Preface

Dear CA Inter Financial Management Students,

Welcome to this comprehensive compilation of MCQs for the CA Inter Financial Management (FM) subject, curated by CA Nitin Guru and proudly presented by Edu91.

This book is a valuable resource designed to aid you in mastering the intricacies of FM.

Financial Management is a crucial subject on your journey to becoming a Chartered Accountant, covering essential concepts vital for understanding organisational finance dynamics.

This book provides a plethora of MCQs sourced from ICAI questions and many practice questions crafted by us, ensuring alignment with exam standards.

We understand the importance of practice and reinforcement in your preparation.

We're delighted to offer this publication to you free of charge, aiming to support your academic journey without financial barriers, courtesy of Edu91.

We express gratitude to students for their dedication, and to ICAI for fostering academic excellence.

This book is a testament to our commitment to your success. With diligence and guidance provided herein, we're confident you'll excel in your CA Inter FM examinations.

Best wishes,
CA Nitin Guru @Edu91.org

ICAI MCQ Questions

Question - 1 :
The shareholder value maximisation model holds that the primary goal of the firm is to maximise its
Answer - 1 : Accounting profit
Answer - 2 : Liquidity
Answer - 3 : Market value
Answer - 4 : Working capital

Question - 2 :
Reserves & Surplus are which form of financing
Answer - 1 : Security Financing
Answer - 2 : Internal Financing
Answer - 3 : Loans Financing
Answer - 4 : International Financing

Question - 3 :
_______ is the main goal of financial management.
Answer - 1 : profit maximization
Answer - 2 : fund transfer
Answer - 3 : maximum returns
Answer - 4 : wealth maximization

Question - 4 :
Which of the following is the common connection in financing, investing decisions
Answer - 1 : Investment instruments type should be same as financing instrument type
Answer - 2 : Investments will definitely grow in line with financing
Answer - 3 : Debt Equity ratio should be same for investments and financing actions
Answer - 4 : Risk Return Trade off

Question - 5 :
Wealth maximisation approach is based on the concept of
Answer - 1 : Cost benefit analysis
Answer - 2 : Cash flow approach
Answer - 3 : Time value of money
Answer - 4 : All of the above

Question - 6 :
A principal agent relationship between _______ and .._______ which is known as Agency Problem
Answer - 1 : Managers & Owner
Answer - 2 : Executive & Proprietor
Answer - 3 : both (a) & (b)
Answer - 4 : Managers & secretary

Question - 7 :
Which of following activities will not lead to increase in shareholders wealth?
Answer - 1 : Investing in projects with high cash flows
Answer - 2 : Raising funds through sources which have low cost
Answer - 3 : Regular growth in dividends
Answer - 4 : Maintaining high levels of cash at bank

Question - 8 :
Which of the following activities are performed by CFOs now in addition to those performed by past CFOs
Answer - 1 : Budgeting
Answer - 2 : Forecasting
Answer - 3 : Risk Management
Answer - 4 : Treasury management

Question - 9 :
The main objective of financial management is to
Answer - 1 : Secure profitability
Answer - 2 : Maximise shareholder wealth
Answer - 3 : Enhancing the cost of debt
Answer - 4 : None of above

Question - 10 :
Focus of financial management is mainly concerned with the decision related to
Answer - 1 : Financing
Answer - 2 : Investing
Answer - 3 : Dividend
Answer - 4 : All of above

Question - 11 :
Which of the following is the disadvantage of having shareholders wealth maximisation goals
Answer - 1 : Emphasizes the short-term gains
Answer - 2 : Ignores the timing of returns
Answer - 3 : Requires immediate resources
Answer - 4 : Offers no clear relationship between financial decisions and share price

Question - 12 :
“Shareholders Wealth” in a firm is reflected by
Answer - 1 : the number of people employed in the firm
Answer - 2 : the book value of the firm’s assets less the book value of its liabilities
Answer - 3 : the amount of salary paid to its employees
Answer - 4 : the market price per share of the firm

Question - 13 :
Financial Management is mainly concerned with the
Answer - 1 : Acquiring and developing assets to forfeit its overall benefit
Answer - 2 : Acquiring, financing and managing assets to accomplish the overall goal of a business enterprise
Answer - 3 : Efficient management of the business
Answer - 4 : Sole objective of profit maximisation

Question - 14 :
Which of the following are microeconomic variables that help define and explain the discipline of finance
Answer - 1 : Risk and return
Answer - 2 : Capital structure
Answer - 3 : Inflation
Answer - 4 : All of the above

Question - 15 :
Management of all matters related to an organisation’s finances is called
Answer - 1 : Cash inflows and outflows
Answer - 2 : Allocation of resources
Answer - 3 : Financial management
Answer - 4 : Finance

SOLUTION SET

Q1	Q2	Q3	Q4	Q5	Q6	Q7	Q8	Q9	Q10	Q11	Q12	Q13	Q14	Q15
3	2	4	4	4	3	4	3	2	4	4	4	2	4	3

ICAI MCQs

Question - 1 :
Marketable securities are primarily
a. short-term debt instruments
b. short-term equity securities
c. long-term debt instruments
d. long-term equity securities

Question - 2 :
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

Question - 3 :
Which of the following is a correct type of Debentures
a. Bearer
b. Mortgage
c. Fully convertible
d. All of the above

Question - 4 :
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

Question - 5 :
Reserves & Surplus are which form of financing
a. Security Financing
b. Internal Financing
c. Loans Financing
d. International Financing

Question - 6 :
The most popular source of short-term funding is
a. Factoring
b. Trade credit
c. Family and friends
d. Commercial banks

Question - 7 :
Internal sources of finance do not include
a. Better management of working capital
b. Ordinary shares
c. Retained earnings
d. Reserve and Surplus

Question - 8 :
A debenture
a. Is a long-term loan
b. Does not require security
c. Is a short-term loan
d. Receives dividend payments

Question - 9 :
A company has an existing EPS of Rs. 7.5; it makes an FPO of 15000 shares issued at a price of Rs. 25 per share. The funds thus raised are expected to earn a post-tax return of 28%. What will be the expected impact on EPS?
a. EPS will remain 7.5
b. EPS will be greater than 7.5
c. EPS will be below 7.5
d. Information not sufficient for calculation

Question - 10 :
With reference to `IFC Masala Bonds', which of the statements given below is/are correct
1. The International Finance Corporation, which offered these bonds, is an arm of the World Bank.
2. They are rupee-denominated bonds and are a source of debt financing for the public and private sector.
a. 1 only
b. 2 only
c. Both 1 and 2
d. Neither 1 nor 2

Question - 11 :
The venture capital financing is a ________ financing of new high risky venture promoted by skilled entrepreneurs who lack _________and funds but have ___________
a. Debt, Experience, Skill
b. Equity, Experience, Idea
c. Debt, Experience, Idea
d. Equity, Skill, Idea

Question - 12 :
_______ bonds give the investor an option back to the company before maturity.
a. Callable
b. Puttable
c. Both
d. Foreign

Question - 13 :
External Commercial Borrowings can be accessed through ....
a. only automatic route
b. only approval route
c. both automatic and approval route
d. neither automatic nor approval route

Question - 14 :
External sources of finance do not include
a. Debentures
b. Retained earnings
c. Overdrafts
d. Leasing

Question - 15 :
In preference shares
a. Dividends are not available
b. Limited voting rights are available
c. Are not part of a company's share capital
d. Interest can be received

Question - 16 :
Which of the following marketable securities is the obligation of a commercial bank
a. Commercial paper
b. Negotiable certificate of deposit
c. Repurchase agreement

d. T-bills

Question - 17 :
Commercial paper is a __________ issued by ___________ interest rate of which is linked to ________________
a. Debenture, Corporates, 1 Yr Gov Securities Yield
b. Promissory Note, Corporates, 1 Yr Gov Securities Yield
c. Promissory Note, Banks, 1 Yr Gov Securities Yield
d. Promissory Note, Banks, RBI Repo rate

Solution Key:

Q1	Q2	Q3	Q4	Q5	Q6	Q7	Q8	Q9	Q10
a	b	d	a	b	b	b	a	c	c
Q11	Q12	Q13	Q14	Q15	Q16	Q17			
b	b	c	b	b	b	b			

Description:
9. Total Funds raised= 15000 x 25 =3,75,000. Return on funds= 375000 x 28%= 1,05,000. EPS on new Shares= 1,05,000/15000= 7. As the EPS on new shares is lower than original EPS, the combined EPS will be lower than original EPS of 7.5
11. VC financing is provided as equity finance to start ups as they don't have capability to service debt.

Practice MCQs

Question - 1 :
What does long-term financial needs of a business include?
a. Funds required for a period exceeding one year but not exceeding 5 years
b. Funds required for periods exceeding 5-10 years
c. Funds required for current assets
d. Funds required for a period not exceeding one year

Question - 2 :
Which of the following is a short-term financial need?
a. Investment in plant and machinery
b. Funds required for stores and critical spares
c. Funds required for current assets like stock and debtors
d. Medium-term loans from commercial banks

Question - 3 :
What is an example of an internal source of finance based on the basic sources?
a. Retained earnings
b. Public deposits
c. Debentures
d. Loans from financial institutions

Question - 4 :
Which type of financial source is trade credit considered as?
a. Long-term
b. Medium-term
c. Short-term
d. Internal source

Question - 5 :
What is a characteristic of equity capital?
a. Non fixed dividends
b. Typically has a fixed dividend rate
c. Subject to redemption
d. Provides tax-deductible dividends

Question - 6 :
What treatment do investments through Global Depository Receipts (GDRs) receive?
a. Treated as loans
b. Treated as Foreign Direct Investment (FDI)
c. Treated as domestic investments
d. Subject to high-interest rates

Question - 7 :
What is the primary disadvantage of issuing new equity shares?
a. Reduces ownership and control
b. Perceived as less risky by investors
c. Reduces earnings per share for existing shareholders
d. Enhances the company's financial base

Question - 8 :
What characteristic defines preference share capital?
a. Permanent source
b. Fixed dividend rate
c. No voting rights
d. Usually subject to redemption

Question - 9 :
What is a key advantage of issuing preference shares in terms of EPS?
a. Avoids dilution in Earnings Per Share (EPS)
b. Enhances the company's financial base
c. Provides flexibility in liquidity concerns
d. Offers voting rights to shareholders

Question - 10 :
What is the leverage advantage associated with preference shares?
a. Enjoying leverage with a fixed charge
b. Preserving market perception
c. Limited takeover risk
d. Fixed and pre-decided preference dividends

Question - 11 :
What is a characteristic of cumulative convertible preference shares (CCPs)?
a. No fixed charge
b. Voting rights for shareholders
c. Allows cumulative dividends before converting into equity
d. Subject to redemption at a pre-decided future date

Question - 12 :
What is a disadvantage of preference shares issuance regarding tax?
a. Tax-deductible dividends
b. Fixed and pre-decided preference dividends
c. Cumulative nature of dividends
d. Preference dividends are not tax-deductible

Question - 13 :
What does the cumulative nature of preference dividends imply?
a. Fixed and pre-decided dividends
b. Accumulated payments in case of non-payment in a particular year
c. Immediate liquidity concerns
d. Limited takeover risk

Question - 14 :
What does the classification of financial sources based on maturity include?

a. Internal sources
b. External sources
c. Long-term, medium-term, and short-term
d. Retained earnings

Question - 15 :
What is the primary purpose of short-term financial needs?
a. Investment in plant and machinery
b. Permanent working capital
c. Meets the working capital requirements for a short period
d. Funds required for periods exceeding 5-10 years

Question - 16 :
What is the primary source of retained earnings?
a. Issuing new shares
b. Accumulating company profits
c. Borrowing from banks
d. Selling assets

Question - 17 :
Who do retained earnings belong to?
a. Debenture holders
b. Ordinary shareholders
c. Preference shareholders
d. Creditors

Question - 18 :
Why must public limited companies retain a reasonable amount of profit annually?
a. To reduce company profits
b. To meet legal requirements
c. To distribute all profits as dividends
d. To avoid expansion plans

Question - 19 :
What is a characteristic of retained earnings regarding risk involvement?
a. High-risk involvement
b. Moderate-risk involvement
c. Low-risk involvement
d. No risk involvement

Question - 20 :
What does the retention of profits preserve in the context of retained earnings?
a. Dilution of control
b. Ownership of creditors
c. Control of present owners
d. Legal obligations

Question - 21 :
What decision does the plough back of retained earnings depend on?
a. Market share
b. Cost of equity
c. Dividend distribution
d. Debenture interest rates

Question - 22 :
Which financial decision is linked to retained earnings and further discussed in the dividend decision chapter?
a. Investment decision
b. Financing decision
c. Plough back decision

d. Dividend decision

Question - 23 :
In what denominations are debentures issued?
a. Fixed denominations only
b. Variable denominations
c. Denominations based on company profits
d. Denominations specified in the company's articles

Question - 24 :
What is the purpose of a debenture trust deed?
a. Determines interest rates
b. Outlines terms and conditions
c. Lists debenture holders
d. Decides maturity periods

Question - 25 :
What makes debentures attractive to investors?
a. Variable interest rates
b. Uncertain interest payments
c. Interest payable regardless of company profits
d. High-risk involvement

Question - 26 :
What is a characteristic of fully convertible debentures?
a. No conversion feature
b. Repayable on maturity
c. Convert into equity shares
d. Offer a higher interest rate

Question - 27 :
What advantage does debenture financing have in inflationary periods for the issuer?
a. Fixed interest outgo increases
b. Fixed interest outgo decreases in real terms
c. Interest becomes tax-deductible
d. It has no impact on inflation

Question - 28 :
What is a disadvantage of debenture financing regarding cash outflow?
a. Cash outflow is not required
b. Cash outflow is required at maturity
c. Cash outflow decreases over time
d. Cash outflow is optional

Question - 29 :
What may be a disadvantage of debenture financing regarding restrictive covenants?
a. Flexibility in operations
b. Lack of protective covenants
c. No impact on operations
d. Restrictive covenants may be restricting management decisions

Question - 30 :
What is required for public debenture issues and private placements?
a. Annual reports
b. Legal documents
c. Credit rating by agencies like CRISIL
d. Debenture trust deeds

Question - 31 :

What is the key characteristic of a callable bond?
a. Has a fixed interest rate
b. Can be redeemed before maturity
c. Offers a put option to the investor
d. Has no predetermined call price

Question - 32 :
What feature distinguishes puttable bonds?
a. The right to sell the bond back to the company
b. A fixed interest rate
c. No predetermined call price
d. Callable option for the issuer

Question - 33 :
What risk is associated with Foreign Currency Convertible Bonds (FCCB)?
a. High-interest rates
b. Currency fluctuation risk
c. Low-cost foreign currency
d. No risk involved

Question - 34 :
What is a characteristic of Plain Vanilla Bonds?
a. Low-interest rates
b. Multiple options for the bondholder
c. Principal amount repayment with interest
d. Only issued as coupon-bearing bonds

Question - 35 :
What protection does a Convertible Floating Rate Note (FRN) offer against falling interest rates?
a. Fixed interest rate
b. Option to convert into a longer-term debt security
c. Higher coupon rate
d. Capital gain applicable to FRN

Question - 36 :
What triggers the conversion of a Drop Lock Bond into a fixed-rate bond?
a. Increase in interest rates
b. Falling interest rates
c. Maturity date arrival
d. Falling interest rates upto predetermined level of interest rate

Question - 37 :
What is the primary mechanism of American Depository Receipts (ADRs)?
a. Raising capital in dollars or Euros
b. Offering privacy to investors
c. Listing on foreign stock exchanges
d. Each ADR represents a specific number of regular shares

Question - 38 :
How does a Yield Curve Note (YCN) respond to prevailing interest rates?
a. Yield increases with declining interest rates
b. Yield remains constant
c. Inverse floater mechanism
d. Yield decreases with declining interest rates

Question - 39 :
In which country's currency are Euro Bonds denominated?
a. The country of the issuer
b. The Eurozone

c. Any country except the issuer's
d. The country where it is traded

Question - 40 :
What is the unique feature of Masala Bonds?
a. Denominated in foreign currency
b. Sold only in India
c. Denominated in Indian Rupees
d. Exclusively issued by the government

Question - 41 :
What purpose do Municipal Bonds serve in India?
a. Financing national projects
b. Raising capital for private companies
c. Financing infrastructure
d. Supporting agricultural development

Question - 42 :
Which entities can issue Government or Treasury Bonds in India?
a. Only the Reserve Bank of India
b. Only state governments
c. Any government department
d. Any government entity including the Reserve Bank of India

Question - 43 :
When was Industrial Finance Corporation of India (IFCI) established?
a. 1918
b. 1951
c. 1954
d. 1964

