce the complexity of decision.

#### **LIMITATION OF SIMULATION ANALYSIS:**

1. Difficult to model the project and specify probability distribution of various variables.
2. Simulation provides only rough approximation of probability distribution of NPV.
3. Simulation model is complex and can be constructed by management expert and not by the decision maker.
4. To determine NPV in simulation run, risk free discount rate is used which may not give correct picture.

Q.No.12. Write a short note on Decision Tree Analysis. (B)

(NEW SM, RM)

- a) Many project decisions are complex investment decisions. Such complex investment decisions involve a sequence of decisions over time.
- b) Decision tree can handle the sequential decisions of complex investment proposals. The decision of taking up an investment project is broken into different stages. At each stage, the proposal is examined to decide whether to go ahead or not.
- c) The multi - stages approach can be handled effectively with the help of decision trees.
- d) Basically decision tree is a graphic display of the relationship between a present decision and future events, future decision and their consequences.

**STEPS INVOLVED IN DECISION TREE ANALYSIS:****Step 1:** Define investment**Step 2:** Identification of Decision Alternatives**Step 3:** Drawing a decision tree**Step 4:** Evaluating the alternatives**ASSUMPTION IN DECISION TREE ANALYSIS:**

This approach assumes that there are only two types of situation that a finance manager has to face.

1. The first situation is where the manager has control or power to determine what happens next. This is known as "Decision", as he can do what he desires to do.
2. The second situation is where finance manager has no control over what happens next. This is known as "Event". Since the outcome of the events is not known, a probability distribution needs to be assigned to various outcomes or consequences.
3. When a finance manager faced with a decision situation, he is assumed to act rationally. For example, in a commercial business, he will choose the most profitable course of action and in non-profit organization, the lowest cost may be rational choice.

**ADVANTAGES OF USING DECISION TREES:**

1. The Decision nodes enable to set out the various options available thus ensuring that no option is left out to be considered.
2. All the options available are considered simultaneously thus allowing comparison.
3. Risk is addressed in an objective manner by using probabilities.
4. Decision Trees enable the evaluation of the options by considering Cash Outflows and Cash Inflows. Thus it enables to evaluate different options on the basis of the Net benefit arising out of that project.
5. Simple to understand and apply.

**LIMITATIONS OF USING DECISION TREES:**

1. Probabilities cannot be calculated objectively.
2. Decision Trees use only that data which can be quantified. It ignores qualitative aspects of decisions.
3. Assignment of probabilities and expected values do not have any relevant basis as it pertains to a future outcome which is uncertain.

Q.No.13. Define the following terms 1) Probability, 2) Expected Net Cash Flows 3) Expected Net Present Value 4) Standard deviation, 5) Variance, 6) Coefficient of Variation, 7) Risk Free Rate, 8) Risk Premium (A) (NEW SM, RI)

1. **PROBABILITY:**

- a) The probability may be defined as the chance of happening or non-happening of an event.
- b) For example, one may say that there are 20% chances that the sales will increase by 80% during the year, or that there are 75% chances that the firm will be able to achieve 50% market share over a period of 5 years. These descriptions of 20% and 75% chances are the description of probability of the respective events.
- c) When an event is certain to occur, probability will be 1 and when there is no chance of happening an event probability will be 0.

2. **EXPECTED NET CASH FLOWS:** Expected Cash flows are calculated as the sum of the likely Cash flows of the Project multiplied by the probability of cash flows.

3. **EXPECTED NET PRESENT VALUE:** Expected net present value = Sum of present values of expected net cash flows

4. **STANDARD DEVIATION:**

- a) Standard Deviation is a degree of variation of individual items of a set of data from its average.
- b) The square root of variance is called Standard Deviation.
- c) For Capital Budgeting decisions, Standard Deviation is used to calculate the risk associated with the estimated cash flows from the project.

5. **VARIANCE:**

- a) Variance is a measurement of the degree of dispersion between numbers in a data set from its average.
- b) In very simple words, variance is the measurement of difference between the average of the data set from every number of the data set.

Variance is calculated as below:

$$\sigma^2 = \sum_{j=1}^n (NCF_j - ENCF)^2 P_j$$

$\sigma^2$  is variance in net cash flow, P is probability, ENCF expected net cash flow.

- c) Variance measures the uncertainty of a value from its average. Thus, variance helps an organization to understand the level of risk it might face on investing in a project.
- d) A variance value of zero would indicate that the cash flows that would be generated over the life of the project would be same. This might happen in a case where the company has entered into a contract of providing services in return of a specific sum.
- e) A large variance indicates that there will be a large variability between the cash flows of the different years. This can happen in a case where the project being undertaken is very innovative and would require a certain time frame to market the product and enable to develop a customer base and generate revenues.
- f) A small variance would indicates that the cash flows would be somewhat stable throughout the life of the project. This is possible in case of products which already have an established market.

6. **COEFFICIENT OF VARIATION:**

- a) The standard deviation is a useful measure of calculating the risk associated with the estimated cash inflows from an Investment. However, in Capital Budgeting decisions, the management in several times need to choose between many investments avenues.

- b) Under such situations, it becomes difficult for the management to compare the risk associated with different projects using Standard Deviation as each project has different estimated cash flow values. In such cases, the Coefficient of Variation become useful.
- c) The Coefficient of Variation calculates the risk borne for every percent of expected return. It is calculated as:

$$\text{Coefficient of variation} = \frac{\text{Standard Deviation}}{\text{Expected Return / Expected Cashflow}}$$

- d) The Coefficient of Variation enables the management to calculate the risk borne by the concern for every unit of estimated return from a particular investment.
- e) Simply put, the investment avenue which has a lower ratio of standard deviation to expected return will provide a better risk – return trade off.
- f) Thus, when a selection has to be made between two projects, the management would select a project which has a lower Coefficient of Variation.
7. **RISK FREE RATE:** It is the rate of return on Investments that bear no risk. For e.g., Government securities yield a return of 6 % and bear no risk. In such case, 6 % is the risk-free rate.
8. **RISK PREMIUM:** It is the rate of return over and above the risk-free rate, expected by the Investors as a reward for bearing extra risk. For high risk project, the risk premium will be high and for low risk projects, the risk premium would be lower.

### MULTIPLE CHOICE QUESTIONS – FOR SELF STUDY

1. Project Analysis can be done using:
- Sensitivity Analysis
  - Scenario Analysis
  - Monte Carlo Simulation
  - All of the Above
2. Which from the following is not a part of Monte Carlo Simulation?
- Modelling the Project
  - Simulating Results
  - Calculating NPV
  - Specifying Probabilities
3. Variance Measures
- How far each number in the set is from the mean
  - The mean of a given data set
  - Return on Investment
  - Level of risk borne for every percent of expected return
4. Certainty Equivalent
- Is a guaranteed return from an Investment after adjusting for risk?
  - Is the return that is expected over the lifetime of a project?
  - Is equivalent to Net Present Value?
  - Is an important component in Decision Tree Analysis?
5. For a project, where the cash flows are Rs. 90,00,000, rate of return is 15%, risk free rate is 4% and risk premium is 9%, the Certainty Equivalent is
- 78,26,087
  - 86,53,846
  - 82,56,881
  - 81,08,108
6. Risk Premium
- Is the extra rate of return expected by the Investors as a reward for bearing extra risk?
  - Is equivalent to the rate of Government Securities?
  - Is the return provided to equity shareholders?
  - Is over and above expected rate of return
7. In Decision Tree Analysis, the Problem / decision is the
- Decision Node
  - Root Node
  - Event Node
  - End Node
8. Scenario Analysis is considered under scenarios such as
- Worst Case Scenario
  - Base Case Scenario
  - Best Case Scenario
  - All of the above



9. Sensitivity analysis is useful in decision making because
- It shows the probabilities associated with each outcome
  - It tells the user how much critical each input is for the Output value
  - It allows to calculate the probable results under different scenarios
  - The results of Sensitivity Analysis are reliable
10. Monte Carlo Simulation involves
- Identification of key variables on which outcome of the experiment would depend.
  - Fixing of the range of values within which the results are expected to vary
  - Assigning Probability Distribution after a large number of random samples is performed.
  - All of the above

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**KEY:**

1.	D	2.	C	3.	A	4.	A	5.	D
6.	A	7.	B	8.	D	9.	B	10.	D

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**THE END**

## 5. LEASE FINANCING

**Q. No.1. What is Lease? Who are the parties to a Lease agreement? (B)**

**(NEW SM)**

- Lease can be defined as a right to use equipment or capital goods on payment of periodical amount.
- This may broadly be equated to an instalment credit being extended to the person using the asset by the owner of capital goods with small variation.

### **PARTIES TO LEASE AGREEMENT:**

There are two principal parties to any lease transaction as under:

1. **Lessor:** Who is actual owner of equipment permitting use to the other party on payment of periodical amount.
2. **Lessee:** Who acquires the right to use the equipment on payment of periodical amount.

**Q.No.2. Explain the difference between Hire Purchase and Lease. (A)**

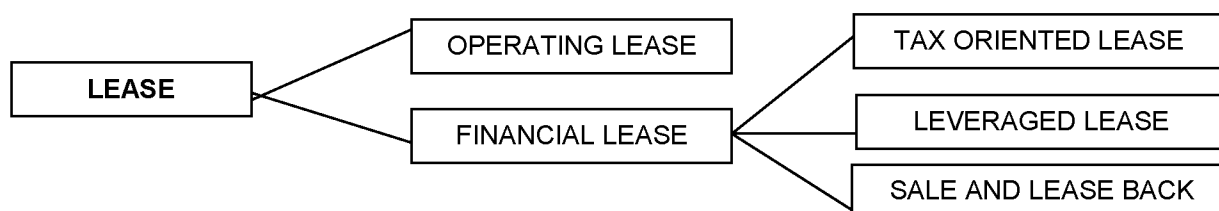
**(NEW SM)**

NO.	COMPARISON	HIRE PURCHASE	LEASE
1.	<b>Meaning</b>	The deal in which one party can use the asset of the other party for the payment of equal monthly installments is known as Hire Purchasing	Leasing is an agreement where one party buys the asset and allows the other party to use it by paying consideration over a specified period is known as Leasing
2.	<b>Down Payment</b>	Required	Not Required
3.	<b>Installments</b>	Principal plus interest	Cost of using the asset
4.	<b>Ownership</b>	Ownership of the asset is transferred to the hire purchaser on the payment of the last installment	Transfer of ownership depends on the type of lease
5.	<b>Repairs &amp; Maintenance</b>	Responsibility of hire purchaser	Depends upon the type of lease
6.	<b>Duration</b>	Short Term	Comparatively Long term
7.	<b>Depreciation &amp; Interest.</b>	Hirer is allowed to take tax benefit on Depreciation and interest.	Lessee is allowed to take tax benefits on lease rent. tax on depreciation is not allowed

**Q.No.3. Explain types of Lease? (Or) what is Operating Lease and Financial lease? (B)**

**(NEW SM, CA FINAL OLD PM)**

Depending upon the terms of the agreement lease takes two fundamental forms – namely-



**OPERATING LEASE:**

- If under the lease agreement the lessor is entitled to take back the possession of the asset leased from the lessee – the arrangement is considered as operating lease.
- In this type of lease, the primary lease period is short and the lessor would not be able to realize the full cost of the equipment and other incidental charges thereon during the initial lease period.
- Besides the cost of machinery, the lessor also bears insurance, maintenance and repair costs etc.
- Agreements of operating lease generally provide for an option to the lessee/lessor to terminate the lease after due notice.

**FINANCIAL LEASE (CAPITAL BASE):**

- It is a long-term arrangement, which is irrevocable during the primary lease period which is generally the full economic life of the leased asset.
- Under this arrangement lessor is assured to realize the cost of purchasing the leased asset, cost of financing it and other administrative expenses as well as his profit by way of lease rent during the initial (primary) period of leasing itself.
- Financial lease involves transferring almost all the risks incidental to ownership and benefits arising there from except the legal title to the lessee.

**Q.No.4. What are the Characteristic features of Operating and Financial Lease? (A) (NEW SM)****SIGNIFICANT FEATURES OF OPERATING LEASE:**

- Payments by way of lease rental over the period of lease are not enough to cover the cost of leased asset.
- The lessor generally takes back the possession of the asset on the expiry of the lease period.
- The lessor bears the cost of insurance, maintenance, tax etc. of the leased asset
- The lessee has the right to cancel the lease before the expiry of the lease term.
- The lessor remains the owner of the asset in the legal and economic sense (in substance).
- Operating lease is always a tax oriented lease.

**SIGNIFICANT FEATURES OF FINANCIAL LEASE:**

- Lease rental over the lease period covers the cost of leased asset plus a return on investment made by the lessor for the leased asset
- Though the lessor may continue to remain the legal owner of the asset, but for all practical purposes (i.e. in substance), risk and reward associated with ownership is substantially transferred to the lessee since the inception of the lease.
- The lessee bears the maintenance cost, insurance and taxes of the asset.
- Under the lease agreement, the lessee is not entitled to cancel or terminate the lease except at a very high penalty. This means lessee must pay the lease instalment otherwise lessor will sue him for nonpayment of unpaid instalments with cost and damage in the capacity of a creditor.