Question - 44 :
What happened to Industrial Development Bank of India (IDBI)?
a. Converted into a public company
b. Converted into a bank
c. Converted into a public bank
d. Privatized and converted into a bank

Question - 45 :
Which financial institution was converted into a bank and privatized?
a. State Financial Corporations (SFCs)
b. National Industrial Development Corporation (NIDC)
c. Industrial Credit and Investment Corporation of India (ICICI)
d. Industrial Reconstruction Bank of India (IRBI)

Question - 46 :
What is the primary role of commercial banks in long-term financing?
a. Catering exclusively to short-term industry requirements
b. Providing long-term loans
c. Offering Working Capital Term Loans (WCTL) for seasonal needs
d. Bridging the gap in short-term financing

Question - 47 :
What is the purpose of Bridge Finance provided by commercial banks?
a. Funding long-term working capital needs
b. Facilitating project initiation while waiting for disbursement from financial institutions
c. Securing movable assets for long-term loans
d. Offering higher interest rates than term loans

Question - 48 :
Why are bridge loans generally secured by movable assets?
a. To reduce the risk for the commercial banks
b. To make them more attractive to borrowers
c. To ensure repayment from term loans
d. To comply with regulatory requirements

Question - 49 :
What is the view of venture capital financing regarding the investment in new companies?
a. It avoids investing in new companies
b. It predominantly provides debt financing to new companies
c. It offers equity finance for new companies
d. It focuses solely on short-term ventures

Question - 50 :
How is venture capital financing different from traditional financing options?
a. It involves only equity financing
b. It provides no support beyond funds
c. It primarily invests in well-established companies
d. It offers comprehensive support beyond funds

Question - 51 :
What is the purpose of Conditional Loan in venture capital financing?
a. Repayable with interest after generating sales
b. Non-cancellable by either party
c. Repaid as a royalty with no interest payment
d. Provides an option for exit

Question - 52 :
What role does the Special Purpose Vehicle (SPV) play in debt securitisation?
a. Facilitates the purchase of assets by the finance company
b. Acts as a mediator between the finance company and investors
c. Pays the finance company for the sold assets and pools them into marketable securities
d. Ensures debtors are aware of the securitisation process

Question - 53 :
How does debt securitisation benefit investors in the context of car loans?
a. Investors receive a diversified pool of car loans with no liquidity advantage
b. Investments become illiquid due to the securitisation process
c. Investors receive liquid investment in a diversified pool of car loans
d. It does not impact the liquidity of car loans

Question - 54 :
What is leasing?
a. A financial arrangement with a bank for long-term funding
b. A contract between asset owners and financial institutions
c. A contractual arrangement between the asset owner and the user over a defined period
d. A method to purchase assets with borrowed money

Question - 55 :
In financial leasing, who bears the risk of obsolescence?
a. The lessee
b. The lessor
c. Shared by both parties
d. Government regulatory bodies

Question - 56 :
What is the primary advantage of a Sales and Lease Back arrangement?
a. The asset physically exchanges hands

b. Lessee ensures asset quality
c. No record-keeping involved
d. Lower lease rentals for the buyer

Question - 57 :
In a Leveraged Lease, who borrows a part of the asset purchase cost from a third party?
a. Lessor
b. Lessee
c. Buyer
d. Seller

Question - 58 :
What is the key feature of a Sales-Aid Lease?
a. Manufacturer solely markets its products
b. Lessor earns only from the lessee
c. Lessor partners with a manufacturer to market the manufacturer's product
d. No income sources for the lessor

Question - 59 :
How does a Close-ended Lease differ from an Open-ended Lease?
a. In an open-ended lease, assets transfer to the lessor at lease end
b. Open-ended lease involves lower risk for the lessor
c. Close-ended lease gives the lessee the option to purchase the asset at the lease end
d. Open-ended lease has higher risk due to potential obsolescence

Question - 60 :
What is the duration of Trade Credit typically?
a. 1 to 5 years
b. 90 to 180 days
c. 15 to 90 days
d. More than 5 years

Question - 61 :
How are Euro Convertible Bonds structured?
a. No conversion option
b. Interest paid during the lock-in period
c. Convertible into a predetermined number of equity shares
d. Fixed interest rate with call or put options

Question - 62 :
What is the primary nature of Short-Term Loans provided by banks?
a. Disbursed in installments
b. Secured by long-term assets
c. Repayable only on demand
d. Entire advance disbursed at once

Question - 63 :
What security does Cash Credit typically rely on?
a. Shares
b. Government securities
c. Personal security
d. Tradables goods

Question - 64 :
In Pre-Shipment Finance, what is Clean Packing Credit based on?
a. Control over raw material or finished goods
b. Submission of stock statements
c. Irrevocable letters of credit
d. Hypothecation of goods

Question - 65 :
What does Post-shipment Finance support exporters after?
a. Shipment of goods
b. Receiving export orders
c. Manufacturing goods
d. Packing goods

Question - 66 :
What is the primary purpose of Social Bonds?
a. Financing "green projects"
b. Financing socially impactful projects
c. Achieving Key Performance Indicators (KPIs)
d. Reducing carbon emissions

Question - 67 :
What type of advance is provided against export bills sent through banks for collection?
a. Clean packing credit
b. E.C.G.C. guarantee
c. Purchase/discounting of documentary export bills
d. Advance against duty drawbacks

Question - 68 :
What do Environmental, Social, and Governance-linked bonds (ESG) focus on?
a. Maximizing profits
b. Prioritizing environmental, social, and governance factors
c. Reducing carbon emissions
d. Providing high-interest payouts

Question - 69 :
What is the main characteristic of Clean Overdrafts?
a. Requires extensive scrutiny
b. Relies on personal security and guarantees
c. Granted based on the financial soundness of the borrower
d. Repayable only on demand

Question - 70 :
What does a Leveraged Lease involve besides the lessor and lessee?
a. Manufacturer
b. Central Government
c. Financial institution
d. Export Credit Guarantee Corporation

Question - 71 :
What is the primary purpose of Seed Capital Assistance by IDBI?
a. Financing large corporations
b. Supporting startups
c. Providing long-term loans
d. Facilitating foreign trade

Question - 72 :
When is Deferred Payment Guarantee advisable?
a. For startups with a moratorium period
b. For profit-making companies with no moratorium period
c. For companies seeking short-term loans
d. For existing companies with deferred payments

Question - 73 :
What is the key characteristic of Deep Discount Bonds?

a. High-interest rates
b. Interest paid during the lock-in period
c. Face value paid on maturity
d. Compulsory conversion

Question - 74 :
How do Zero Coupon Bonds differ from other bonds?
a. They carry no interest
b. They have a floating interest rate
c. Interest is paid periodically
d. Interest rate is adjusted for inflation

Question - 75 :
What is the primary advantage of Zero Interest Fully Convertible Debentures?
a. Compulsory and automatic conversion
b. High-interest payouts
c. Low conversion flexibility
d. No conversion option

Question - 76 :
What type of bonds are Euro Convertible Zero Bonds?
a. Zero Coupon Bonds
b. Foreign Bonds
c. Euro Bonds
d. Fully Hedged Bonds

Question - 77 :
How are Secured Premium Notes redeemed?
a. After a specified period
b. Compulsory and automatic conversion
c. Interest paid during the lock-in period
d. Through foreign currency options

Question - 78:
What is the purpose of Inflation Bonds?
a. Eliminate currency fluctuation risk
b. Adjust interest rates for inflation
c. Provide interest free from the effects of inflation
d. Hedge against interest rate volatility

Question - 79 :
What is the key feature of Euro Commercial Papers (ECP)?
a. Long-term maturity
b. Denominated in multiple currencies
c. Usually designated in US Dollars
d. Convertible into equity

Question - 80 :
How are Foreign Currency Futures different from Foreign Currency Options?
a. Both provide the right to buy or sell foreign currency
b. Futures involve an obligation, while options provide a right
c. Options involve an obligation, while futures provide a right
d. Both involve compulsory conversion

Solution Key:

Q1	Q2	Q3	Q4	Q5	Q6	Q7	Q8	Q9	Q10
b	c	a	c	a	b	c	b	a	a

Q11	Q12	Q13	Q14	Q15	Q16	Q17	Q18	Q19	Q20
c	d	b	c	c	b	b	b	c	c
Q21	Q22	Q23	Q24	Q25	Q26	Q27	Q28	Q29	Q30
b	d	b	b	c	c	b	b	d	c
Q31	Q32	Q33	Q34	Q35	Q36	Q37	Q38	Q39	Q40
b	a	b	c	b	d	d	a	c	c
Q41	Q42	Q43	Q44	Q45	Q46	Q47	Q48	Q49	Q50
c	d	a	b	c	b	b	a	c	d
Q51	Q52	Q53	Q54	Q55	Q56	Q57	Q58	Q59	Q60
c	c	c	c	a	b	a	c	c	c
Q61	Q62	Q63	Q64	Q65	Q66	Q67	Q68	Q69	Q70
c	d	c	c	a	b	c	b	b	c
Q71	Q72	Q73	Q74	Q75	Q76	Q77	Q78	Q79	Q80
b	b	c	a	a	a	a	c	c	b

Description:

1. Long-term financial needs include funds required for periods exceeding 5-10 years, covering investments in plant, machinery, land, buildings, and permanent working capital.
2. Short-term financial needs involve funds required for current assets like stock, debtors, and cash, typically for a short period not exceeding one year.
4. Trade credit is considered a short-term financial source.

6. Investments through Global Depository Receipts (GDRs) are treated as Foreign Direct Investment (FDI).
7. Issuing new equity shares reduces earnings per share for existing shareholders unless profits increase proportionately.

9. Issuing preference shares avoids dilution in Earnings Per Share (EPS), preserving market perception compared to equity shares.
10. Leverage advantage with a fixed charge is associated with preference shares.
11. Cumulative convertible preference shares (CCPs) allow cumulative dividends for a specified period before converting into equity.
12. Preference dividends are not tax-deductible, making them costlier compared to debt instruments like debentures.
13. Cumulative nature of preference dividends may lead to accumulated payments if not made in a particular year, impacting ordinary shareholders and the company's reputation.
14. The classification of financial sources based on maturity includes long-term, medium-term, and short-term.
15. The primary purpose of short-term financial needs is to meet the working capital requirements for a short period, typically not exceeding one year.
16. Retained earnings are accumulated company profits reinvested back into the business.
17. Retained earnings belong to ordinary shareholders, contributing to the company's net worth.
18. Public limited companies must retain a reasonable amount of profit annually to meet legal requirements and support expansion plans.
19. Retained earnings entail minimal risk for the company.
20. The retention of profits preserves the control of present owners without dilution.
21. The decision to plough back depends on the rate of return generated by the company compared to the expected cost of equity.
22. The dividend decision is linked to retained earnings and is further discussed in the dividend decision chapter.
23. Debentures are issued in various denominations with different interest rates.
24. A debenture trust deed outlines terms and conditions for debenture issuance.
25. Debentures are attractive to investors as interest is payable regardless of company profits.
26. Fully convertible debentures convert into equity shares as per specified terms, offering a lower interest rate.
27. Debenture financing is advantageous in rising prices; fixed interest outgo decreases in real terms.
28. Large cash outflow is required at the maturity of debentures.
29. A disadvantage of debenture financing may be restrictive covenants.

30. Public debenture issues and private placements require credit rating by agencies like CRISIL, evaluating various factors.
31. Callable bonds have a call option allowing the issuer to redeem the bond before maturity at a predetermined price.
32. Puttable bonds give the investor the right to sell the bond back to the company before maturity.
33. FCCBs come at a low rate but pose a risk if redemption is required when the issuer may not have the money due to currency fluctuations.
34. Plain Vanilla Bonds involve the payment of the principal amount along with the interest rate and do not have additional options.
35. Convertible FRNs protect against falling interest rates by offering an option to convert into a longer-term debt security.
36. Drop Lock Bonds automatically convert into fixed-rate bonds if interest rates fall below a predetermined level.
37. American Depository Receipts (ADRs) are securities offered by non-US companies for listing on US exchanges, and each ADR represents a specific number of regular shares.
38. YCNs respond to prevailing interest rates by increasing yield when interest rates decline.
39. Euro Bonds are issued or traded in a country using a currency other than the one in which the bond is denominated.
40. Masala Bonds are Rupee-denominated bonds that Indian corporate borrowers sell to investors in overseas markets.
41. Municipal Bonds in India are used to finance urban infrastructure projects.
42. Government or Treasury Bonds in India can be issued by any government entity, including the Reserve +Bank of India.
43. IFCI was established in 1918.
44. IDBI was converted into a bank.
45. ICICI was converted into a bank and privatized.
46. Commercial banks primarily cater to short-term industry requirements but are increasingly involved in providing long-term loans for expansion.
47. Bridge Finance from commercial banks is designed to bridge the gap before disbursement of loans sanctioned by financial institutions.
48. Bridge loans are normally secured by movable assets, personal guarantees, and demand promissory notes to reduce the risk for commercial banks.
49. Venture capital financing predominantly involves equity finance for new companies.
50. Venture capital financing goes beyond funds, offering sales strategy, business networking, and management expertise.
51. Conditional Loan in venture capital financing is repayable as a royalty after generating sales, with no interest payment.
52. The SPV in debt securitisation pays the finance company for the sold assets and pools them into marketable securities.
53. Debt securitisation benefits investors by providing a liquid investment in a diversified pool of car loans.
54. Leasing is defined as a contractual arrangement between the asset owner (lessor) and the user (lessee) over a defined period.
55. In financial leasing, the lessee bears the risk of obsolescence.
56. The advantage of a Sales and Lease Back arrangement is that the lessee ensures the quality of the asset and converts the sale into a lease after possession.
57. In a Leveraged Lease, the lessor borrows part of the asset purchase cost from a third party.
58. In a Sales-Aid Lease, the lessor partners with a manufacturer to market the manufacturer's product and earns from both the lessee and the manufacturer.
59. In a Close-ended Lease, assets transfer to the lessor at the lease end, while in an Open-ended Lease, the lessee has the option to purchase the asset at the lease end.
60. Trade Credit typically has a duration of 15 to 90 days.
61. Euro Convertible Bonds allow holders to convert bonds into a predetermined number of equity shares.
62. Short-Term Loans provided by banks have the nature of the entire advance being disbursed at once.
63. Cash Credits typically rely on personal security and may require guarantees.
64. In Pre-Shipment Finance, Clean Packing Credit is based on firm export orders or irrevocable letters of credit.
65. Post-shipment Finance supports exporters after the shipment of goods.
66. Social Bonds are designed to finance socially impactful projects addressing concerns like human rights, equality, and animal welfare.

67. Advances against export bills sent through banks for collection involve the purchase/discounting of documentary export bills.
68. Environmental, Social, and Governance-linked bonds (ESG) focus on issuer commitments to prioritize environmental, social, and governance factors.
69. Clean Overdrafts rely on personal security and may require guarantees.
70. In a Leveraged Lease, besides the lessor and lessee, it involves a third party (lender), which is usually a financial institution.
71. Seed Capital Assistance by IDBI aims to support entrepreneurs lacking financial resources, especially qualified entrepreneurs or those with relevant experience.
72. Deferred Payment Guarantee is advisable for existing profit-making companies, and there is no moratorium period.
73. Deep Discount Bonds are zero-interest bonds sold at a discounted value, and the face value is paid on maturity.
74. Zero Coupon Bonds do not carry any interest and are issued at a discount, with the difference representing the investor's interest.
75. Zero Interest Fully Convertible Debentures involve compulsory and automatic conversion, offering benefits if the market share price is high.
76. Euro Convertible Zero Bonds are structured as a convertible bond, similar to zero coupon bonds, with no interest payable and conversion at maturity.
77. Secured Premium Notes are redeemable after a specified period, and the detachable warrant converts into equity shares within a notified time frame.
78. Inflation Bonds provide interest adjusted for inflation, protecting investors from the effects of inflation.
79. Euro Commercial Papers (ECP) are short-term money market instruments usually designated in US Dollars.
80. Foreign Currency Futures involve an obligation to buy or sell specified foreign currency, while Foreign Currency Options provide the right but not the obligation.