**Q.No.5. Explain the difference between Financial Lease and Operating Lease (A) (NEW SM, RTP N18 (N))**

	FINANCIAL LEASE	OPERATING LEASE
1.	The <u>risk and reward</u> incident to ownership are <u>passed on to the lessee</u> . The <u>lessor</u> only remains the <u>legal owner</u> of the asset.	The lessee is only provided the use of the asset for a certain time. <u>Risk</u> incident to ownership belong <u>wholly to the lessor</u> .
2.	The <u>lessee</u> bears the <u>risk of obsolescence</u> .	The <u>lessor</u> bears the <u>risk of obsolescence</u> .

3.	The lessor is interested in his rentals and not in the asset. He must get his principal back along with interest. Therefore, the lease is <u>non-cancellable by either party.</u>	As the lessor does not have difficulty in leasing the same asset to other willing lessee, <u>the lease is kept cancellable by the lessor at the request of lessee.</u>
4.	The <u>lessor</u> enters into the transaction only as financier. He does <u>not bear the cost of repairs, maintenance or operations.</u>	Usually, <u>the lessor bears cost</u> of repairs, maintenance or operations.
5.	The lease is usually <u>full payout</u> , that is, the <u>single lease repays the cost of the asset together with the interest.</u>	The lease is usually <u>non-payout</u> , since the lessor expects to <u>lease the same asset over and over again to several users.</u>

**Q.No.6. Who is entitled to claim Tax Shield of Depreciation in case of operating lease. (B)  
(ACADEMIC INTEREST) (NEW SM)**

- a) In case of operating lease there is no confusion as to tax treatment of depreciation on leased asset.
- b) It is always the lessor who is entitled to claim depreciation on asset leased as he fulfills the two criteria for claiming depreciation namely – ‘ownership of asset’ and ‘use of asset for the purpose of business’.

**Q. No.7. Explain the classification of Financial Lease? (Or) What is Tax oriented Lease and What is Sale and Lease back transaction? (A)  
(NEW SM)**

**1. TAX-ORIENTED LEASE:**

- a) In Financial lease, risk and reward of ownership are substantially transferred to lessee in economic sense. Nevertheless in a Financial lease if the lessor is considered as the owner of the asset for claiming tax benefit of depreciation, then the Financial lease is considered as ‘tax - oriented lease’.
- b) Deduction of depreciation from lease rental reduces profit of lessor which is then subjected to tax. In other words, depreciation reduces the tax burden. Depreciation is a non-cash expenditure that results in ‘tax saving’. This is a genuine benefit that arises from depreciation being a tax deductible non-cash expenditure.
- c) The lessor can pass on a part of depreciation benefit to the lessee making the arrangement attractive for the lessee. This enhances the competitive advantage of the lessor.
- d) If in place of lessor, lessee is entitled to claim depreciation for tax purpose then it is not a ‘tax oriented lease’. In that case, the tax treatment will be same as that of owning an asset through borrowing.
- e) Depreciation benefit of tax is of paramount importance in lease versus buy decision in determining cash flow implication to the lessor and lessee and the subsequent value of the lease to the respective parties

**2. LEVERAGED LEASE:**

- a) A leveraged lease is tax oriented lease where the lessor borrows substantial amount from the lender to purchase the asset he leases.
- b) But an arrangement is made in such a way through tripartite agreement between the lender (Financier of the leased asset), lessor and the lessee, so that, in case of default of payment of lease rental by the lessee, the lessor is not liable to make loan repayment to the lender.

- c) Instead of lessor, the lender has to take appropriate steps to recover the loan instalments due on loan to purchase the leased asset from the lessee.
- d) Leveraged lease is a complicated arrangement and normally entered in case of very high value transactions.
3. **SALE AND LEASE BACK:** It is an arrangement under which an entity sells the asset to another party and simultaneously takes it back from other party under a lease arrangement.
- The important features of sale and lease back arrangement are:
- a) The lessee gets a lump sum amount as sale consideration of the asset.
- b) The lessee continues to use the asset.
- c) If the terms of the lease make it an operating lease or tax oriented finance lease, the buyer - cum-lessor is entitled to get tax benefit of depreciation.

**Q. No.8. What are the advantages of Leasing? (or) State the reasons for opting Leasing (B)**  
(NEW SM, N18 (N) - 4M)

- Lease may be low cost alternative:** Leasing is alternative to purchasing. As the lessee is to make a series of payments for using an asset, a lease arrangement is similar to a debt contract. The benefit of lease is based on a comparison between leasing and buying an asset.
- Tax benefit:** In certain cases tax benefit of depreciation available for owning an asset may be less than that available for lease payment. In other words, differential tax treatment between owning an asset and taking it on lease may result in a decision in favour of lease.
- Working capital conservation:** When a firm buys an equipment by borrowing from a bank (or financial institution), they never provide 100% financing. Depending upon the firm's credit rating bank may finance 75% or 60% (say) of total cost of equipment. But in case of lease one gets normally 100% financing in the sense that one needn't bring in margin money.
- Preservation of Debt Capacity:** As per the accounting standard operating lease is not capitalised in the books of the lessee. Operating lease payment is treated as expenditure in the profit and loss account. Neither the asset taken on lease appears as asset nor does the liability representing present value of future lease payment (cost of leased asset) appear as liability in the balance sheet. That is, operating lease doesn't have any balance sheet impact. So, operating lease does not matter in computing debt equity ratio.
- Obsolescence and Disposal:** After purchase of leased asset there may take place technological obsolescence of the asset. To retain competitive advantage the lessee as user may have to go for the upgraded asset. The obsolete old asset may fetch a small portion of the book value upon disposal resulting in capital loss. In case of cancellable operating lease, the lessee can terminate the contract in such circumstances. *However, it is to be kept in mind that where there is a possibility of technological obsolescence the lessor will cover the risk by fixing a higher lease rental.*
- Restrictive Conditions for Debt Financing:** When a company takes loan to purchase equipment (say), in the loan agreement lender may impose several restrictions on the borrower company to protect his interest. In case of lease such tight conditions are not imposed as lessor remains the owner of the asset legally and he can recover the asset if the lessee fails to abide by the lease terms and conditions.

**Q. No.9. What are the Limitations/ Disadvantages of Leasing? (B)** (NEW SM)

- No Moratorium:** The lease rentals become payable soon after the acquisition of assets and no moratorium period is permissible as in case of term loans from financial institutions. The lease arrangement may, therefore, not be suitable for setting up of the new projects as it would entail cash outflows even before the project comes into operation.

2. **Seller's warranties:** The leased assets are purchased by the lessor who is the owner of equipment. The seller's warranties for satisfactory operation of the leased assets may sometimes not be available to lessee.
3. **Default by Lessor:** Lessor generally obtains credit facilities from banks etc. to purchase the leased equipment which are subject to hypothecation in favour of the bank. Default in payment by the lessor may sometimes result in seizure of assets by banks causing loss to the lessee.
4. **High cost:** Lease financing has a very high cost as compared to interest charged on term loans by financial institutions/banks.

**Q. No.10. Write about various methods of Evaluating Lease Financing. (A)**

**(NEW SM)**

There are **three methods** of evaluating a leasing proposal viz. Present Value analysis, Internal Rate of Return analysis, and the Bower Herringer Williamson method.

- a) **Present Value Analysis:** In this method, the present value of the annual lease payments (tax adjusted) is compared with that of the annual loan repayments adjusted for tax shield on depreciation and interest, and the alternative which has the lesser cash outflow will be chosen.
- b) **Internal Rate of Return Analysis:**
  - Under this method there is no need to assume any rate of discount. To this extent, this is different from the former method where the after-tax cost of borrowed capital was used as the rate of discount.
  - The result of this analysis is the after tax cost of capital explicit in the lease which can be compared with that of the other available sources of finance such as a fresh issue of equity capital, retained earnings or debt.
  - Simply stated, this method seeks to establish the rate at which the lease rentals, net of tax shield on depreciation are equal to the cost of leasing.
- c) **Bower-Herringer-Williamson Method:** This method segregates the financial and tax shield aspects of lease financing. This model compares the financing benefit of leasing with tax advantage/operating benefit of leasing.

### MULTIPLE CHOICE QUESTIONS – FOR SELF STUDY

1. You have sufficient fund and you need a car for 5 months. You will -
  - a) Purchase the car using your fund, use for 5 months and sell the car after 5 months.
  - b) Purchase the car by borrowing, use for 5 months, sell the car and repay the loan.
  - c) You will take the car on lease for 5 months and return it after lease period is over.
  - d) None of the above.
2. From finance angle -
  - a) Lease has advantage over bank loan as lease requires no margin money and hence means 100% financing.
  - b) Bank loan is always preferable despite margin money requirement.
  - c) Margin money is not an important consideration in borrow and buy versus lease decision.
  - d) Margin money requirement is the only criterion for which lease is always considered better than bank loan.
3. Leasing -
  - a) Increases earning per share.
  - b) Reduces earning per share.
  - c) Has no impact on earnings per share.
  - d) Can't say – varies on case to case.
4. Long term financial lease is -
  - a) An off balance sheet item and has no impact on debt equity ratio.
  - b) A balance sheet item and increases debt equity ratio.
  - c) A balance sheet item and reduces debt equity ratio.
  - d) A balance sheet item and has no impact on debt equity ratio.

5. Lease has value, when –
  - a) Post-tax cost lease of lease rental < an equivalent loan principal and post-tax interest.
  - b) Post-tax cost lease of lease rental > an equivalent loan principal and post-tax interest.
  - c) Post-tax cost lease of lease rental = an equivalent loan principal and post-tax interest.
  - d) None of the above
  
6. An operating lease is –
  - a) Non-cancellable
  - b) cellable at the option of either lessor or lessee.
  - c) cellable at the option of lessor only
  - d) cellable at the option of lessee only.
  
7. From the lessee’s angle, the risk of –
  - a) Operating lease is same as that of financing lease.
  - b) Operating lease is greater than that of financing lease
  - c) Operating lease is lesser than that of financing lease.
  - d) Operating lease is not comparable with that of finance lease
  
8. Lease rental –
  - a) Will increase minimum alternative tax
  - b) Has no impact on minimum alternative tax.
  - c) Is tax neutral, being balance sheet item.
  - d) May reduce minimum alternative tax.

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**KEY:**

1.	C	2.	A	3.	D	4.	B	5.	A
		6.	D	7.	C	8.	D		

**THE END**

## 6. DIVIDEND DECISIONS

Q. No.1.What do you understand by dividend decision? (B)

(NEW SM)

Financial management is the process of making financial decisions. Financial decision broadly covers three areas:

- i) Financing decision
- ii) Investment decision
- iii) Dividend decision

Dividend decision is one of the most important areas of management decisions. It is easy to understand but difficult to implement.

Let's understand this with the help of an example,

*Suppose a company, say ABC limited, which is continuously paying the dividend at a normal growth rate, earns huge profits this year. Now the management has to decide whether continue to pay dividend at normal rate or to pay at an increasing rate?*

**Why this dilemma?**

The reason is that, if the management decides to pay higher dividend, then it might be possible that next year, the company will not achieve such higher growth rate, resulting the next year's dividend will be low as compared.

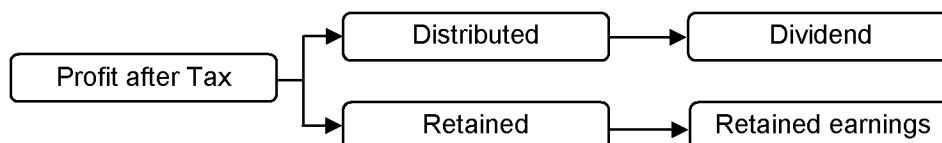
However, if the company decides to stay on the normal rate of dividend then surplus amount of retained earnings would remain idle which will result in over capitalization, if no opportunity existing to utilize the funds.

Q. No.2.Explain the meaning of dividend? (B)

(NEW SM)

**MEANING OF DIVIDEND:**

- a) Dividend is that part of profit after tax which is distributed to the shareholders of the company.
- b) In other words, the profit earned by a company after paying taxes can be used for:
  - i) Distribution of dividend or
  - ii) Can be retained as surplus for future growth.



Q. No.3. Explain the Significance of Dividend Policy (B)

(NEW SM)

Dividend policy of the firm is governed by:

**1. LONG TERM FINANCING DECISION:**

- a) Equity can be raised externally through issue of equity shares or can be generated internally through retained earnings. But retained earnings are preferable because they do not involve floatation costs.
- b) Under this purview, the decision is based on the following:
  - i) Whether the organization has opportunities in hand to invest the amount of profits, if retained?
  - ii) Whether the return on such investment (ROI) will be higher than the expectations of shareholders i.e., Ke.