ICAI MCQs

Question - 1 :
Current Ratio is 2.5:1 and Liquid Ratio is 1.5:1. If inventory is ₹ 9,60,000, then the amount of current assets will be:
a. ₹ 9.6 Lakh
b. ₹ 14.40 Lakh
c. ₹ 24 Lakh
d. ₹ 38.40 Lakh

Question - 2 :
Observing changes in the financial variables across the years is
a. Vertical analysis
b. Horizontal Analysis
c. Peer-firm Analysis
d. Industry Analysis

Question - 3 :
Which of the following is a liquidity ratio
a. Equity ratio
b. Proprietary ratio
c. Net Working Capital
d. Capital Gearing ratio

Question - 4 :
Which of the following is not a part of Quick Assets
a. Disposable investments
b. Receivables
c. Cash and Cash equivalents
d. Prepaid expenses

Question - 5 :
Ratio of net profit before interest and tax to sales is
a. Gross profit ratio
b. Net profit ratio
c. Operating profit ratio
d. Interest coverage ratio

Question - 6 :
A company has average accounts receivable of ₹ 10,00,000 and annual credit sales of ₹ 60,00,000. Its average collection period would be
a. 60.83 days
b. 6.00 days
c. 1.67 days
d. 0.67 days

Question - 7 :
If Gross Profit=54000, GP Ratio=20%, Average collection period is 18 days (360 Days year), then find out Average Debtors considering that credit sales are 80% of total sales?
a. 13500
b. 10800
c. 12000
d. 14000

Question - 8 :
Capital Gearing ratio is the fraction of
a. Preference Share Capital and Debentures to Equity Share Capital and Reserve & Surplus.

b. Equity Share Capital and Reserve & Surplus to Preference Share Capital and Debentures.
c. Equity Share Capital to Total Assets.
d. Total Assets to Equity Share Capital

Question - 9 :
From the following information, calculate P/E ratio:

Equity share capital of ₹ 10 each	₹ 8,00,000
9% Preference share capital of ₹ 10 each	₹ 3,00,000
Profit (after 35% tax)	₹ 2,67,000
Depreciation	₹ 67,000
Market price of equity share	₹ 48

a. 15 times
b. 16 times
c. 17 times
d. 18 times

Question - 10 :
Inventory ratio is a relationship between ______.
a. Cost of goods purchased and cost of average inventory
b. Cost of goods sold and cost of average inventory, and cost of goods purchased and cost of average inventory
c. Cost of goods sold and cost of average inventory
d. None of the options is correct

Question - 11 :
The Receivable-Turnover ratio helps management to
a. Managing resources
b. Managing inventory
c. Managing customer relationship
d. Managing working capital

Question - 12 :
Total sales=3000000, Cash sales 25% of credit sales, Debtors Turnover is 8 times then what are the average debtors?
a. 2400000
b. 300000
c. 600000
d. 900000

Question - 13 :
Which of the following is not true about ratio analysis?
a. It is affected by price level changes.
b. It is difficult to evolve a standard ratio.
c. It can give false and misleading results.
d. It is not useful in inter-firm and intra firm comparison.

Question - 14 :
If the Working capital of the company is ₹1,35,000, Current ratio=2.5, Liquid ratio=1.5, reserve & surplus is=₹90,000 then what are the Quick assets of the company?
a. 90,000
b. 1,35,000
c. 1,45,000
d. 60,000

Question - 15 :
Given data:- Gross Profit= ₹60,000, GP Ratio=20%, Stock Velocity=6 times then find out what is average stock ?
a. 40,000
b. 300,000

c. 240,000
d. 37,500

Question - 16 :
Long-term solvency is indicated by
a. Debt/equity ratio
b. Current Ratio
c. Operating ratio
d. Net profit ratio

Question - 17 :
The __________ is useful in evaluating credit and collection policies.
a. Average payment period
b. Current ratio
c. Average collection period
d. Inventory turnover ratio

Question - 18 :
Calculate operating expenses from the information given below

Sales	₹ 75,00,000
Rate of income tax	50%
Net profit to sales	5%
Cost of goods sold	₹ 32,90,000
Interest on debentures	₹ 60,000

a. ₹ 41,00,000
b. ₹ 8,10,000
c. ₹ 34,00,000
d. ₹ 33,90,000

Solution Key:

Q1	Q2	Q3	Q4	Q5	Q6	Q7	Q8	Q9	Q10
c	b	c	d	c	a	b	a	b	c
Q11	Q12	Q13	Q14	Q15	Q16	Q17	Q18		
d	b	d	b	a	a	c	c		

Description:
1. CurrentRatio=CurrentAssets/CurrentLiab.
2.5=X/Y
2.5y=x
LiquidRatio=CurrentAssets-Stock/CurrentLiab.
1.5=2.5y-960000/y
1.5y=2.5y-9,60,000
y=9,60,000
x = 9,60,000 × 2.5 = 24,00,000
7. Sales = GP/20%=54000/20%=270000 2. Credit Sales=80% of 270000=216000 3. Average Collection Period=Avg. Debtors/Net Credit Sales*360 Or 18=Avg. Debtors/216000*360 or Avg. Debtors=10800.
12.1. Let Credit Sales= X 2.Cash Sales= .025x 3.Total Sales= Credit Sales + Cash Sales = 3000000=X + .25x = 3000000= 1.25x = X = 2400000(Credit Sales) hence, 0.25x=0.25*2400000=600000(Cash Sales), 4.Debtors T/O Ratio= Net Credit Sales/Avg. Debtors =8=2400000/Avg. debtors hence, Avg. Debtors=300000
13. The importance of ratio analysis is to evaluate the performance and also the growth of inter-firm and intra-firm comparisons. On the basis of ratio analysis, we can compare two companies' growth.
14. 1.Let Current Liability=X,CurrentAssets=2.5x,
2.WorkingCapital=CurrentAssets-CurrentLiabilities=135000=2.5x-x
Or 135000=1.5x or x=90000(CurrentLiability) hence,2.5x=2.5*90000=225000(CurrentAssets)
3.QuickRatio=QuickAssets/CurrentLiabilities
Or 1.5=QuickAssets/90000
Or Q.A.=135000

15. 1. Sales=GP/20%=60000/20%=300000
2. COGS=Sales-GP=300000-60000=240000
3. Stock velocity/Stock turnover ratio=COGS/Avg. Stock
6=240000/Avg. Stock
Avg. Stock=40000
17. The average collection period is used as an accounting measure to symbolise the avg. No. of days among a credit score sale date and the date whilst the customer remits payment. An entity's average collection period indicates the effectiveness of its Accounts Receivable (or Trade Receivables) Management.

CASE BASED MCQs

CASE 1
Equity shares 80,000 @ 10 each ₹ 8,00,000 & 9% Preference shares of ₹ 3,00,000, Profit (after tax at 35 per cent), ₹ 2,70,000; Depreciation, ₹ 60,000; Equity dividend paid, 20 per cent; Market price of equity shares, ₹ 40.

Question - 1 :
What is the dividend yield on the equity shares?
a) 2.5%
b) 5%
c) 7.5%
d) 10%

Question - 2 :
What is the dividend coverage ratio for preference shares?
a) 5 times
b) 10 times
c) 15 times
d) 20 times

Question - 3 :
What is the equity dividend coverage ratio?
a) 0.75 times
b) 1.25 times
c) 1.52 times
d) 2.5 times

Question - 4 :
What is the earnings per equity share?
a) ₹2.00 per share
b) ₹2.50 per share
c) ₹3.04 per share
d) ₹3.50 per share

Question - 5 :
Find the Price-Earnings (P/E) ratio based on the given data.
a) 8.5 times
b) 10 times
c) 13.2 times
d) 15 times

CASE 2
From the following information, prepare a summarised Balance sheet as at 31st March 2002:
(Note- use quick ratio = quick assets / quick liabilities), where quick liability = CL - Bank overdraft

Working Capital	₹ 2,40,000
Bank overdraft	₹ 40,000
Fixed Assets to Proprietary Ratio	0.75
Reserves and Surplus	₹ 1,60,000

Current ratio Liquid Ratio	2.5 1.5

Question - 6 :
What was the total amount of Current Liabilities as of 31st March 2002?
a) ₹ 1,20,000
b) ₹ 1,60,000
c) ₹ 2,40,000
d) ₹ 4,00,000

Question - 7 :
What was the amount of Quick Assets as of 31st March 2002?
a) ₹ 1,20,000
b) ₹ 1,60,000
c) ₹ 1,80,000
d) ₹ 2,20,000

Question - 8 :
What was the amount of Stock as of 31st March 2002?
a) ₹ 1,40,000
b) ₹ 1,80,000
c) ₹ 2,20,000
d) ₹ 2,40,000

Question - 9 :
What was the Proprietary Fund as of 31st March 2002?
a) ₹ 6,40,000
b) ₹ 8,00,000
c) ₹ 9,60,000
d) ₹ 11,20,000

Question - 10 :
What was the total amount of Fixed Assets as of 31st March 2002?
a) ₹ 6,40,000
b) ₹ 7,20,000
c) ₹ 8,00,000
d) ₹ 9,60,000

Q1	Q2	Q3	Q4	Q5	Q6	Q7	Q8	Q9	Q10
b	b	c	c	c	b	c	c	c	b

Explanation to case studies -
CASE 1

(a) **Dividend Yield on the Equity Shares** = $\frac{Dividend\ per\ Share}{Market\ Price\ per\ Share} \times 100 = \frac{₹2\ (0.20 \times ₹10)}{₹40} \times 100 = 5\%$

(b) **Dividend Coverage Ratio**

(i) Preference = $\frac{Profit\ after\ Taxes}{Dividend\ Payable\ to\ Prefernce\ Shareholders} = \frac{₹2,70,000}{₹27,000\ (0.09 \times ₹3,00,000)}$ = 10 times

(ii) EquityCoverage Ratio = $\frac{Profit\ after\ Taxes - Preference\ Share\ Dividend}{Dividend\ Payable\ to\ Equity\ Shareholders\ at\ Current\ rate\ of\ ₹2\ per\ share}$ = $\frac{₹2,70,000 - ₹27,000}{₹1,60,000\ (80,000\ shares \times ₹2)}$ = 1.52 times

(c) **Earnings per equity share**= $\frac{Earnings\ available\ to\ Equity\ Shareholders}{Number\ of\ Equity\ Shares\ outstanding} = \frac{₹2,43,00}{80,000}$ = ₹ 3.04 per share

(d) **Price-earning (P/E) ratio**= $\frac{Market\ Price\ per\ Share}{Equity\ per\ Share} = \frac{₹40}{₹3.04}$ = 13.2 times

CASE 2

Balance Sheet

Liabilities	Amount (₹)	Assets	Amount (₹)
Capital	8,00,000	Fixed Assets	7,20,000
Reserves & Surplus	1,60,000	Stock	2,20,000
Bank Overdraft	40,000	Current Assets	1,80,000
Sundry Creditors	1,20,000		
	11,20,000		11,20,000

Working Notes

(1) **Current Ratio** = $\frac{Current\ Assets}{Current\ Liabilities}$

2.5 = $\frac{Current\ Assets}{Current\ Liabilities}$

2.5 = $\frac{Working\ Capital + Current\ Liabilities}{Current\ Liabilities}$

Current Liabilities = ₹ 1,60,000

(2) Working Capital = Current Assets – Current Liabilities

₹ 2,40,000 = Current Assets – ₹ 1,60,000

Current Assets = ₹ 4,00,000

(3) Quick Liabilities = Current Liabilities – Bank overdraft

= ₹ 1,60,000 – ₹ 40,000 = ₹ 1,20,000

(4) Quick Ratio = $\frac{Quick\ Assets}{Quick\ Liabilities}$

1.5 = $\frac{Quick\ Assets}{₹1,20,000}$

Quick Assets = ₹ 1,80,000

(5) Stock = Current Assets – Quick Assets

= ₹ 4,00,000 – ₹ 1,80,000 = ₹ 2,20,000

(6) $\frac{Fixed\ Assets}{Proprietary\ Fund}$ **= 0.75**

Fixed Assets = 0.75 Proprietary Fund

Working Capital = 0.25 Proprietary Fund

Proprietary Fund = $\frac{₹\ 2,40,000}{0.25}$

Proprietary Fund = ₹ 9,60,000

(7) Fixed Assets = 0.7 × ₹ 9,60,000 = ₹ 7,20,000.

Practice MCQs

Question - 1 :

What is the primary purpose of ratio analysis in financial statements?

a. Evaluate organisational growth

b. Assess overall financial health

c. Provide mathematical figures

d. Derive financial statements

Question - 2 :

Which of the following is a component of the DuPont model for calculating Return on Equity (ROE)?

a. Earnings per Share

b. Capital Turnover

c. Price Earnings Ratio

d. Dividend Payout Ratio

Question - 3 :
How is Return on Equity (ROE) calculated using the DuPont model?
a. Net Profit Margin multiplied by Dividend Payout Ratio
b. Equity Multiplier divided by Asset Turnover
c. Multiplication of Net Profit Margin, Asset Turnover, and Equity Multiplier
d. Division of Earnings per Share by Price Earnings Ratio

Question - 4 :
What is the objective of shareholders in financial analysis?
a. Ensure safety of lent money
b. Understand overall financial health
c. Assess liability position
d. Interested in profitability and organisational growth

Question - 5 :
What is the primary focus of vertical analysis in financial statement analysis?
a. Inter-firm comparison
b. Analysing trends and changes over time
c. Evaluating composition and structure of financial statements for a specific period
d. Internal assessment

Question - 6 :
What is the primary objective of lenders in financial analysis?
a. Assess overall financial health
b. Ensure safety of lent money
c. Understand liability position
d. Evaluate profitability

Question - 7 :
Which key ratios are of interest to creditors for assessing short-term liability position?
a. Profitability Ratios
b. Solvency Ratios
c. Liquidity Ratios
d. Turnover Ratios

Question - 8 :
What is the primary objective of employees in financial analysis?
a. Assess overall financial health
b. Understand liability position
c. Make sales predictions
d. Interested in profitability and organisational growth

Question - 9 :
What financial information is of interest to regulators/government in financial analysis?
a. Capital Structure Ratios
b. Turnover Ratios
c. Profitability Ratios
d. All Ratios

Question - 10 :
Which ratios are specifically relevant for production managers in financial analysis?
a. Liquidity Ratios
b. Turnover Ratios
c. Input-Output Ratio
d. Raw Material Consumption Ratio

Question - 11 :
In the telecom industry, which ratios are likely to be relevant?
a. Loan to Deposit Ratios

b. Room Occupancy Ratio
c. Revenue and Expenses per Customer
d. Passenger-Kilometre

Question - 12 :
For a hotel, which ratios are commonly used to assess performance?
a. Room Occupancy Ratio
b. Loan to Deposit Ratios
c. Operating Cost-per Passenger Kilometre
d. Earnings per Share

Question - 13 :
What does horizontal analysis in financial statement analysis compare?
a. Financial statements from different years
b. Financial statements of different firms
c. Profitability and liquidity ratios
d. Vertical analysis and horizontal analysis

Question - 14 :
What is the primary focus of vertical analysis on the Profit and Loss statement?
a. Expression of items as a percentage of total assets
b. Expression of items as a percentage of gross sales
c. Assessing long-term viability
d. Comparing profitability with industry averages

Question - 15 :
What does the DuPont system aim to reveal about a company's Return on Equity (ROE)?
a. Profitability only
b. Asset Turnover only
c. Sources of ROE through net profit margin, asset turnover, and equity multiplier
d. Liquidity position only

Question - 16 :
What is the primary objective of liquidity ratios in financial analysis?
a. Assess long-term financial viability
b. Evaluate management efficiency
c. Assess liquidity to meet obligations
d. Measure profitability

Question - 17 :
Which of the following ratios is used to evaluate long-term financial viability?
a. Liquidity Ratios
b. Activity Ratios
c. Leverage/Capital Structure Ratios
d. Profitability Ratios

Question - 18 :
What do operating efficiency ratios primarily assess?
a. Profitability
b. Asset utilisation efficiency
c. Long-term solvency
d. Liquidity

Question - 19 :
Why is inter-firm comparison important in financial analysis?
a. To hide financial weaknesses
b. To ensure uniform reporting standards
c. To compare with industry averages for corrective measures
d. To limit disclosure of financial information

Question - 20 :
What is the significance of predictive value in financial ratios?
a. Only analyses past operations
b. Serves as predictors for the future
c. Provides standardised interpretations
d. Focuses on industry averages

Solution Key:

Q1	Q2	Q3	Q4	Q5	Q6	Q7	Q8	Q9	Q10
b	b	c	d	c	b	c	a	c	c
Q11	Q12	Q13	Q14	Q15	Q16	Q17	Q18	Q19	Q20
c	a	a	b	c	c	c	b	c	b

Description:
1. Ratio analysis, through mathematical relationships between figures, aims to evaluate the overall financial health of an organization.
2. Capital Turnover is one of the components of the DuPont model for calculating Return on Equity (ROE).
3. ROE using the DuPont model is calculated by multiplying the three components: Net Profit Margin, Asset Turnover, and Equity Multiplier.
4. Shareholders are primarily interested in profitability and organizational growth.
5. Vertical analysis focuses on evaluating the composition and structure of financial statements for a specific period.
6. Lenders aim to ensure the safety of the money they lend.
7. Creditors are interested in Liquidity Ratios to assess short-term liability positions.
8. Employees are interested in assessing the overall financial health and making comparisons with competitors.
9. Regulators/government are primarily interested in Profitability Ratios for taxation and other government-related details.
10. Production managers are interested in ratios like Input-Output Ratio and Raw Material Consumption Ratio.
11. In the telecom industry, ratios related to revenue and expenses per customer are likely to be relevant.
12. For hotels, Room Occupancy Ratio is commonly used to assess performance.
13. Horizontal analysis compares financial statements from different years to analyze trends and changes over time.
14. Vertical analysis on the Profit and Loss statement expresses items as a percentage of gross sales.
15. The DuPont system aims to reveal the sources of a company's ROE through net profit margin, asset turnover, and equity multiplier.
16. Liquidity ratios, such as current ratio and quick ratio, are essential for assessing a firm's ability to meet short-term payment commitments.
17. Leverage/Capital Structure Ratios are used to evaluate long-term financial viability.
18. Operating efficiency ratios, or activity ratios, assess management and asset utilization efficiency.
19. Inter-firm comparison is important to identify variances and take corrective actions, often by comparing with industry averages.
20. Ratios not only analyze past operations but also serve as predictors for the future, aiding in forecasting and planning business activities.