**2. WEALTH MAXIMIZATION DECISION:**

- a) Shareholders give higher value to near dividends than future dividends and capital gains.
- b) Payment of dividends influences the market price of the share.
- c) Higher dividends increase value of shares and low dividends decrease it. A proper balance has to be struck between the two approaches.
- d) When the firm increases retained earnings, shareholders' dividends decrease and consequently market price is affected.
- e) Use of retained earnings to finance profitable investments increases future earnings per share.

Management should develop a dividend policy which divides net earnings into dividends and retained earnings in an optimum way so as to achieve the objective of wealth maximization for shareholders.

**Q. No.4. Explain Different forms of Dividend. & Briefly Explain Advantages & Disadvantages of Stock. (A) (NEW SM, PD)**

ASPECT	CASH DIVIDEND	STOCK DIVIDEND (BONUS SHARES)
MEANING	It involves distribution of cash to the Shareholders, leading to reduction in Reserves and Cash Balances of the Company.	It involves distribution of Shares to the Shareholders, in proportion to their existing Shareholding.
EFFECT ON CASH	There is a reduction in Cash and Bank balances of the Company. If the Company does not have adequate funds, it should borrow money to meet payout Obligations.	There is no reduction in Cash/Bank. Only Shares are allotted to Shareholders, by capitalizing profits, without any consideration being received from them.
EFFECT ON NET WORTH	Net Worth is reduced to the extent of Dividend declared and paid.	Total Net Worth or Total Net Assets, are not affected by Bonus Issue.

**ADVANTAGES & DISADVANTAGES OF STOCK DIVIDEND**

	ADVANTAGES	DISADVANTAGES
TO SHARE-HOLDERS	<ol style="list-style-type: none"> <li>a) No tax effect at the time of distribution of Bonus Shares.</li> <li>b) Favourable psychological impact on Share-holders, and is greeted by them on the ground that it gives an indication of the Company's growth.</li> <li>c) Increase in number of shares will lead to higher Incomes in future, when Cash Dividend is declared.</li> </ol>	<ol style="list-style-type: none"> <li>a) Lack of immediate cash income / fixed revenue stream.</li> <li>b) No change in proportionate ownership in the Company, since Bonus Shares are declared in the same ratio as existing holdings.</li> <li>c) Market Price of the Share may fall, to the extent of dividend distributed</li> </ol>
TO COMPANY	<ol style="list-style-type: none"> <li>a) No need for payment of Dividend Distribution Tax.</li> <li>b) No reduction in Net Assets or Net Worth.</li> <li>c) Conservation of cash for meeting profitable investment opportunities.</li> <li>d) Suitable in case of cash deficiency, or restrictions imposed by Lenders to pay cash dividend.</li> </ol>	<ol style="list-style-type: none"> <li>a) Leads to reduction in future EPS.</li> <li>b) Leads to higher cash Outflow in future when Cash dividends are declared</li> <li>c) May not be suitable in case Company access to low cost debt funds, and can use such funds for its growth plans.</li> </ol>

**Q.No.5. What are the determinants or Factors effecting Dividend Decisions? (A) (NEW SM)**

The dividend policy is affected by the following factors:

1. **AVAILABILITY OF FUNDS:** If the business is in requirement of funds, then retained earnings could be a good source. Since it saves the floatation cost and further the control will not be diluted as in case of further issue of share capital.
2. **COST OF CAPITAL:** If the financing requirements can be financed through debt (relatively cheaper source of finance), then it should be preferred to distribute more dividend but if the financing is to be done through fresh issue of equity shares, it is better to use retained earnings as much as possible.
3. **CAPITAL STRUCTURE:** An optimum Debt equity ratio should also be under consideration for the dividend decision.
4. **STOCK PRICE:** Stock price here means market price of the shares. Generally, higher dividends increase value of shares and low dividends decrease it.
5. **INVESTMENT OPPORTUNITIES IN HAND:** The dividend decision is also affected, if there are investment opportunities in hand, the company may prefer to retain more from the earnings.
6. **INTERNAL RATE OF RETURN:** If the internal rate of return is more than the cost of retained earnings, it's better to distribute the earnings as much as possible.
7. **TREND OF INDUSTRY:** Few industries have been seen by investors for regular income, hence in such cases, the firm will have to pay dividend for survival.
8. **EXPECTATION OF SHAREHOLDERS:** The shareholders can be categorised in two categories: (i) those who invests for regular income, & (ii) those who invests for growth. Generally, the investor prefers current dividend more than the future growth.
9. **TAXATION:** As per Section 115-O, dividend is subject to dividend distribution tax (DDT) in the hands of the company. Under the existing provisions of Section 10(34) of the Income Tax Act, 1961, dividend which suffer dividend distribution tax (DDT) under section 115-O is exempt in the hands of the shareholder.

Further, any income by way of dividend in excess of Rs. 10 lakhs shall be chargeable to tax in the case of an individual, HUF or a firm who is resident in India, at the rate of ten percent.

**Q.No.6. What are the Practical Considerations in dividend policy (A) (NEW SM)**

1. Financial needs of the Company
2. Constraints on paying Dividends
  - a) Legal
  - b) Liquidity
  - c) Access to capital Market
  - d) Investment Opportunities
3. Desire of Shareholders
4. Stability of Dividends
  - a) Constant Dividend per Share
  - b) Constant Percentage of Net Earnings
  - c) Small constant Dividend per share plus Extra dividend

**Q.No.7. Financial needs of the Company is one of the Practical Consideration which determine the dividend policy of a company. Explain. (OR) Explain how Financial needs of the Company will influence the dividend policy of a company. (C) (NEW SM)**

1. Retained earnings can be a source of finance for creating profitable investment opportunities.

2. When internal rate of return of a company is greater than return required by shareholders, it would be advantageous for the shareholders to re-invest their earnings.

MATURE COMPANIES	GROWTH COMPANIES
1. Mature companies having <u>few investment opportunities</u> will show <u>high pay-out ratios</u> .	1. Growth companies, on the other hand, <u>have low pay-out ratios</u> . They are in need of funds to finance fast growing fixed assets.
2. <u>Share prices</u> of such companies are <u>sensitive to dividend charges</u> .	2. <u>Distribution of earnings</u> reduces the funds of the company. They retain all the earnings and declare bonus shares to <u>offset the dividend requirements</u> of the shareholders.
3. So a <u>small portion of the earnings are kept to meet emergent and occasional financial needs</u> .	3. These <u>companies increase the amount of dividends gradually as the profitable investment opportunities start falling</u> .