ICAI MCQs

Question - 1 :
While issuing new equity shares, the cost of issue is known as
a) WACC
b) Cost of Equity
c) Cost of Debt
d) Floatation Cost

Question - 2 :
A company's debt equity ratio is 3:5. Pretax cost of debt and equity are 7% and 10% respectively. What is the weighted average cost of capital if the tax rate is 30%?
a) 12.21%
b) 17%
c) 14.9%
d) 8.09%

Question - 3 :
Increase in which of the following would not increase cost of equity calculated on the basis of capital asset pricing model?
a) Market Risk premium
b) Expected market rate of interest
c) Beta
d) Effective tax rate

Question - 4 :
Cost of Capital refers to
a) Floatation Costs
b) Dividend
c) Minimum Required Rate of Return
d) Opportunity cost

Question - 5 :
In order to find cost of equity under CAPM, which of these is not required
a) Risk free rate
b) Beta
c) Market Price of the Security
d) Market Rate of Return

Question - 6 :
Which of the following has an implicit cost of capital
a) Equity Shares
b) Preference Shares
c) Retained Earnings
d) Debentures

Question - 7 :
Cost of capital is lowest in case of debt because of
a) Tax Deductibility
b) Lower Stated rate
c) Time Value of Money
d) All of the above

Question - 8 :
Which of the following statement is false
a) Retained earnings do not involve any cost
b) Weighted average cost of capital is sum total of cost of debt and equity
c) Cost of equity is impacted by tax effects

d) All of the above

Question - 9 :
A company is considering a project with an initial cost of Rs.1 million. The project is expected to generate cash flows of Rs.500,000 per year for 5 years. The company's cost of capital is 12%. What is the project's net present value?
a) ₹ 8,02,388.00
b) ₹ 10,24,323.00
c) ₹ 10,93,515.00
d) ₹ 11,68,916.00

Question - 10 :
An organisation can affect its WACC through changing
a) Capital Structure
b) Dividend Policy
c) Investment Policy
d) All of these

Question - 11 :
With retention ratio of 60% and return on equity of 15.5%, the growth rate shall be
a) 14.90%
b) 9.30%
c) 25.84%
d) 16.10%

Question - 12 :
A company recently issued 9% preferred shares. The preferred shares sold for Rs. 40 a share with a par of Rs. 20. The cost of issuing the stock was Rs. 5 a share. What is the company's cost of preferred share
a) 9%
b) 4.5%
c) 5.1%
d) 10.3%

Question - 13 :
Capital Structure weights can be based on
a) Market Values of Debt & Equity
b) Market Value of Equity & Face value of Debt
c) Initial Issue Price of Debt & Equity
d) Book Value of Assets

Question - 14 :
A company's equity share is currently selling for 50 per share. Current year's dividend was Rs. 2 per share and the earnings of the company is expected to increase by 5%. What is the firm's cost of existing equity
a) 9.2%
b) 4.2%
c) 14%
d) 9%

Question - 15 :
Cost of capital is that minimum ___, which a firm must and is expected to earn on its ___ so as to maintain the market value of its shares
a) investments, rate of return
b) rate of return, investments
c) expenditure, rate of return
d) rate of return, expenditure

Question - 16 :
A company's equity share is currently selling for Rs. 50 per share. Current year's dividend was Rs. 2 per share and the earnings of the company is expected to increase by 5%. What is the firm's cost of existing equity

a) 9.2%
b) 4.2%
c) 14%
d) 9%

Question - 17 :
Interest on government bonds is also known as
a) Beta of the security
b) Market Rate of Return
c) Market Price of the Security
d) Risk Free Rate of Return

Question - 18 :
The cost of equity capital is all of the following except
a) The minimum rate that a firm should earn on the equity-financed part of an investment
b) A return on the equity-financed portion of an investment that, at worst, leaves the market price of the stock unchanged
c) By far, the most difficult component cost to estimate
d) Generally, lower than the before-tax cost of debt

Question - 19 :
Cost of capital is highest in case of
a) Debt
b) Equity
c) Loans
d) Bonds

Question - 20 :
Equity financing may be considered better than debt financing because of the fact that
a) Issuance cost of equity is lesser than that of debt
b) It is more attractive for investors because of potential for higher returns
c) Dividend is tax deductible
d) It is less expensive than debt

Solution key

Q1	Q2	Q3	Q4	Q5	Q6	Q7	Q8	Q9	Q10
d	d	d	c	c	c	a	d	a	d
Q11	Q12	Q13	Q14	Q15	Q16	Q17	Q18	Q19	Q20
b	c	a	a	b	a	d	d	b	b

Description
1. Issuing new equity shares entails certain costs like underwriting commission, brokerage costs etc. which are known as floatation costs.
2. Weighted average cost of capital is calculated by proportionally weighing each category of capital including debt, preferred stock and common stock. Cost of debt is calculated after tax, because of benefit of tax deduction on interest paid. The calculation for weighted average cost of capital (WACC) will be as follows: After tax cost of debt = 7 (1 - Tax rate) = 7 x (1 - 0.30) = 4.9% , Cost of equity = 10%. Thus, weighted average cost of capital (after assigning weights) = (4.9% x 3 / 8) + (10% x 5 / 8) = 8.09%.
3. Capital Asset pricing model considers the risk free rate of return, Market rate of return and Beta. Hence, any changes in tax rate would be irrelevant.
4. It is the expected rate of return by the providers of finance. Floatation costs are costs incurred while issuing the securities. Dividend is the part of earnings that gets distributed. Opportunity cost is the cost of next best alternative.

5. CAPM is used to calculate Cost of Equity using the formula Ke = RF + β (RM – RF) where in RF represents risk free rate, β represents beta i.e., systematic risk and RM represents market rate of return. Thus, the model doesn't use market price of security.
6. Other three sources of capital have explicit cost i.e. dividends in case of equity & preference shares and interest in case of debentures whereas in case of Retained Earnings, there is an implied expectation from equity shareholders that it will result in overall growth as it represents that part of earnings which is reinvested in business rather than being distributed as dividends.
7. As interest is a tax-deductible expense which results in reduction of tax liability, and it doesn't have any relation to time value of money or lower rate since any difference in stated interest rate and market rate results in discount or premium.
8. All of the above as Retained Earnings have implicit cost. Weighted Average cost of capital is total of weighted cost of individual components of cost of capital. Cost of Equity doesn't involve any tax benefits as dividend is not tax deductible.
10. As Cost of capital can be directly influenced by changing composition of capital structure or dividend policy and indirectly influenced by changing Investment policy.
11. Growth rate can be calculated using Gorden growth model using formula G = b X r where b represents earning retention ratio and r represents rate of return. Hence, G = 0.60 X 0.155 = 0.093 or 9.3%.
12. Cost of Preferred Share = Dividend/ Net Proceeds or Market Price, where Dividend = Rs. 20 x 9% = Rs. 1.8 and Net Proceeds = Rs. 40 - Rs. 5 = Rs. 35. Therefore, cost of Preferred Stock = 1.8/ 35 = 5.1%.
13. Calculation of weighted average cost of capital involves either using book value of debt & equity or market values of debt & equity. Other options are not relevant.
14. Cost of existing equity can be calculated by using Gordon's growth model with the following formula: Cost of existing equity = (Next expected dividend / Current stock price) + Expected growth in earnings. Next expected dividend = Current year's dividend + Expected increase in dividend = 2 + 5% (2) = 2.1. Thus, cost of existing equity = (2.1 / 50) + 5% = 9.2%.
15. As cost of capital is that minimum rate of return that the capital providers expect to earn on their investments.
16. Cost of existing equity can be calculated by using Gordon's growth model with the following formula: Cost of existing equity = (Next expected dividend / Current stock price) + Expected growth in earnings. Next expected dividend = Current year's dividend + Expected increase in dividend = 2 + 5% (2) = 2.1. Thus, cost of existing equity = (2.1 / 50) + 5% = 9.2%.
17. As government bonds are considered as the most secure means of investments as those are not impacted by market related factors as in case of other options. Beta represents systematic or non-diversifiable risk.
19. because of other 3 options debt, loans and bonds involve interest expense which is tax deductible and there is no tax benefit on dividends in case of equity. Further, in terms of expectations the equity shareholders expect higher returns as they take more risk.
20. Issuance cost of equity is more than that of debt because of floatation costs and neither the equity dividend is tax deductible. Thus, the only reason that the equity financing may be considered better than debt financing is it may be more attractive for investors because of potential for higher returns on the upside.

CASE BASED MCQs

CASE 1

Jason Limited is planning to raise additional finance of ₹ 20 lakhs for meeting its new project plans. It has ₹ 4,20,000 in the form of retained earnings available for investment purposes. Further details are as following:

Debt / Equity Mix	30 / 70
Cost of Debt	
Upto ₹ 3,60,000	8 % (before tax)
Beyond ₹ 3,60,000	12 % (before tax)
Earnings per share	₹ 4
Dividend pay-out	50% of earnings
Current Market Price per share	₹ 44
Expected Growth rate in Dividend	10 %
Tax	40%

Question - 1 :
What is the cost of equity for Jason Limited, calculated using the dividend growth model?
A) 10%

B) 12%
C) 15%
D) 18%

Question - 2 :
What is the post-tax cost of additional debt for Jason Limited?
A) 4.8%
B) 5.76%
C) 6.4%
D) 7.2%

Question - 3 :
How much additional finance will Jason Limited raise through equity in total?
A) ₹ 9,80,000
B) ₹ 14,00,000
C) ₹ 4,20,000
D) ₹ 6,00,000

Question - 4 :
What is the overall weighted average after-tax cost of additional finance for Jason Limited?
A) 11.23%
B) 12.23%
C) 13.23%
D) 14.23%

CASE 2
JAmrit Corporation has the following book value capital structure:

Equity Capital (50 lakh shares of ₹ 10 each).	₹ 5,00,00000
15% Preference share (50,000 shares ₹ 100 each)	₹ 50,00,000
Retained earnings	₹ 4,00,00,000
Debentures 14% (2,50,000 debentures ₹ 100 each)	₹ 2,50,00,000
Term loan 13%	₹ 4,00,00000

The companies last year earnings per share was ₹ 5, and it maintains a dividend pay-out ratio of 60% and returns on equity is 10%. The market price per share is ₹ 20.8. Preference share redeemable after 10 years is currently selling for ₹ 90 per share. Debentures redeemable after 6 years are currently selling for ₹ 75 per debenture. The income tax rate is 40%.

1. Calculate the Weighted Average Cost of Capital (WACC) using market value proportions.
2. Determine the Marginal Cost of Capital (MACC) if it needs ₹ 5,00,00000 next year assuming the amount will be raised by 60% equity, 20% debt and 20% retained earnings. Equity issues will fetch a net price of ₹ 14 and cost of debt will be 13% before tax up to ₹ 40,00,000 and beyond ₹ 40,00,000 it will be 15% before tax.

Question - 5 :
What is the Weighted Average Cost of Capital (WACC) for JAmrit Corporation using market value proportions?
A) 14.2%
B) 15.74%
C) 16.84%
D) 22.73%

Question - 6 :
What would be the original cost of equity?
A) 15%
B) 19%
C) 20%
D) 22%

Question - 7 :

What is the cost of preference shares for JAmrit Corporation?
A) 14.2%
B) 15.74%
C) 16.84%
D) 22.73%

Question - 8 :
If JAmrit Corporation's retained earnings increase to ₹ 6,00,00,000, what would be the impact on WACC?
A) Increase
B) Decrease
C) No change
D) Cannot be determined

Question - 9 :
What is the Marginal Cost of capital for JAmrit Corporation before tax?
A) 8.52%
B) 22.73%
C) 14.2%
D) 16.84%

Question - 10 :
If JAmrit Corporation decides to finance 80% of its capital requirement through equity, what would be the impact on MACC?
A) Increase
B) Decrease
C) No change
D) Cannot be determined

Q1	Q2	Q3	Q4	Q5	Q6	Q7	Q8	Q9	Q10
C	B	B	B	B	B	C	B	B	A

ICAI MCQs

Question - 1 :
The term "capital structure" means
a) Long-term debt, preferred stock, and equity shares
b) Current assets and current liabilities
c) Net working capital
d) Shareholder’s equity

Question - 2 :
Which one of the following approaches of the capital structure pleads that debt financing initially increases the value of the firm;however excess debt financing beyond a particular point reduces the value of the firm?
a) Net income approach
b) Net operating income approach
c) Traditional approach
d) M&M Approach

Question - 3 :
The cost of monitoring management is considered to be a (an)
a) Bankruptcy cost
b) Transaction cost
c) Agency cost
d) Institutional cost

Question - 4 :
If the debt component in the capital structure is predominant
a) The fixed interest cost of the firm will be minimum thereby decreasing its risk.
b) Earning per share (EPS)will be very low.
c) Dividend expectation of the equity shareholders are also & PE ratio may decrease.
d) The fixed interest cost of the firm increases thereby increasing its risk.

Question - 5 :
Which of the following steps may be adopted to avoid the negative consequences of over-capitalisation
a) The shares of the company should be split up. This will reduce dividend per share, though EPS shall remain unchanged
b) Issue of Bonus Shares
c) Revising upward the par value of shares in exchange of the existing shares held by them
d) Reduction in claims of debenture-holders and creditors

Question - 6 :
Statement 1: If our corporate tax rate increases from 25% to 30%, our weighted average cost of capital is likely to decline.
Statement 2: What is happening in the stock or bond markets is irrelevant to our decisions for how to raise capital. We should always seek to raise capital in the exact proportions called for by our optimal capital structure
Which of the Statements 1 and 2, correct or incorrect?
a) Correct, Correct
b) Incorrect, correct
c) Incorrect, Incorrect
d) Correct, Incorrect

Question - 7 :
Assertion(A)Risk principle of capital structure is one that minimize cost of capital structure.
Reason (R)According to this principle, reliance is placed more on equity for financial purpose.
a) Both A & R are true, and R is correct explanation of A
b) Both A & R are true, but R is not correct explanation of A
c) A is true, but R is false
d) A is false, but R is true

Question - 8 :
An EBIT-EPS indifference analysis chart is used for
a) Evaluating the effects of business risk on EPS
b) Examining EPS results for alternative financial plans at varying EBIT levels
c) Determining the impact of a change in sales on EBIT
d) Showing the changes in EPS quality over time

Question - 9 :
Mr. Dashan recently came back from a conference titled Capital Structure Theory and was extremely excited about what he learned concerning Modigliani and Miller's capital structure propositions. He has been trying to choose between three potential capital structures for his firm,Dashmart Corporation, and believes that Modigliani and Miller's work may guide him in the right direction. The capital structures considering are:
CSI: 100% equity.
CS II: 50% equity and 50% debt.
CS III: 100% debt.
If he uses Modigliani and Miller's propositions and includes all of their assumptions including the assumption of no taxes, which capital structure is he most likely to choose?
Which capital structure would be chosen in case of tax regime?
a) CS I and CS II
b) CS I and CS III
c) CS II and CS III
d) Any CS

Question - 10 :
Consider the below mentioned statements
1. A company is considered to be over-capitalised when its actual capitalisation is lower than the proper capitalisation as warranted by the earning capacity.
2. Both over-capitalisation and under-capitalisation are detrimental to the interests of the society.
State True or False:
a) 1-True, 2-True
b) 1-False, 2-True
c) 1-False, 2-False
d) 1-True, 2-False

Question - 11 :
Financial Structure refers to
a) All financial resources
b) Short-term funds
c) Long-term funds
d) None of these

Question - 12 :
The number of indifference points possible between 5 financial plans are
a) 5
b) 8
c) 3
d) 10

Question - 13 :
A firm's optimal capital structure
a) Is the debt-equity ratio that results in the minimum possible weighted average cost of capital
b) 40 percent debt and 60 percent equity
c) When the debt-equity ratio is 0.50
d) When Cost of equity is minimum.