**Q.No.8. What are the constraints on paying Dividends? (A)**

**(NEW SM)**

- LEGAL:** The Company has to comply with the Provisions of Section 123 of the Companies Act 2013.
- LIQUIDITY:** Payment of dividends means outflow of cash. Ability to pay dividends depends on cash and liquidity position of the firm.
- ACCESS TO THE CAPITAL MARKET:**
  - By paying large dividends, cash position is affected.
  - If new shares have to be issued to raise funds for financing investment programmes and if the existing shareholders cannot buy additional shares, control is diluted.
- INVESTMENT OPPORTUNITIES:** If investment opportunities are inadequate, it is better to pay dividends and raise external funds whenever necessary for such opportunities.

**Q.No.9. Desire of Shareholders is one of the Practical Consideration which determine the dividend policy of a company. Explain. (OR) Explain how Desire of Shareholder will influence the dividend policy of a company. (C)**

**(NEW SM)**

**DESIRE OF SHAREHOLDERS:** The desire of shareholders (whether they prefer regular income by way of dividend or maximize their wealth by way of gaining on sale of the shares).

- In this connection it is to be noted that as per the current provisions of the Income Tax Act, 1961, tax on dividend is borne by the corporate as (Dividend Distribution Tax) and shareholders need not pay any tax on income received by way of dividend from domestic companies. To the extent small shareholders who are concerned with regular dividend income or who do not form a dominant group or retired and old people investing their savings, pension to purchase shares may prefer regular income and hence select shares of companies paying regular and liberal dividend.
- As compared to those shareholders who prefer regular dividend as source of income, there are shareholders who prefer to gain on sale of shares at times when shares command higher price in the market. For such of those who prefer to gain on sale of shares, as per the provisions of the Income Tax Act, 1961, tax on capital gains (short-term @ 15%) are attracted if they sell the shares on holding less than one year and there is no tax on long-term sale (if held for more than one year) However, shareholders have to pay Securities Transaction Tax (STT) on sale of shares.

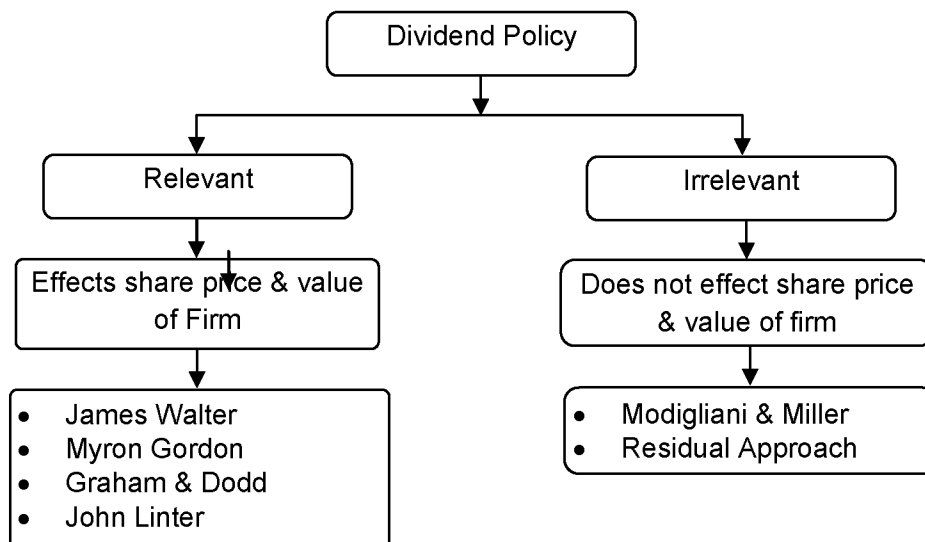
The dividend policy, thus pursued by the company should strike a balance on the desires of the shareholders who may belong either of the group as explained above. Also the dividend policy once established should be continued as long as possible without interfering with the needs of the company to create clientele effect.

**Q. No.10. Explain the various dividend Approaches.(OR) Write a short note on Stable Dividend policy. (A)** **(NEW SM, PA)**

FORM	DESCRIPTION	ADVANTAGES
<b>Constant DPS</b>	Company pays a certain fixed amount per share as Dividend every year. If the Company reaches new level of earnings and expects to maintain it, the annual DPS may be increased,	<p>a) Consistency of future stream of Income to the Shareholders.</p> <p>b) Treats Equity Shareholders at par with Preference Shareholders.</p> <p>c) Preferred by persons and institutions that depend on Dividend Income to meet living and operating expenses.</p> <p>d) Most suited for Companies with stable earnings, or Companies having Dividend Equalisation Reserve to plan for variation in their earnings.</p>
<b>Constant Payout Ratio</b>	Company pays a fixed percentage of earnings every year. In this policy, the amount of dividend will fluctuate in direct proportion to Earnings.	<p>a) Dividend is related to the Company's ability to pay dividends, and this policy is equitable for the Company and Shareholders.</p> <p>b) Internal Financing with Retained Earnings is automatic.</p> <p>c) This policy has a conservative approach and provides a guarantee against over / under-payment.</p> <p>d) Management is not allowed to pay dividend if profits are not earned in current year and at the same time, dividend is not allowed to forego if profits are earned.</p>
<b>Constant DPS plus Extra Dividend</b>	Company pays a Fixed dividend to the Shareholders every year and Additional Dividend in a year of good earnings.	<p>a) Minimum DPS with a step-up feature is ideal for Companies with fluctuating earnings.</p> <p>b) Enables the Company to pay constant amount of dividend regularly without default, and also extra dividend in periods of prosperity.</p> <p>c) Allows Shareholders to plan on set amounts of cash, and at the same time be pleased when extra dividends are announced.</p>

**Q. No.11. List out various Theories of Dividend (C)**

**(NEW SM)**



## Q.No.12. Stock Splits (B)

(NEW SM)

- Stock split means splitting one share into many, say, *one share of Rs. 500 in to 5 shares of Rs. 100.*
- Stock splits is a tool used by the companies to regulate the prices of shares i.e. if a share price increases beyond a limit, it may become less tradable, *for e.g. suppose a company's share price increases from Rs. 50 to Rs. 1000 over the years, it is possible that it might goes out of range of many investors.*

**ADVANTAGES OF STOCK SPLITS:**

1. It makes the share affordable to small investors.
2. Number of shares may increase the number of shareholders; hence the potential of investment may increase.

**LIMITATIONS OF STOCK SPLITS:**

1. Additional expenditure need to be incurred on the process of stock split.
2. Low share price may attract speculators or short term investors, which are generally not preferred by any company.

**SIMILAR QUESTION:**

1. **State the advantages of Stock-split.** (MTP2 N18 (N) - 2M)
- A. Refer advantages point above

## Q.No.13. State two advantages of Walter Model of Dividend Decision. (B) (MTP1 N18 (N) - 2M)

**Advantages of Walter Model:**

1. The formula is simple to understand and easy to compute.
2. It can envisage different possible market prices in different situations and considers internal rate of return, market capitalisation rate and dividend payout ratio in the determination of market value of shares.

**MULTIPLE CHOICE QUESTIONS – FOR SELF STUDY**

1. Which one of the following is the assumption of Gordon Model:
  - a)  $K_e > g$
  - b) Retention ratio(b),once decide upon, is constant
  - c) Firm is an all equity firm
  - d) All of the above
2. What should be the optimum Dividend payout ratio, when  $r = 15\%$  &  $K_e = 12\%$ :
  - a) 100%
  - b) 50%
  - c) Zero
  - d) None of the above.
3. Which of the following is the irrelevance theory?
  - a) Walter model
  - b) Gordon model
  - c) M.M. hypothesis
  - d) Linter's model
4. If the company's D/P ratio is 60% & ROI is 16%, what should be the growth rate:
  - a) 5%
  - b) 7%
  - c) 6.4%
  - d) 9.6%
5. If the shareholders prefer regular income, how does this affect the dividend decision:
  - a) It will lead to payment of dividend
  - b) It is the indicator to retain more earnings
  - c) It has no impact on dividend decision
  - d) Can't say
6. Mature companies having few investment opportunities will show high payout ratios, this statement is:
  - a) False
  - b) True
  - c) Partial true
  - d) None of these

7. Which of the following is the limitation of Linter's model:
- This model does not offer a market price for the shares
  - The adjustment factor is an arbitrary number and not based on any scientific criterion or methods
  - Both a) & b)
  - None of the above.

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**KEY:**

1.	D	2.	C	3.	C	4.	C
	5.	A	6.	B	7.	C	

**THE END**

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## 7. 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  $CFAT = PAT + \text{Depreciation and other amortizations}$ .
- 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 after the initial investment to their present value.
- c) Thus:  $NPV = \text{Discounted Cash Inflows} - \text{Discounted Cash Outflows}$ .

**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.

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**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.

- 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.
- The different rankings given by the NPV and IRR methods could be due to size disparity problem, time disparity problem and unequal expected lives.
- The NPV is expressed in financial values whereas IRR is expressed in percentage terms.
- 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)

- In most of the situations the Net Present Value Method (NPV) and Profitability Index (PI) yield same accept or reject decision.
- 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.
- Under NPV method a project is acceptable if net present value of a project is positive and rejected if it is negative.
- 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):**

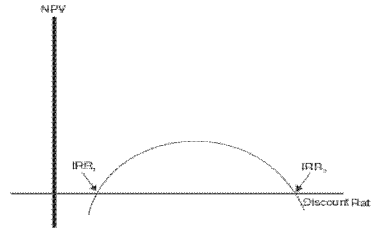
- There are several limitations attached with the concept of the conventional Internal Rate of Return. The MIRR addresses some of these deficiencies.
- For example, it eliminates multiple IRR rates, it addresses the reinvestment rate issue and produces results, which are consistent with the Net Present Value method.
- 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).
- 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.
- 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)

**Multiple Internal Rate of Return (MIRR):**

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

**Discounted Payback Period:**

- a) Payback Period is time taken to recover the original investment 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 limitation of ignoring time value of money and profitability.
- c) Discounted payback period considers present value of cash flows, 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.

**FOR ACADEMIC INTEREST ONLY**

**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:

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

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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## 8. 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.No.1. 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 particular project or business. The performance of a project or business is 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.

- 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.

**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  $k_0$ .

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

Where,  $k_1, k_2$  are component costs and  $w_1, w_2$  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:**

- In dividend price approach, cost of equity capital is computed by dividing the current dividend by average market price per share.
- This ratio expresses the cost of equity capital in relation to what yield the company should pay to attract investors.
- 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:**

- The advocates of earnings price approach co-relate the earnings of the company with the market price of its share.
- Accordingly, the cost of ordinary share capital would be based upon the expected rate of earnings of a company.
- 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).**

- CAPM was developed by sharp Mossin and Linter in 1960.
- CAPM model describes the risk-return trade-off for securities. It describes the linear relationship between risk and return for securities.
- 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  $\beta$ ) 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:

$$K_e = R_f + \beta (R_m - R_f)$$

Where,

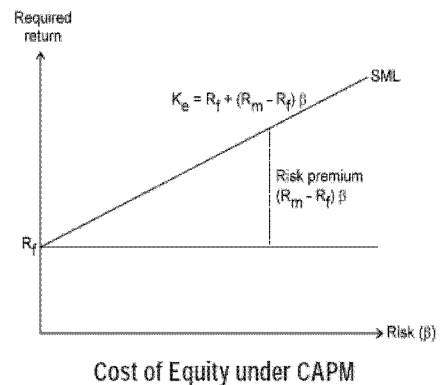
$K_e$  = Cost of equity capital

$R_f$  = Rate of return on security

$\beta$  = Beta coefficient

$R_m$  = Rate of return on market portfolio

$(R_m - R_f)$  = Market premium



**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.7. "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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## 9. 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	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
12	B	-	-	-	-	-	-	-	-	2	-	-	-	-	-	-	-	-	-	-	-	-	-
13	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:

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

**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.

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

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.