Question - 14 :

Which of the following statements regarding Modigliani and Miller's propositions (assuming perfect capital markets and homogenous expectations) is most accurate?

a) Firm value is maximized with a capital structure consisting of 100% equity.
b) The cost of equity increases as the firm increases its financial leverage
c) The use of debt financing increases the firm's weighted average cost of capital
d) None of the above

Question - 15 :
A critical assumption of the Net Operating Income (NOI) approach to valuation is
a) That debt and equity levels remain unchanged
b) That dividends increase at a constant rate
c) That ko remains constant regardless of changes in leverage
d) That interest expense and taxes are included in the calculation

Question - 16 :
The assumptions of MM hypothesis of capital structure do not include the following
a) Capital markets are imperfect
b) Investors have homogeneous expectations
c) All firms can be classified into homogeneous risk classes
d) The dividend-payout ratio is cent percent, and there is no corporate tax

Question - 17 :
To have optimal capital structure the firm must have fulfill the following condition -
a) Return on investment should be greater than cost of investment.
b) There should be minimum financial risk.
c) Cost of investment should be less than return of investment.
d) All the above.

Question - 18 :
Ram Verse Ltd is an all equity financed company. It is considering replacing Rs. 275 lakhs equity shares with 15% debentures of the same amount. Current Market value of the company is 1750 lakhs with cost of capital at 20%. Future EBITs are going to be constant and entire earnings are going to be distributed. Corporate Tax Rate can be assumed to be 30%. What will be the new market value of the firm?
a) Rs.1832.5 lakhs
b) Rs.82.50 lakhs
c) Rs.1750 lakhs
d) Rs.1732.50 lakhs

Solution key

Q1	Q2	Q3	Q4	Q5	Q6	Q7	Q8	Q9	Q10
1	3	3	4	4	4	4	2	4	2
Q11	Q12	Q13	Q14	Q15	Q16	Q17	Q18		
1	4	1	2	3	1	4	1		

Description

2. Traditional approach strikes a balance between equity and debt financing by considering the adverse effects of excessive debt in the form of increase in Ke due to higher level of risk faced by equity shareholders.
4. Higher proportion of debt in capital leads to higher load of interest cost which is fixed in nature and adds to the risk of the organisation.
6. If corporate tax rates go up, kd will fall, leading to fall in overall cost of capital. The events in bond and equity markets play a pivotal role in understanding the expectations of the investors and thereby key to calculation of cost of capital.

7. According to risk principal reliance is placed more on common equity for financing capital requirement than excessive use of debt. With the increase in debt, financial risk would also increase leading to erosion in shareholders wealth.
9. Modigliani and Miller's original study was based on the assumption of perfect markets with no taxes and no costs of financial distress. Their conclusion was that under such assumptions, capital structure has no impact on firm value. MM Proposition with taxes concludes that the optimal capital structure is 100% debt. This is because the tax deductibility of interest payments provides a tax shield that adds value to the firm, and the value of the tax shield is maximized with 100% debt.
12. MM's Proposition I (No Taxes) states that the cost of equity increases linearly as a company increases its proportion of debt financing. Because debt is cheaper than equity, the net result is a zero change in the firm's WACC. The other statements are incorrect. Under MM's Proposition I (No Taxes), capital structure is irrelevant because value is based on operating cash flows. Note that we are not told whether to assume a world with taxation or without. The most appropriate answer choice is one that applies to either scenario.
14. MM's Proposition I (No Taxes) states that the cost of equity increases linearly as a company increases its proportion of debt financing. Because debt is cheaper than equity, the net result is a zero change in the firm's WACC. The other statements are incorrect. Under MM's Proposition I (No Taxes), capital structure is irrelevant because value is based on operating cash flows. Note that we are not told whether to assume a world with taxation or without. The most appropriate answer choice is one that applies to either scenario.
17. All three correct options are pre-requisites for optimal capital structure.
18. Value (L)= Value (UL)+ Debt x t =1750+275 x 30%=1832.5

CASE BASED MCQs

Case 1

Current Capital Structure of XYZ Ltd is as follows:
Equity Share Capital of 7 lakh shares of face value ₹ 20 each Reserves of ₹ 10,00,000
9% bonds of ₹ 3,00,00,000
11% preference capital: 3,00,000 shares of face value ₹ 50 each Additional Funds required for XYZ Ltd are ₹ 5,00,00,000.
XYZ Ltd is evaluating the following alternatives:

1. **Proposed alternative I:** Raise the funds via 25% equity capital and 75% debt at 10%. PE ratio in such scenario would be 12.
2. **Proposed alternative II:** Raise the funds via 50% equity capital and rest from 12% Preference capital .PE ratio in such scenario would be 11.

Any new equity capital would be issued at a face value of ₹ 20 each. Any new preferential capital would be issued at a face value of ₹ 20 each. Tax rate is 34%
Determine the indifference point under both the alternatives.

Question 1
What is the indifference point?
A) ₹72,63,636.36
B) ₹82,63,636.36
C) ₹62,63,636.36
D) ₹92,63,636.36
Explanation: The indifference point is the point where the earnings per share (EPS) is the same regardless of the proposal chosen. In Proposal I and II, the calculation leads to an EPS equation equating two different expressions. Solving this equation gives the indifference point, which is ₹72,63,636.36.
Therefore, **option A) is correct.**

Question 2
What is the total amount of capital to be raised in Proposal II?
A) ₹5,00,00,000
B) ₹4,00,00,000
C) ₹3,50,00,000
D) ₹4,50,00,000
Explanation: In Proposal II, 50% of the required funds are to be raised through equity capital and the rest from 12% preference capital. So, the total amount to be raised is ₹5,00,00,000. Therefore, option A) is correct.

Question 3
What is the interest for Proposal II?
A) ₹27,00,000
B) ₹64,50,000
C) ₹46,50,000
D) ₹30,00,000
Explanation: In Proposal II, only debt financing is used, and the interest is calculated on the total debt amount. So, the interest for Proposal II is ₹27,00,000. Therefore, option A) is correct.

Question 4
Which proposal would result in a lower EPS at the indifference point?
A) Proposal I
B) Proposal II
C) Both proposals would have the same EPS at the indifference point
D) Insufficient information to determine
Explanation: The indifference point is the point where EPS is the same regardless of the proposal chosen. Therefore, at this point, both proposals would result in the same EPS. So, option C) is correct.

Case 2
Delta Ltd. Currently has an Equity Share Capital of ₹ 10,00,000 consisting of 1,00,000 Equity Shares of ₹ 10 each. The company is going through a major expansion plan requiring to raise finds to the tune of ₹ 6,00,000. To finance the expansion, the management has following plans:
Plan I Issue of 60,000 Equity shares of ₹ 10 each.
Plan II Issue of 40,000 Equity shares of ₹ 10, and the balance through long term borrowing at 12% interest p.a.
Plan III Issue of 30,000 Equity shares of ₹ 10 each and 3,000 ₹ 100 9% Debentures.
Plan IV Issue of 30,000 Equity shares of ₹ 10 each and balance through 6% preference shares.
The Company's EBIT is expected to be ₹ 4,00,000 p.a. Assume Corporate tax rate of 40%. Required:
1. Calculate EPS in each of the above plan.
2. Ascertain the degree of financial leverage in each plan.

Question 1
What is the EPS (Earnings Per Share) for Plan III?
A) ₹ 1.50
B) ₹ 1.61
C) ₹ 1.72
D) ₹ 1.71
Correct Answer: C) ₹ 1.72
Explanation: EPS is calculated by dividing the residual earnings by the number of equity shares. For Plan III, the residual earnings are ₹ 2,23,800 and the number of equity shares is 1,30,000. So, EPS = ₹ 2,23,800 / 1,30,000 = ₹ 1.72.
Question 2
Which plan has the highest degree of financial leverage considering only interest expenses?
A) Plan I
B) Plan II
C) Plan III
D) Plan IV
Correct Answer: C) Plan III
Explanation: Degree of Financial Leverage (DFL) for interest = EBIT / EBT. For Plan III, DFL (for interest) = ₹ 4,00,000 / ₹ 3,73,000 = 1.07 times. This indicates the multiple by which earnings before interest and taxes (EBIT) change in response to a change in earnings before taxes (EBT).

Question 3
What is the EPS for Plan II considering both interest and preference dividend?
A) ₹ 1.50
B) ₹ 1.61
C) ₹ 1.72
D) ₹ 1.71

Correct Answer: B) ₹ 1.61
Explanation: EPS considering both interest and preference dividend is calculated by dividing the residual earnings by the number of equity shares. For Plan II, the residual earnings are ₹ 2,25,600 and the number of equity shares is 1,40,000. So, EPS = ₹ 2,25,600 / 1,40,000 = ₹ 1.61.

Question 4
Which plan exhibits the highest overall degree of financial leverage, including both interest and preference dividend?
A) Plan I
B) Plan II
C) Plan III
D) Plan IV
Correct Answer: D) Plan IV
Explanation: Degree of Financial Leverage (DFL) with interest and preference dividend = EBIT / (EBIT - Interest - Pre-tax Preference Dividend). For Plan IV, DFL = ₹ 4,00,000 / (₹ 4,00,000 - ₹ 30,000) = 1.08 times. This indicates the multiple by which earnings before interest and taxes (EBIT) change in response to a change in earnings before interest, taxes, and preference dividend.

Practice MCQs

Question - 1:
What does the term "Capital Structure" refer to in a business context?
a) The mix of a firm's short-term and long-term sources of funds
b) The composition of a firm's assets and liabilities
c) The mix of a firm's long-term sources of funds, including equity, preference shares, and long-term debts
d) The distribution of profits among shareholders

Question - 2 :
What is the primary company objective concerning capital structure?
a) Maximize company value
b) Minimize company risks
c) Preserve majority stake for existing shareholders
d) Minimize the cost of equity

Question - 3 :
What are the main influencing factors in determining the capital structure of a company?
a) Earnings per share, market value, and dividends
b) Control, risk, and cost
c) Market trends, flexibility, and profitability
d) Marketability, manoeuvrability, and timing

Question - 4 :
What is the major consideration in capital structure concerning risk?
a) Risk of cash insolvency increases with debt
b) Risk of equity dilution
c) Risk of market fluctuations
d) Risk of excessive dividends

Question - 5 :
What is the definition of "Optimum Capital Structure"?
a) The maximum debt a company can bear
b) The capital structure with the highest equity
c) The capital structure that maximizes firm value while prudently managing debt levels
d) The minimum capital required for a firm's operations

Question - 6 :
What is the primary impact of over capitalization on a company's market goodwill?
a) Market goodwill increases

b) Market goodwill decreases
c) Market goodwill remains unchanged
d) Market goodwill becomes irrelevant

Question - 7 :
What does under capitalization encourage according to the data?
a) Higher market prices for shares
b) Acute competition
c) Window dressing
d) Profit manipulation

Question - 8 :
What does the term "EPS Indifference Point" signify?
a) The point where earnings per share (EPS) remains the same for different capital structures
b) The level of earnings at which a firm achieves financial break-even
c) The point of maximum equity dilution
d) The point where dividends per share are indifferent to capital structure

Question - 9 :
What is the "Financial Break-even Point" in a firm's operations?
a) The point at which financial losses begin
b) The point where earnings per share (EPS) is maximized
c) The level of earnings sufficient to cover interest, tax, and preference dividends
d) The point at which dividends are equal to capital structure costs

Question - 10 :
What is the primary objective of the Net Income (NI) approach to capital structure?
a) Maximize firm value by minimizing overall cost of capital
b) Minimize business risk
c) Increase financial leverage without considering cost
d) Optimize market value by capitalizing net operating income

Question - 11 :
According to the Net Operating Income (NOI) approach, how is the market value of a firm ascertained?
a) By deducting total assets from total liabilities
b) By capitalizing net operating income at the cost of debt
c) By considering the overall cost of capital as constant
d) By adjusting dividend payouts

Question - 12 :
What does the Traditional Approach suggest regarding the optimal capital structure?
a) Minimize the use of both debt and equity
b) Strive for an optimal capital structure to maximize firm value
c) Avoid financial leverage to reduce risks
d) Focus on increasing financial leverage without limit

Question - 13 :
Which assumptions are made in the Modigliani-Miller (MM) approach?
a) Perfect capital markets, well-informed investors, and no corporate income tax
b) Imperfect capital markets, irrational investors, and no borrowing cost
c) Perfect capital markets, irrational investors, and no corporate income tax
d) Imperfect capital markets, well-informed investors, and borrowing cost

Question - 14 :
What is the primary effect of financial leverage on market values according to the MM approach?
a) Financial leverage decreases market values
b) Financial leverage increases market values
c) Financial leverage has no impact on market values
d) Financial leverage is irrelevant

Question - 15 :
What is the impact of taxation on the value of the levered firm under the MM Approach (1963)?
a) Value of the firm decreases
b) Value of the firm remains constant
c) Value of the firm increases
d) Taxation has no impact on the value

Question - 16 :
What is the Tax Shield in the context of the MM Approach?
a) Deductible expenses for taxation purposes
b) Corporate income tax savings due to debt funds
c) The impact of taxation on shareholder dividends
d) The overall cost of capital with tax savings

Question - 17 :
How does the use of debt funds affect the overall cost of capital when corporate taxation is considered?
a) Overall cost of capital increases
b) Overall cost of capital decreases
c) Overall cost of capital remains constant
d) Overall cost of capital becomes irrelevant

Question - 18 :
What is the primary reason for the tax-saving advantage of debt funds in the MM Approach?
a) Equity dividends are deductible for taxation
b) Retained earnings have tax advantages
c) Interest payments on debt are tax-deductible
d) Debt issuance costs are tax-shielded

Question - 19 :
What does the Tax Shield in the MM Approach refer to?
a) Deductible expenses for taxation purposes
b) The overall cost of capital
c) Corporate income tax savings
d) The impact of dividends on firm value

Question - 20 :
How is the value of the levered firm calculated in relation to the unlevered firm in the presence of tax saving?
a) Value of Levered Firm = Value of Unlevered Firm - Debt × Tax Rate
b) Value of Levered Firm = Value of Unlevered Firm + Debt × Tax Rate
c) Value of Levered Firm = Value of Unlevered Firm / Debt × Tax Rate
d) Value of Levered Firm = Value of Unlevered Firm × Debt × Tax Rate

Explanation:

1. Correct Option: c) The mix of a firm's long-term sources of funds, including equity, preference shares, and long-term debtsThe term "Capital Structure" refers to the mix of a firm’s long-term sources of funds, such as debentures, preference share capital, equity share capital, and retained earnings.

2. Correct Option: a) Maximize company value
The primary company objective concerning capital structure is to maximize company value.

3. Correct Option: b) Control, risk, and cost
Influencing factors in determining the capital structure include control, risk, and cost.

4. Correct Option: a) Risk of cash insolvency increases with debt
The major consideration in capital structure concerning risk is that as a firm raises more debt, the risk of cash insolvency increases.

5. Correct Option: c) The capital structure that maximizes firm value while prudently managing debt levels
The optimum capital structure focuses on determining the optimal blend of debt and equity that maximizes firm value while prudently managing debt levels.

6. Correct Option: b) Market goodwill decreases
Over capitalization leads to a reduction in the rate of interest and dividend payments, causing a decrease in market goodwill.

7. Correct Option: b) Acute competition
Under capitalization encourages acute competition according to the data.

8. Correct Option: a) The point where earnings per share (EPS) remains the same for different capital structures
EPS Indifference Point signifies the point where earnings per share (EPS) remains the same for different capital structures.

9. Correct Option: c) The level of earnings sufficient to cover interest, tax, and preference dividends
The Financial Break-even Point denotes the level of earnings at which a firm's EBIT is just sufficient to cover interest, tax, and preference dividends.

10. Correct Option: a) Maximize firm value by minimizing overall cost of capital
The Net Income (NI) approach aims to increase firm value by lowering the overall cost of capital through an increase in the proportion of debt.

11. Correct Option: c) By considering the overall cost of capital as constant
According to the Net Operating Income (NOI) approach, the market value of a firm is ascertained by capitalizing the net operating income at the overall cost of capital, which is considered constant.

12. Correct Option: b) Strive for an optimal capital structure to maximize firm value
The Traditional Approach suggests that the firm should strive to reach the optimal capital structure for minimum overall cost of capital and maximum firm value.

13. Correct Option: a) Perfect capital markets, well-informed investors, and no corporate income tax
The MM approach assumes perfect capital markets, well-informed investors, and no corporate income tax.

14. Correct Option: c) Financial leverage has no impact on market values
The primary effect of financial leverage on market values in the MM approach is that it has no impact; market values remain constant.

15. Correct Option: c) Value of the firm increases
Under the MM Approach (1963), the value of the levered firm increases due to the tax shield effect.

16. Correct Option: b) Corporate income tax savings due to debt funds
The Tax Shield in the MM Approach refers to corporate income tax savings due to the tax-deductible effect of interest payments on debt.

17. Correct Option: b) Overall cost of capital decreases
The use of debt funds has a tax-saving advantage, leading to a decrease in the overall cost of capital when corporate taxation is considered.

18. Correct Option: c) Interest payments on debt are tax-deductible
The primary reason for the tax-saving advantage of debt funds in the MM Approach is that interest payments on debt are tax-deductible.

19. Correct Option: c) Corporate income tax savings
The Tax Shield in the MM Approach refers to corporate income tax savings due to the tax-deductible effect of interest payments on debt.

20. Correct Option: b) Value of Levered Firm = Value of Unlevered Firm + Debt × Tax Rate
The value of the levered firm is calculated as the sum of the value of the unlevered firm and the tax shield resulting from the use of debt, which is Debt × Tax Rate.

Q1	Q2	Q3	Q4	Q5	Q6	Q7	Q8	Q9	Q10
C	A	B	A	C	B	B	A	C	A
Q11	Q12	Q13	Q14	Q15	Q16	Q17	Q18	Q19	Q20
C	B	A	C	C	B	B	C	C	B

ICAI MCQs

Question - 1 :
Which of the following is correct
a. CL = OL + FL
b. CL = OL − FL
c. CL = OL × FL
d. OL = OL ÷ FL

Question - 2 :
There is no operating leverage if there is no ………..
a. Profit
b. Sales
c. Fixed cost
d. EPS

Question - 3 :
If DOL is 1.24 and DFL is 1.99, DCL would be
a. 2.14
b. 2.18
c. 2.31
d. 2.47

Question - 4 :
If degree of financial leverage is 3 and there is 15% increase in Earning per share (EPS), then EBIT will be
a. Decrease by 15%
b. Increase by 45%
c. Decrease by 45%
d. Increase by 5%

Question - 5 :
The cash required during a specific period to meet interest expenses and principal payments is referred to as the:
a. Debt capacity
b. Debt-service burden
c. Adequacy capacity
d. Fixed-charge burden

Question - 6 :
Financial leverage may be defined as
a. Use of funds with a product cost in order to increase earnings per share
b. Use of funds with a contribution cost in order to increase earnings before interest and taxes
c. Use of funds with a fixed cost in order to increase earnings per share
d. Use of funds with a fixed cost in order to increase earnings before interest and taxes

Question - 7 :
Operating Leverage is calculated as
a. Contribution ÷ EBIT
b. EBIT ÷ PBT
c. EBIT ÷ Interest
d. EBIT ÷ Tax

Question - 8 :
Financial Leverage is calculated as
a. EBIT ÷ Contribution
b. EBIT ÷ PBT
c. EBIT ÷ Sales
d. EBIT ÷ Variables Cost

Question - 9 :

1. Given

Operating fixed costs	₹ 20,000
Sales	₹ 1,00,000
P/ V ratio	40%

The operating leverage is:

a. 2.00
b. 2.50
c. 2.67
d. 2.47

Question - 10 :

A firm has a DOL of 4.5 at Q units. What does this tell us about the firm?
a. If sales rise by 4.5%, then EBIT will rise by 1%
b. If EBIT rises by 4.5%, then EPS will rise by 1%.
c. If EBIT rises by 1 %, then EPS will rise by 4.5%.
d. If sales rise by 1 %, then EBIT will rise by 4.5%

Question - 11 :

Operating leverage is 7 and financial leverage is 2.2858. How much change in sales will be required to bring 70% change in EBIT?
a. 10%
b. 70%
c. 11.429%
d. 30%

Question - 12 :

Which of the following indicates business risk
a. Operating leverage
b. Financial leverage
c. Combined leverage
d. Total leverage

Question - 13 :

Degree of combined leverage is the fraction of
a. Degree of combined leverage is the fraction of
b. Percentage change in EPS on Percentage change in Sales
c. Percentage change in Sales on Percentage change in EPS
d. Percentage change in EPS on Percentage change in EBIT

Question - 14 :

A firm with high operating leverage is characterized by………… while one with high financial leverage is characterized by ……….
a. Low fixed cost of production; low fixed financial costs
b. High variable cost of production; high variable financial costs
c. High fixed costs of production; high fixed financial costs
d. Low costs of production; high fixed financial costs

Question - 15 :

A firm has sales of ₹ 75,00,000, variable cost of ₹ 42,00,000 and fixed cost of ₹ 6,00,000. It has a debt of ₹ 45,00,000 at 9% and equity of ₹ 55,00,000. Does it have favourable financial leverage?
a. ROI is less than interest on loan funds and hence it has no favourable financial leverage."
b. ROI is equal to interest on loan funds and hence it has favourable financial leverage.
c. ROI is greater than interest on loan funds and hence it has favourable financial leverage.
d. ROI is greater than interest on loan funds and hence it has unfavourable financial leverage.

Question - 16 :
If EBIT is ₹ 15,00,000, interest is ₹ 2,50,000, corporate tax is 40%, degree of financial leverage is;
a. 1.11
b. 1.20
c. 1.31
d. 1.41

Question - 17 :
………….. is the ratio of net operating income before fixed charges to net operating income after fixed charges.
a. Financial Leverage
b. Operating Leverage
c. Operation Leverage
d. Combined Leverage

Question - 18 :
Total assets of Alpha Company are ₹ 3,00,000. The company's total assets turnover ratio is 3, its fixed operating cost is ₹ 1,50,000 and its variable operating cost ratio is 50%.
The income-tax rate is 50%. It also has long term debts of ₹ 1,20,000 on which interest @ 10% is payable.
Operating, Financial & Combined Leverages of the company are –
a. 1.5; 1.042; 1.563 respectively
b. 1.05; 1.42; 1.05625 respectively
c. 1.50; 1.42; 2.13 respectively
d. 1.55; 1.042; 1.6151 respectively

Question - 19 :
From the following information, calculate combined leverage:

Sales	₹ 20,00,000
Variable Cost	40%
Fixed Cost	₹ 10,00,000
Borrowings	₹ 10,00,000 @ 8% p.a.

a. 10 times
b. 6 times
c. 1.667 times
d. 0.10 times

Question - 20 :
If Margin of Safety is 0.25 and there is 8% increase in output, then EBIT will be:
a. Decrease by 2%
b. Increase by 32%
c. Increase by 2%
d. Decrease by 32%

Solution Key:

Q1	Q2	Q3	Q4	Q5	Q6	Q7	Q8	Q9	Q10
c	c	d	d	b	c	a	b	a	d
Q11	Q12	Q13	Q14	Q15	Q16	Q17	Q18	Q19	Q20
a	a	b	c	c	b	b	a	a	b

Description:
10. DOL definition is for 1% change in sales what will be the % change in EBIT
11. OL=% change in EBIT/ %change in Sales, For OL of 7, 1%change in sales will cause 7%change in EBIT. For 70% change in EBIT, 10% change in sale is required.
14. Operating leverage is the result of fixed cost in operations while Financial Leverage is the result of fixed interest and PD cost
15. Description: EBIT=7500000-4200000-600000=2700000, ROI=2700000/(4500000+5500000)=27%, Rate of Interest lower than Return on investment. Therefore, there is favourable leverage
17. Operating Leverage= Contribution/EBIT

18. Sales=300000x3=900000, VC=900000x50%=450000, Contribution= 900000-450000=450000, EBIT= 450000-150000=300000, PBT=300000-120000x10%=288000, OL=450000/300000=1.5, FL=300000/288000=1.042, CL=1.5x1.042=1.563

CASE BASED MCQs

CASE 1

X Ltd. details are as under:

Sales (@ 100 per unit)	₹ 24,00,000
Variable Cost	50%
Fixed cost	₹ 10,00,000

It has borrowed ₹ 10,00,000 @ 10% p.a. and its equity share capital share capital is ₹ 10,00,000 (₹ 100 each). The company is in a tax bracket of 50%.

Question - 1 :
What is the operating leverage of X Ltd.?
a) 3 times
b) 6 times
c) 9 times
d) 12 times

Question - 2 :
What is the financial leverage of X Ltd.?
a) 1 time
b) 2 times
c) 3 times
d) 4 times

Question - 3 :
What is the combined leverage of X Ltd.?
a) 5 times
b) 8 times
c) 10 times
d) 12 times

Question - 4 :
What is the Return on Equity (ROE) for X Ltd.?
a) 2.5%
b) 5%
c) 7.5%
d) 10%

Question - 5 :
If the sales of X Ltd. increase by ₹6,00,000, what will be the new EBIT?
a) ₹2,50,000
b) ₹4,00,000
c) ₹5,00,000
d) ₹7,00,000

CASE 2

Details of a company for the year ended 31st March, 2022 are given below:

Sales	₹ 86 lakhs
Profit Volume (P/V) Ratio	35%
Fixed Cost excluding interest expenses	₹ 10 lakhs
10% Debt	₹ 55 lakhs
Equity Share Capital of ₹ 10 each	₹ 75 lakhs
Income Tax Rate	40%

Question - 6 :
What is the Return on Capital Employed (ROCE) of the company before tax?
a) 10.25%
b) 15.46%
c) 20.30%
d) 25.75%

Explanation: ROCE (Pre-tax) is calculated as EBIT/Capital Employed * 100. Substituting the given values: ₹20,10,000/₹(75,00,000+55,00,000) * 100 = 15.46%.

Question - 7 :
What is the company's EPS (Earnings Per Share)?
a) ₹0.98
b) ₹1.17
c) ₹1.35
d) ₹1.52

Question - 8 :
What is the operating leverage of the company?
a) 0.754
b) 1.377
c) 1.497
d) 2.062

Question - 9 :
If the sales increase by 10%, what is the expected percentage change in EBIT?
a) 10%
b) 12%
c) 14.97%
d) 20%

Question - 10 :
At what level of sales will the Earning before Tax (EBT) be equal to zero?
a) ₹38,67,000
b) ₹44,29,000
c) ₹51,25,000
d) ₹59,80,000

Q1	Q2	Q3	Q4	Q5	Q6	Q7	Q8	Q9	Q10
b	b	d	b	c	b	b	c	c	b

Practice MCQs
Question - 1 :
What is the primary aim of calculating business risk?
a. Relationship between EBIT and EPS
b. Predictability of future operating income
c. Financial leverage analysis
d. Fixed operating costs

Question - 2 :
How is financial risk related to a company's capital structure?
a. It is unavoidable and uncontrollable
b. It arises from fluctuations in economic environment
c. Shareholders face additional risk with debt use
d. It is measured by the standard deviation of ROCE

Question - 3 :
What are equity shareholders entitled to in terms of residual earnings?

a. Interest on debt
b. Preference dividend
c. Earnings available for equity
d. Fixed operating costs

Question - 4 :
What is the formula for Operating Leverage?
a. Contribution/EBIT
b. EBIT/EBT
c. EBIT/(EBT - Preference Dividend.
d. Contribution/EBT

Question - 5 :
How is the effect of change in sales on EBIT measured by Operating Leverage?
a. (% Change in EBIT)/(% Change in Sales)
b. (% Change in Sales)/(% Change in EBIT)
c. (Increase in EBIT/EBIT)/(Increase in Sales/Sales)
d. (Increase in Sales/Sales)/(Increase in EBIT/EBIT)

Question - 6 :
What is the definition of Financial Leverage?
a. The relationship between Sales and EPS
b. The firm's ability to use fixed financial charges to magnify changes in EBIT on EPS
c. The impact of fixed operating costs on business risk
d. The effect of interest expenses on EBT

Question - 7 :
How is Financial Leverage calculated?
a. EBIT/(EBT - (Preference Dividend./((1-t)))
b. EBIT/EBT
c. (% Change in EPS)/(% Change in EBIT)
d. EBIT/(EBT + Preference Dividend)

Question - 8 :
In financial leverage analysis, when is the situation characterized by "Positive Financial Leverage"?
a. No fixed financial cost
b. Higher financial leverage
c. EBIT is higher than Financial Break-even point
d. EBIT is lower than Finance Break-even point

Question - 9 :
Why is financial leverage considered a 'Double-edged Sword'?
a. It is both fixed and variable
b. It has advantages and disadvantages
c. It is used for both operating and financial purposes
d. It magnifies business and financial risk

Question - 10 :
What does Financial Leverage impact when ROI is less than the interest cost?
a. Favourable - Advantage
b. Unfavourable - Disadvantage
c. Neutral - Neither advantage nor disadvantage
d. No impact on EPS and ROE

Question - 11 :
What is the Gearing Effect also known as?
a. Equity Leverage
b. Financial Distress
c. Operating Leverage

d. Dividend Yield

Question - 12 :
What characterises the Break-even point in production and sales?
a. Maximum profit
b. No profit and no loss
c. Infinite profit
d. Minimum loss

Question - 13 :
What creates a gain for Equity Shareholders in the Gearing Effect?
a. A decrease in ROE
b. An increase in the number of Equity Shares issued
c. Excess of return on investment over the cost of Debt Funds
d. High-cost Debt Funds

Question - 14 :
What is the formula for Degree of Operating Leverage (DOL)?
a. 1/(Margin of Safety)
b. Margin of Safety/1
c. Margin of Safety × Fixed Cost
d. Operating Leverage/1

Question - 15 :
When does operating leverage exist?
a. DOL is less than one
b. DOL is exactly one
c. DOL is more than one
d. DOL is zero

Question - 16 :
What does a positive Degree of Operating Leverage (DOL) indicate?
a. The firm is operating at a lower level than the break-even point
b. The firm is operating at the break-even level
c. The firm is operating at a higher level than the break-even point
d. The firm is not operating

Question - 17 :
In Combined Leverage, what does DFL measure?
a. Level of business risk
b. Level of financial risk
c. Level of total or combined risk
d. Level of fixed cost

Question - 18 :
What is the effect of a 8% increase in output on EBIT when DOL is 3?
a. EBIT will increase by 3%
b. EBIT will increase by 9%
c. EBIT will increase by 24%
d. EBIT will decrease by 3%

Question - 19 :
When is Combined Leverage (DCL) undefined?
a. At Operating Break-even Point (BEP)
b. At Financial Break-even Point (BEP)
c. At Maximum Profit
d. At Minimum Loss

Question - 20 :
What does DFL measure in Combined Leverage?
a. % change in EBIT resulting from a 1% change in Sales
b. % change in EPS resulting from a 1% change in EBIT
c. % change in EPS resulting from a 1% change in Sales
d. % change in Sales resulting from a 1% change in EBIT

Solution Key:

Q1	Q2	Q3	Q4	Q5	Q6	Q7	Q8	Q9	Q10
b	c	c	a	a	b	a	c	b	b
Q11	Q12	Q13	Q14	Q15	Q16	Q17	Q18	Q19	Q20
a	b	c	a	c	c	b	c	b	b

Description:

1. Business risk pertains to the uncertainties associated with a firm's operations, specifically the predictability of future operating income (EBIT).
2. Financial risk arises from the use of debt in a company's capital structure, and shareholders face additional risk when a company utilizes debt alongside equity financing.
3. Equity shareholders are entitled to Residual Earnings, i.e., after paying interest on debt and preference dividend.
4. Operating Leverage is defined as the Firm's ability to use fixed operating costs to magnify effects of changes in sales on its EBIT.
5. The effect of change in sales on EBIT is measured by Operating Leverage using this formula.
6. Financial Leverage is defined as the ability of a Firm to use fixed financial charges (interest) to magnify the effects of changes in EBIT on the Firm's Earning Per Share (EPS).
7. Financial Leverage is calculated using this formula.
8. "Positive Financial Leverage" occurs when EBIT is higher than the Financial Break-even point.
9. Financial leverage is considered a 'Double-edged Sword' because, on one hand, it can increase return on equity and EPS, but on the other hand, it can lead to financial distress if the cost of debt is higher than the return.
10. When ROI is less than the interest cost, the impact of Financial Leverage is unfavourable and considered a disadvantage.
11. The Gearing Effect is also known as "Equity Leverage" or "Trading on Equity."
12. At the Break-even point in production level and sales, there is no profit and loss; total cost equals total sales revenue.
13. A gain for Equity Shareholders in the Gearing Effect is created by the excess of return on investment over the cost of Debt Funds.
14. Degree of Operating Leverage (DOL) is calculated using the formula 1/(Margin of Safety).
15. Operating leverage exists when DOL is more than one.
16. A positive DOL means that the firm is operating at a higher level than the break-even point, and both sales and EBIT move in the same direction.
17. In Combined Leverage, DFL measures the level of financial risk.
18. If DOL is 3 and there is an 8% increase in output, EBIT will increase by 24%.
19. Combined Leverage (DCL) is undefined at Financial Break-even Point (BEP).
20. DFL measures the % change in EPS resulting from a 1% change in EBIT in Combined Leverage.