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## 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)  $\kappa_d < \kappa_e$  : The debt capitalisation rate ( $\kappa_d$ ) is less than the equity capitalisation rate ( $\kappa_e$ ).
- 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 ( $\kappa_d$ ) and equity capitalisation rate ( $\kappa_e$ ) 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

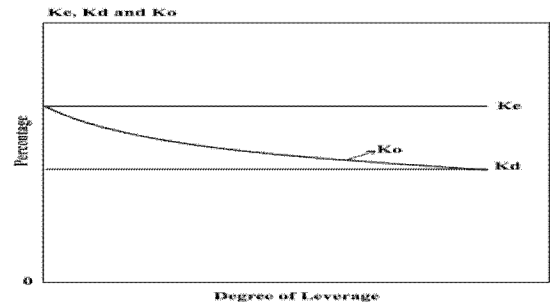
$D$  = Market value of debt

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

Where,

$NI$  = Earnings available for equity shareholders

$K_e$  = Equity Capitalisation rate



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

**Conclusion:**

- This theory suggests total or maximum possible debt financing for minimising the cost of capital. The overall cost of capital under this approach is:
- Overall cost of capital =  $\frac{EBIT}{\text{Value of the firm}}$
- 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:**

- 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.
- 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:**

- The corporate income taxes do not exist.
- The market capitalizes the value of the firm as 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.
- 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**

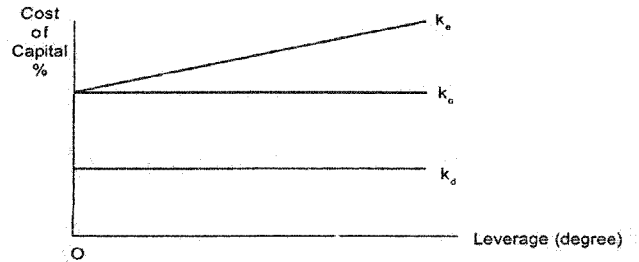
It means Cost of Equity Capital ( $K_e$ ) is equal to:

$$K_e = (K_o - K_d) D/E$$

Where,  $K_e$  = 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:**

- Modigliani and Miller's argue that the total cost of capital of a particular corporation is independent of its methods and level of financing.
- 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.
- Hence they contend that leverages have little effect on the overall cost of capital or on the market price.

**Assumptions:**

- Capital markets are perfect. Information is costless and readily available to all investors, there are no transaction costs, and all securities are infinitely divisible.
- Investors are assumed to be rational and to behave accordingly.
- Firms can be categorised into "equivalent return" classes. All firms within a class have the same degree of business risk.
- The absence of corporate income taxes is assumed.

**Their three Basic Propositions are:**

- 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.
- 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.
- 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:**

- 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.
- 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.
- 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.

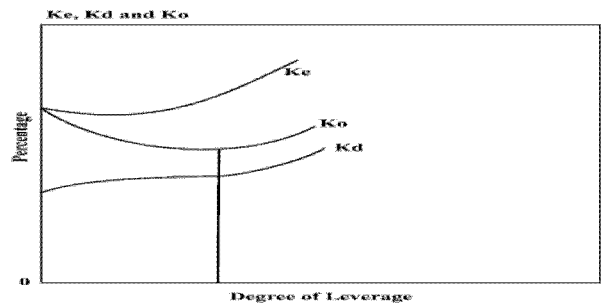
**Graphical Presentation of the effect of change in leverage on  $K_e$ ,  $K_d$  & WACC under Traditional approach**

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)

- Optimum capital structure deals with the issue of right mix of debt and equity in the long-term capital structure of a firm.
- 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.
- 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.12. How does Capital Structure differ from Financial Structure?

(PM) (M 10-2M)

**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.

**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.13. 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

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

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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**10. LEVERAGES**

Q.N O	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:**

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

- It exists when a firm has a fixed cost that must be defrayed regardless of volume of business.
- 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.
- 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:**

- It involves the use fixed cost of financing and refers to mix of debt and equity in the capitalisation of a firm.
- 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:**

- 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.
- 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.
- 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:**

- It 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. If there is no fixed cost, there would be no operating risk.

**Financial Risk:**

- 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.
- Companies that issue more debt instruments would have higher financial risk than companies financed mostly by equity.
- 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:**

- 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.

**Q.No.4. "Financial Leverage is a Double edge Sword." Comment.**

(SM)(N15 - RTP)

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

**Justification:**

- 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

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

(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) =  $\text{ROA} + \frac{\text{Debt}}{\text{Equity}} [\text{ROA} - \text{Interest}]$

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

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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# 11. 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)

**MEANING:** 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.

#### TYPES OF RATIOS:

- Liquidity Ratios:** Liquidity or short term solvency means ability of the business to pay its short-term liabilities.
- 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.
- Coverage Ratios:** The coverage ratios measure the firm's ability to service the fixed liabilities.
- Activity Ratios:** These ratios are employed to evaluate the efficiency with which the firm manages and utilize its assets.
- 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	$\frac{\text{Cash \& Bank Balances + Marketable securities}}{\text{Current Liabilities}}$	It measures absolute liquidity of the business.
Basic Defense Interval Ratio	$\frac{\text{Cash \& Bank Balances + Marketable securities}}{\text{operating expenses / No of days}}$	It measures the ability of the business to meet regular cash expenditures.
Net Working Capital Ratio	$\text{Current Assets} - \text{Current Liabilities}$	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.

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

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## 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	$\frac{\text{Total Outside liabilities}}{\text{Total debt + Networth}}$	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)	$\frac{\text{Earnings available for debt service}}{\text{Interest + Instalment s}}$	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:

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

Earnings 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:

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

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

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

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

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**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.

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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 RATIOS

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.

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

**Note:** 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)**

**COMPOSITION OF RETURN ON EQUITY USING THE DUPONT MODEL:**

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:

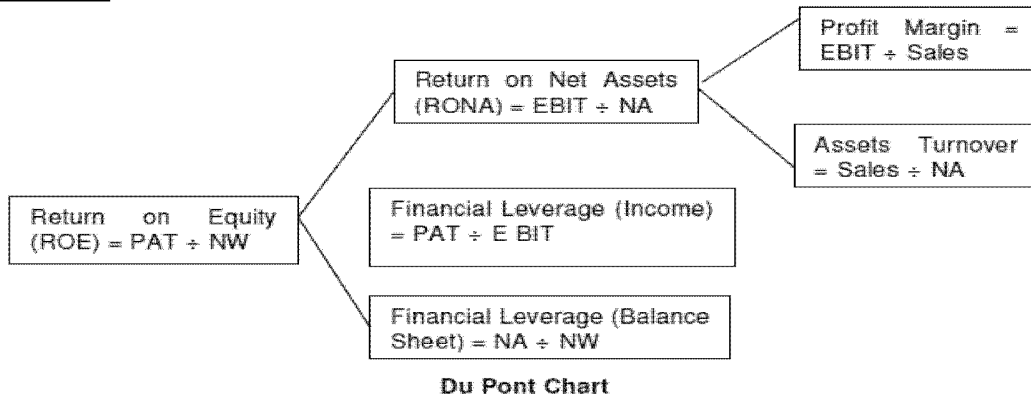
$$\text{Equity Multiplier} = \text{Assets} \div \text{Shareholders' Equity.}$$

### 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.)

$$\text{Return on Equity} = \text{Net profit margin} \times \text{Asset turnover} \times \text{Equity multiplier}$$

### 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**