ICAI MCQs

Question - 1 :
Which of these methods of capital budgeting are based on cash flows
a. Payback Method
b. NPV
c. Profitability Index
d. All of the above

Question - 2 :
Depreciation is taken into consideration in capital budgeting because
a. It reduces Tax liability
b. It is unavoidable
c. It is a cash outflow
d. t is a cash inflow

Question - 3 :
A project whose useful life is 4 years has IRR of 15% and will save cost of ₹ 1,60,000 annually. What is the project cost i.e. initial investment?
a. ₹ 10,66,667
b. ₹ 4,60,000
c. ₹ 5,32,800
d. ₹ 4,56,800

Question - 4 :
Which of the following is not a capital budgeting decision
a. Inventory Control
b. Business Expansion
c. Acquisition of Long Term Asset
d. Replacement of Existing Asset

Question - 5 :
Capital Budgeting is important for the below reasons except
a. They are irreversible
b. They involve substantial investment
c. They are for short period of time
d. They are complex & futuristic

Question - 6 :
Which of the following is one of the steps in capital budgeting process
a. Controlling Selling Expenses
b. Determination of Price
c. Deciding the capital structure
d. Estimation of Project cash flows

Question - 7 :
Which of the following statement is not true for capital budgeting
a. Irreversible decisions
b. Sunk Cost is Relevant cost
c. Affect future stability of firm
d. Can relate to Business Expansion

Question - 8 :
With IRR criteria and no limitation on funds, one can accept projects which have
a. IRR more than cost of capital
b. IRR less than cost of capital
c. IRR being equal to borrowing rate
d. All of the above

Question - 9 :
The best methods to evaluate the projects with unequal lives can be
a. ARR or Payback Period
b. Replacement Chain or Equivalent Annualized Criteria
c. NPV or Discounted Payback
d. None of these

Question - 10 :
Discounted payback period for a project shall be ________ the payback period of the same project.
a. Equal to
b. More Than
c. Less Than
d. Half

Question - 11 :
With limited capital & number of available projects, one should select the project with
a. IRR less than Cost of Capital
b. Profitability Index less than 1
c. Lowest Internal Rate of Return
d. Highest Net Present Value

Question - 12 :
A project whose useful life is 4 years has IRR of 15% and will save cost of ₹ 1,60,000 annually. What is the project cost i.e. initial investment?
a. ₹ 10,66,667
b. ₹ 4,60,000
c. ₹ 5,32,800
d. ₹ 4,56,800

Question - 13 :
Using capital budgeting techniques, A project is accepted when
a. Net Present Value is positive
b. Profitability Index is more than 1
c. Its IRR is greater than Cost of Capital
d. Any of the above

Question - 14 :
Which of the following is not followed in discounting techniques of capital budgeting
a. Cash Flow Principal
b. Accrual Principal
c. Interest Exclusion
d. Post Tax Principal

Question - 15 :
The Reinvestment assumption under NPV method assumes that the cash flows are reinvested at the
a. Marginal Cost of Capital
b. Internal Rate of Return
c. Discount rate used to calculate NPV
d. Bank Borrowing rate

Question - 16 :
A project's net present value, ignoring income tax considerations, is normally affected by the
a. Proceeds from the sale of the asset to be replaced
b. Carrying amount of the asset to be replaced by the project
c. Amount of annual depreciation on the asset to be replaced
d. Amount of annual depreciation on fixed assets used directly on the project

Question - 17 :
With initial investment of ₹ 100,000 and yearly cash inflows of ₹ 27,000 for 5 years, the NPV of the project with cost of capital of 10% shall be approximately
a. 35,000
b. -2,357
c. 2,357
d. -35,000

Question - 18 :
Which of the following events would decrease the internal rate of return of a proposed asset purchase?
a. Decrease related working capital requirements
b. Shorten the payback period
c. Decrease tax credits on the asset
d. Use accelerated, instead of straight-line depreciation

Question - 19 :
In considering the payback period for three projects, Sun Corp. gathered the following data about cash flows:

	Year 0	Year 1	Year 2	Year 3	Year 4
Project X	(20,000)	6,000	6,000	6,000	6,000
Project Y	(50,000)	30,000	30,000	10,000	5,000
Project Z	(20,000)	10,000	10,000	5,000	

If Cut off period is 2 years which projects can be taken up.
a. Projects X, Y and Z.
b. Projects Y and Z.
c. Project Y only.
d. Projects X and Z

Question - 20 :
Bhaskar Ltd. estimated that a proposed project's 8-year net cash benefit will be ₹ 4,000 per year for years 1 to 8, with an additional terminal benefit of ₹ 8,000 at the end of the eighth year. Assuming that these cash inflows satisfy exactly the required rate of return of 8 percent, the project's initial cash outflow is closest to which of the following four possible answers?
a. ₹ 27,308
b. ₹ 25,149
c. ₹ 14,851
d. ₹ 40,000

Solution Key:

Q1	Q2	Q3	Q4	Q5	Q6	Q7	Q8	Q9	Q10
d	a	d	a	c	d	b	a	b	b
Q11	Q12	Q13	Q14	Q15	Q16	Q17	Q18	Q19	Q20
d	d	d	b	c	a	c	c	b	a

Description:
1. All the capital budgeting methods except Accounting Rate of Return method require consideration of cash flows associated with a project.
2. Although capital budgeting techniques are generally based on project cash flows. Depreciation is a non-cash expense, however, since it results in reduction of tax liability, the tax savings are also taken into account for computing the relevant cash flows.
3.
Annual cost saving = Cash inflow = 1,60,000
Useful life = 4 years
IRR = 15%
At 15% IRR, total present value of cash inflow is equal to initial cash outlay.
Total present value of cash inflow @ 15% for 4 years is 2.855 = 1,60,000×2.855
= 4,56,800
Thus, Project cost = 4,56,800.

4. Inventory control relates to working capital management where as other three options involve capital budgeting techniques
5. Capital budgeting is a technique used for evaluating Investment decisions which involve huge investments, are complex as involve futuristic assumptions and are for long term.
6. Capital budgeting process involves estimating future cash flows relating to respective projects for evaluating the best one. It doesn't involve determination of capital structure, price or controlling of selling expenses.
7. Capital budgeting decisions are of long term nature and hence they are generally irreversible, affect the future stability of the form and result in expansion. Any sunk cost that is incurred in past is irrelevant for these decisions.
8. With IRR criteria, projects should be accepted only if IRR is more than the cost of capital. IRR is the rate of return where NPV is zero and hence if IRR is more than cost of capital, the NPV of the project at the cost of capital shall always be positive
9. While evaluating projects with unequal lives and cash flows spread across in different pattern the traditional methods like NPV, IRR, Payback may not be the best to select a project. Replacement Chain method that equalizes the life of the projects by repeating shorter projects or Equivalent Annualized criteria methods are more helpful in such scenarios.
10. Since discounted payback period considers discounted cash flows and the payback period considers undiscounted cash flows, it will take much longer to recover the initial investments in case of Discounted payback period.
11. With limited funds, any organization shall select the project with highest NPV or whose IRR is more than Cost of capital or whose Profitability index more than 1.
12. Annual cost saving = Cash inflow = 1,60,000
Useful life = 4 years
IRR = 15%
At 15% IRR, total present value of cash inflow is equal to initial cash outlay.
Total present value of cash inflow @ 15% for 4 years is 2.855 = 1,60,000×2.855
= 4,56,800
Thus, Project cost = 4,56,800.
13. Projects with positive NPV, or PI more than 1 or whose IRR is more than the cost of capital may be accepted.
14. Capital budgeting discounting techniques such as NPV, IRR, Discounted payback etc involves projecting cash flows and considering time value of money resulting in exclusion of interest. It doesn't follow accrual principal.
15. Under NPV method, it is assumed that the cash flows are reinvested at the discount rate used to calculate NPV which is generally the WACC. Under IRR method, the reinvestment is assumed to be at the IRR itself
16. Cash flows from Sale of existing asset will be considered in calculating the NPV. Whereas, the carrying value and depreciation of existing asset and annual depreciation of assets used in the project shall not impact the NPV (only the tax savings are considered which is ignored in the question).
17. The present value annuity factor @ 10% for 5 years is 3.791. Hence, NPV = 27,000 X 3.791 – 100,000 = 2,357 /-
18. The Internal rate of return determines the rate of discount at which the present value of the future cash flows equals the investment outlay (i.e. the rate that results in an NPV of zero). A tax credit is a tax incentive (example – grant) which allows certain taxpayers to subtract the amount of the tax credit from the total they owe the government. A decrease in the tax credits on the asset would result in a n increase in the initial outlay for the asset. This increase would cause the present value factor to increase and would result in a decline in internal rate of return. As a result the internal rate of return will decrease. Option (a) is incorrect because a decrease in the related working capital requirements decreases the initial outlay thereby resulting in an increase in the internal rate of return. Option (b) is incorrect because a decrease in the working capital requirement would result in a decrease in the initial outlay and hence an increase in the internal rate of return for NPV = 0. Option (d) is incorrect because the use of accelerated depreciation would result in an increase in the cash flows in form of higher tax shield in earlier years resulting in a higher internal rate of return for NPV = 0.
19. Project X seems to achieve payback in 5th year with cumulative inflows of 18,000 till Year 4. Whereas, both projects Y & Z clearly achieve payback period within three years.
20. Years CAFT PV Factor 8% Present Value 1 to 8 4000 5.747 22988 2 25000 0.54 4320 Total PV 27308 (-) Initial Invt. -27308 NPV (Given) 0 hence, A) 25149

Practice MCQs

Question - 1 :
What is the primary purpose of Capital Budgeting?
a. Identifying short-term investment opportunities
b. Maximizing shareholder's wealth
c. Enhancing daily operational efficiency
d. Minimizing financial risks

Question - 2 :
What characterizes the Irreversibility aspect of Capital Budgeting decisions?
a. Easy reversibility once implemented
b. Decisions that are difficult to change once implemented
c. Frequent changes in investment choices
d. Quick adaptation to market fluctuations

Question - 3 :
Which phase of Capital Budgeting involves assessing the ability of the management to exploit investment opportunities?
a. Evaluation Phase
b. Selection Phase
c. Planning Phase
d. Implementation Phase

Question - 4 :
What is the primary focus of Phase II (Evaluation) in the Capital Budgeting process?
a. Monitoring project progress
b. Estimating cash flows
c. Choosing among projects
d. Identifying potential investment opportunities

Question - 5 :
What is the primary objective of Expansion Decisions in Capital Investment?
a. Reducing risk by operating in different products
b. Adding capacity to meet growing product demand
c. Upgrading technology to stay current
d. Improving operating efficiency and reducing costs

Question - 6 :
In Mutually Exclusive Decisions, what is the characteristic of the choices presented?
a. Acceptance of one proposal excludes others
b. Independent proposals not competing with each other
c. Investment in one proposal requires investment in others
d. Replacement and modernization of existing assets

Question - 7 :
What is the Equivalent Annualized Criterion used for in projects with unequal lives?
a. To compare projects based on absolute NPV
b. To convert project values into equivalent annual cash flows
c. To evaluate projects in succession
d. To minimize NPV

Question - 8 :
What is the objective of the Replacement Chain Method in projects with unequal lives?
a. To replace old assets with new ones
b. To evaluate projects in succession to maintain uniform life
c. To address challenges in retaining old assets
d. To convert project values into equivalent annual cash flows

Question - 9 :
What is a limitation of the Accounting Rate of Return (ARR) in Capital Budgeting?
a. Immediate cash outflows
b. Lack of immediate cash outflow for non-cash items
c. Timings of cash flow may not align with profit periods
d. Dependence on various departmental inputs

Question - 10 :
What departments provide crucial inputs for Cash Flow Estimation in Capital Budgeting?
a. Only Production department
b. Only Finance department
c. Only Marketing department
d. Various departments (Production, Finance, Marketing)

Question - 11 :
How are costs labeled in the context of Cash Outflows vs. Cash Inflows in Capital Budgeting?
a. Costs are considered "cash inflows."
b. Costs are unrelated to cash flows.
c. Costs are labeled as "cash outflows."
d. Costs are not considered in project evaluation.

Question - 12 :
What influences the Project Life in Capital Budgeting?
a. Marketing efforts
b. Technological obsolescence, physical deterioration, and demand decline
c. Timings of cash flows
d. Daily operational efficiency

Question - 13 :
What is the nature of Depreciation in the context of cash flows?
a. Cash inflow item
b. Non-cash item
c. Directly impacts cash flow
d. Irrelevant for cash flow analysis

Question - 14 :
What is considered when calculating the tax benefit from Depreciation?
a. Tax is an additional cash outflow
b. Tax benefit is irrelevant
c. Tax benefit is considered a cash inflow
d. Tax has no relation to Depreciation

Question - 15 :
What does Opportunity Cost refer to in cash flow analysis?
a. Direct cash outflow
b. Foregoing a benefit by choosing an alternative investment
c. Sunk cost
d. Consideration for tax benefit

Question - 16 :
When are Sunk Costs relevant in decision-making according to capital budgeting analysis?
a. Always relevant
b. Irrelevant for decision-making
c. Relevant during project implementation
d. Considered in cash flow analysis

Question - 17 :
How is Working Capital initially treated in cash flow analysis?
a. Always considered as a cash inflow

b. Treated as a tax expense
c. Initial requirement treated as a cash outflow
d. Provided with depreciation

Question - 18 :
What is the treatment of Allocated Overheads in cash flow analysis?
a. Treated as cash inflows
b. Excluded from cash flow considerations
c. Treated as incremental overhead costs
d. Directly impacts the cash outflow

Question - 19 :
How are independent and divisible projects ranked under Capital Rationing?
a. By using the 'NPV per rupee of Capital' method or using Profitability Index
b. By selecting projects until resources are exhausted
c. By ranking projects on absolute NPV
d. By optimising resource allocation based on maximum NPV

Question - 20 :
In which category of cash flows does the Initial Cash Outflow fall?
a. Terminal-Year Net Cash Flow
b. Interim Cash Flows
c. Initial Cash Outflow
d. Tax Shield Cash Flow

Question - 21 :
What does NPV Maximisation aim to achieve in Capital Rationing?
a. Minimize the wealth of shareholders
b. Allocate funds to maximize NPV
c. Ignore resource constraints
d. Undertake all available projects

Question - 22 :
What adjustments are made to calculate Terminal-Year Net Cash Flow?
a. Deduction of sunk costs
b. Deduction of working capital
c. Deduction of allocated overheads
d. Incorporation of salvage value and tax savings

Question - 23 :
What is the importance of Tax Shield in calculating project cash flows?
a. Integral for assessing project risk
b. Vital for determining project life
c. Derived from the tax benefit resulting from depreciation
d. Only applicable in specific industries

Question - 24 :
In Capital Rationing, what is Soft Capital Rationing?
a. The budget ceiling imposed internally
b. A market constraint on available funds
c. The maximum funds that can be invested
d. Allocating limited funds to maximize NPV

Question - 25 :
What does the Payback Period represent in capital budgeting?
a. The time taken to achieve break-even
b. The time required for complete recovery of the initial investment
c. The time until the project generates positive cash flows
d. The duration for full project implementation

Question - 26 :
What is the primary advantage of the Payback Period technique?
a. Comprehensive profitability measurement
b. Considers the time value of money
c. Quick and straightforward calculation
d. Relative measure of project profitability

Question - 27 :
What does Payback Reciprocal approximate in capital budgeting?
a. Internal Rate of Return (IRR)
b. Net Present Value (NPV)
c. Profitability Index (PI)
d. Modified Internal Rate of Return (MIRR)

Question - 28 :
In Accounting Rate of Return (ARR), what is used for evaluation instead of CFAT?
a. Net Initial Investment
b. Profit after Taxes (PAT)
c. Salvage Value
d. Discounted Payback Period

Question - 29 :
What does the Reinvestment Assumption imply in the NPV technique?
a. Cash flows can be reinvested at the discount rate
b. Cash flows are reinvested at the project's IRR
c. Projects with early-year cash concentration are preferred
d. Cash flows are reinvested at a rate equal to the cost of capital

Question - 30 :
What is the theoretical basis for determining the discount rate?
a. Net present value of the project
b. Weighted debt cost
c. Desired or expected rate of return
d. Internal Rate of Return (IRR)

Solution Key:

Q1	Q2	Q3	Q4	Q5	Q6	Q7	Q8	Q9	Q10
b	b	c	b	b	a	b	b	c	d
Q11	Q12	Q13	Q14	Q15	Q16	Q17	Q18	Q19	Q20
c	b	b	c	b	b	c	b	a	c
Q21	Q22	Q23	Q24	Q25	Q26	Q27	Q28	Q29	Q30
b	d	c	a	b	c	a	b	a	c

Description

1. Capital Budgeting aims to maximize the return to investors and, consequently, shareholder's wealth.
2. Irreversibility in Capital Budgeting refers to the difficulty in changing decisions once implemented.
3. The Planning Phase involves the identification of potential investment opportunities and assessing the ability to exploit them.
4. The Evaluation Phase primarily focuses on determining the proposal's investment, inflows, and outflows.
5. Expansion Decisions aim to add capacity to meet the growing demand for products.
6. Mutually Exclusive Decisions involve choosing one proposal that excludes others.
7. The Equivalent Annualized Criterion is used to convert project values into equivalent annual cash flows for comparison.
8. The Replacement Chain Method is used to evaluate projects in succession to maintain a uniform life.
9. ARR has a limitation as the timings of cash flow may not align with profit periods.

10. Multiple departments provide crucial inputs for Cash Flow Estimation in Capital Budgeting.
11. Costs are considered "cash outflows," and revenues and gains are considered "cash inflows."
12. Project life in Capital Budgeting is influenced by technological obsolescence, physical deterioration, and demand decline.
13. Depreciation is a non-cash item that doesn't impact cash flow directly.
14. The tax benefit resulting from depreciation is considered a cash inflow.
15. Opportunity Cost in cash flow analysis refers to the benefit foregone by choosing an alternative investment.
16. Sunk Costs are past cash outlays and are considered irrelevant for decision-making in capital budgeting.
17. Working Capital is initially treated as a cash outflow in cash flow analysis.
18. Allocated Overheads are excluded from cash flow considerations; only incremental overhead costs are treated as cash outflows.
19. Independent and divisible projects are ranked by using the 'NPV per rupee of Capital' method to optimize resource allocation based on maximum NPV per unit of capital.
20. Initial Cash Outflow falls under the category of Initial Cash Outflow in the context of cash flow analysis.
21.NPV Maximisation in Capital Rationing aims to allocate the limited funds available in such a way that maximizes the NPV of the firm.
22. Adjustments made for Terminal-Year Net Cash Flow include the incorporation of salvage value, tax savings, and other relevant factors.
23. Tax Shield is derived from the tax benefit resulting from depreciation, and it is integral to calculating project cash flows.
24. Soft Capital Rationing is when the firm internally imposes a budget ceiling on the maximum funds that can be invested in capital projects during a given period.
25. Payback Period represents the time required for complete recovery of the initial investment.
26. The Payback Period technique offers ease of computation with a quick and straightforward calculation.
27. Payback Reciprocal is considered an approximation of the Internal Rate of Return (IRR) under specific conditions.
28. ARR uses Profit after Taxes (PAT) for evaluation, instead of Cash Flow After Taxes (CFAT).
29. The Reinvestment Assumption in NPV implies that cash flows can be reinvested at the discount rate used for NPV calculation.
30. The discount rate in capital budgeting represents the desired or expected rate of return on an investment.

ICAI MCQs

Question - 1 :
Which one of the following is the assumption of Gordon's Model
a. Ke > g
b. Retention ratio, (b), once decide upon, is constant
c. Firm is an all equity firm
d. All of the above

Question - 2 :
The 'Dividend-Payout Ratio' is equal to
a. The Dividend yield plus the capital gains yield
b. Dividends per share divided by Earning per Equity Share
c. Dividends per share divided by par value per share
d. Dividends per share divided by current price per share

Question - 3 :
What are the different options other than cash used for distributing profits to shareholders
a. Bonus shares
b. Stock split
c. Both (a) and (b)
d. None of the above

Question - 4 :
According to the residual dividend theory ,dividend payment is determined based on
a. The availability of excess fund after all investment opportunities with positive net present value are undertaken
b. The preference of shareholder for a consistent dividend payout ratio
c. The desire to maintain a stable dividend payout ratio regardless of investment opportunity.
d. The goal of maximising shareholder wealth by paying out all available earning as dividend

Question - 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

Question - 6 :
Which of the following is the irrelevance theory?
a. Walter model
b. Gordon model
c. M.M. hypothesis
d. Linter's model

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

Question - 8 :
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

Question - 9 :
If a firm declared a 25% dividend on a share of face value of Rs 10 its growth rate is 5%& its rate of capitalization is 12% its expected price would be ₹..
a. 31.2
b. 33.50
c. 36
D. 37.50

Question - 10 :
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%

Question - 11 :
Which of the following is the limitation of Linter's model?
a. Market price per share is reduced after the split.
b. the number of outstanding shares is increased.
c. Retained earnings are changed.
d. Proportional ownership is unchanged.

Question - 12 :
All of the following are true of stock splits except:
a. More Dividend
b. Less dividend
c. No Dividend
d. None of the above

Question - 13 :
If the financing requirements are to be executed through debt (relatively cheaper source of finance), then it would be preferable to distribute....,,,,,,
a. More Dividend
b. Less dividend
c. No Dividend
d. None of the above

Question - 14 :
What should be the optimum Dividend pay-out ratio, when r = 15% & K_e = 12%:
a. 100%
b. 50%
c. Zero
d. None of the above

Question - 15 :
Which of the following statement is correct with respect to Gordon's model
a. When IRR is greater than cost of capital, the price per share increases and dividend pay-out decreases.
b. When IRR is greater than cost of capital, the price per share decreases and dividend pay-out increase
c. When IRR is equal to cost of capital, the price per share increases and dividend pay-out decreases
d. When IRR is lower than cost of capital, the price per share increases and dividend pay-out decreases

Question - 16 :
Determine the market price of share of XYZ ltd as per gordon's model, given equity capitalisation rate =11% expected earning =₹ 20 rate of return on investment =10% & retention ratio =30%
a. 165
b. 175
c. 185
d. 195

Question - 17 :
Compute EPS according to Graham & Dodd approach from the given information:

Market price	₹56
Dividend pay-out ratio	60%
Multiplier	2

a. ₹ 30
b. ₹ 56
c. ₹ 28
d. ₹ 84

Question - 18 :
The cost of capital of a firm is 12% & its expected earning per share at the end of the year is Rs 20. its existing payout ratio is 25%. the company is planning to increase its payout ratio to 50% what will be the effect of this change on the market price of equity share (MPS) of the company as per Gordon model ,If the reinvestment rate of the company is 15%
a. It will increase by ₹ 444.45
b. It will decrease by ₹ 444.45
c. It will increase by ₹ 222.22
d. It will decrease by ₹ 222.22

Solution Key:

Q1	Q2	Q3	Q4	Q5	Q6	Q7	Q8	Q9	Q10
d	b	a	a	a	c	c	b	d	c
Q11	Q12	Q13	Q14	Q15	Q16	Q17	Q18		
c	a	a	c	a	b	a	b		

Description:
9. Lintner's Model is for estimating the dividend for the next year. It is not a model for calculating price of share. The adjustment factor in the model is a arbitrary number and doesn't have any methodology to calculate
13. As additional funds are to be procured by debt, companies need not retain any profits. So it would preferably distribute more dividends.
16. g= 0.3x10%=3%, D1=20*0.7=14, Po=14/(0.11-0.03)=175
18. Current D1= 20 x 25%=5, Current g=0.75x0.15=11.25%, Current MPS= 5/(0.12-0.1125)=666.67 Proposed D1=20x50%=10, proposed g=0.5x0.15=0.075, Proposed MPS=10/(0.12-0.075)=222.22 Change in MPS=666.67-222.22=444.45

Practice MCQs
Question - 1 :
What is the primary concern of the Financing Decision in long-term finance function decisions?
a. Determining the dividend payout
b. Identifying potential investment opportunities
c. Allocating resources effectively
d. Determining the optimal capital structure

Question - 2 :
What does the Investment Decision focus on in the long-term finance function?
a. Dividend payout
b. Allocating resources effectively
c. Identifying and evaluating potential investment opportunities
d. Determining the optimal capital structure

Question - 3 :
What is the main objective of the Dividend Decision in long-term finance function decisions?
a. Determining the optimal capital structure
b. Allocating resources effectively
c. Balancing the need for distributing profits with the retention of earnings

d. Identifying and evaluating potential investment opportunities

Question - 4 :
How does a share buyback affect future dividends per share for existing shareholders?
a. Reduces future dividends
b. Has no impact on future dividends
c. Increases future dividends
d. Eliminates future dividends

Question - 5 :
What is Ex-Dividend in the context of dividends?
a. Shares that entitle the holder to receive the upcoming dividend payment
b. Shares that no longer entitle the holder to receive the upcoming dividend payment
c. The dividend payment made in excess of profits
d. The dividend payment made before the ex-dividend date

Question - 6 :
What is the impact of Ex-Dividend on investors purchasing shares on or after the ex-dividend date?
a. They are eligible to receive the declared dividend
b. They receive the dividend payment in excess
c. They are not eligible to receive the declared dividend
d. They receive double the declared dividend

Question - 7 :
What is the common form of Cash Dividend distribution?
a. In-kind payments
b. Share repurchases
c. Paid in cash, cheque, or warrant
d. Distribution of shares instead of cash

Question - 8 :
What is the significance of Share Repurchases from a financial management perspective?
a. Increases shareholder wealth
b. Reduces shareholder wealth
c. Viewed as a form of dividend distribution
d. Improves liquidity

Question - 9 :
What does a Stock Dividend involve?
a. Distribution of shares instead of cash dividend
b. Buying back shares with corporate cash
c. Issuing new shares to existing shareholders without consideration
d. Retiring shares from issued share capital

Question - 10 :
What advantage does a stock split offer to small investors?
a. Decreased liquidity
b. Increased share prices
c. Affordable shares
d. Reduced potential for investment

Question - 11 :
What is the primary purpose of a stock split?
a. Increase share prices
b. Decrease liquidity
c. Regulate share prices
d. Reduce the number of shareholders

Question - 12 :
How does the Dividend Payout Ratio (D/P) influence the market price of shares?
a. Higher dividends decrease share value
b. Higher dividends increase share value
c. D/P has no impact on share value
d. Market price is unrelated to dividend payout

Question - 13 :
What does the ‘b’ represent in the equation for Growth (g)?
a. Rate of return on investment
b. Growth rate of the firm
c. Retention ratio
d. Market price of shares

Question - 14 :
In the Determinants of Dividend Decisions, what does the debt-equity ratio impact?
a. Market value of shares
b. Capital structure balance
c. Availability of funds
d. Cost of capital

Question - 15 :
What is the relationship between share price growth and dividend growth in Gordon’s Model?
a. Share price grows at a different rate
b. Share price and dividend grow at the same rate
c. Share price grows faster than dividends
d. Share price remains constant

Question - 16 :
Which factor is emphasized in Practical Considerations regarding Financial Needs?
a. Maximizing dividends for shareholders
b. Retained earnings as a source of finance
c. Raising capital through new share issuance
d. Increasing financial obligations

Question - 17 :
What constraint on paying dividends is related to the firm's cash position?
a. Legal constraints
b. Liquidity constraints
c. Access to the capital market
d. Constraints on investment opportunities

Question - 18 :
What was the taxation treatment of dividends before April 2020?
a. Taxable at applicable slab rates in the hands of the investor
b. Tax-free for investors
c. Subject to dividend distribution tax (DDT)
d. Exempt from any form of taxation

Question - 19 :
What is a limitation of Gordon’s Model regarding intrinsic stock value?
a. It provides an accurate intrinsic value
b. Difficulty in calculating growth rates
c. Difficulty in determining the true intrinsic value
d. It considers only short-term projections

Question - 20 :
In the Gordon’s Growth Model, what does the variable 'g' represent?
a. Initial high growth rate

b. Capitalization rate
c. Growth rate of dividends
d. Steady growth rate

Question - 21 :
According to Linter's Model, what is the Adjustment factor (Af) in the dividend adjustment formula?
a. Dividend in year 1
b. Dividend in year 0 (last year dividend.
c. Earnings per share
d. Speed of adjustment

Question - 22 :
Which theory suggests that a firm's dividend policy has no impact on stock price or cost of capital?
a. Dividend's Relevance Theory
b. Modigliani and Miller(MM) Hypothesis
c. Walter's Model
d. Gordon's Model

Question - 23 :
According to the Modigliani and Miller(MM) Hypothesis, what is the basis of equity value dependency?
a. Dividend size
b. Earning power
c. Retained earnings
d. Dividend payout ratio

Question - 24 :
In the MM Hypothesis, how does the stock value react to the size of dividends?
a. Stock value increases with larger dividends
b. Stock value remains unaffected
c. Stock value decreases with larger dividends
d. Stock value is inversely proportional to dividends

Question - 25 :
What does the MM Hypothesis assume regarding capital markets?
a. Perfect capital markets
b. Imperfect capital markets
c. Tax discrimination
d. Fixed investment policy

Question - 26 :
In the MM Hypothesis, what scenario results in shareholders facing a capital loss?
a. Firm pays cash dividends from reserves
b. Firm pays cash dividends from new issue of shares
c. Firm does not pay any dividend
d. All scenarios result in capital gain for shareholders

Question - 27 :
What is one of the key assumptions of Walter's Model regarding financing investment proposals?
a. Debt financing
b. Equity financing
c. Hybrid financing
d. Preference share financing

Question - 28 :
According to Walter's Model, what is assumed about the rate of return ('r') and the cost of capital ('Ke')?
a. They are variable
b. They are declining
c. They are constant
d. They are inversely proportional

Question - 29 :
What does Walter's Model assume about the firm's operation in terms of information availability?
a. Limited information
b. No information
c. Freely available information
d. Selectively available information

Question - 30 :
In which condition would shareholders prefer a lower dividend according to Walter's Model?
a. Growth-oriented company
b. Declining company
c. Stable company
d. All companies equally prefer lower dividends

Solution Key:

Q1	Q2	Q3	Q4	Q5	Q6	Q7	Q8	Q9	Q10
d	c	c	c	b	c	c	c	c	c
Q11	Q12	Q13	Q14	Q15	Q16	Q17	Q18	Q19	Q20
c	b	c	b	b	b	b	c	c	c
Q21	Q22	Q23	Q24	Q25	Q26	Q27	Q28	Q29	Q30
d	b	b	b	a	b	b	c	c	a

Description:

1. The primary concern of the Financing Decision is determining the optimal capital structure for the company.
2. The Investment Decision focuses on identifying and evaluating potential investment opportunities.
3. The main objective of the Dividend Decision is balancing the need for distributing profits to shareholders with the retention of earnings for future growth.
4. A share buyback, considered a form of dividend, reduces circulating shares, increasing future dividends per share for existing shareholders.
5. Ex-Dividend refers to shares that no longer entitle the holder to receive the upcoming dividend payment.
6. Investors purchasing shares on or after the ex-dividend date are not eligible to receive the declared dividend.
7. Cash Dividend is the most prevalent form and is paid in cash, cheque, or warrant, excluding in-kind payments.
8. Share Repurchases are viewed as a form of dividend distribution from a financial management perspective.
9. A Stock Dividend involves issuing new shares to existing shareholders without consideration.
10. A stock split makes the share affordable to small investors.
11. The primary purpose of a stock split is to regulate share prices, making them more tradable.
12. The Dividend Payout Ratio (D/P) influences the market price of shares by increasing share value with higher dividends.
13. The retention ratio (b) represents the portion of earnings retained in the equation for Growth (g).
14. The debt-equity ratio impacts the balance in the capital structure in the Determinants of Dividend Decisions.
15. With dividends growing at a constant rate of 'g,' the share price also grows at 'g.'
16. Practical Considerations regarding Financial Needs emphasize the importance of retained earnings as a source of finance.
17. Liquidity constraints on paying dividends are related to the firm's cash position.
18. Before April 2020, dividends were subject to dividend distribution tax (DDT).
19. A limitation of Gordon's Model is that the true intrinsic value of a stock is difficult to determine realistically.
20. In Gordon's Growth Model, 'g' represents the growth rate of dividends.
21. The Adjustment factor (Af) in the dividend adjustment formula of Linter's Model represents the Speed of adjustment.

22. Modigliani and Miller(MM) Hypothesis suggests that a firm's dividend policy has no impact on stock price or cost of capital.
23. Equity value dependency in the Modigliani and Miller(MM) Hypothesis is based on earning power.
24. According to the MM Hypothesis, the stock value remains unaffected by the size of dividends.
25. The MM Hypothesis assumes perfect capital markets.
26. In the MM Hypothesis, if the firm pays cash dividends from a new issue of shares, shareholders face a capital loss due to dilution.
27. Walter’s Model assumes that all investment proposals are to be financed exclusively through retained earnings, which implies equity financing.
28. Walter’s Model assumes that the rate of return ('r') and the cost of capital ('Ke') are constant.
29. Walter’s Model assumes the firm operates in a market where all investors are rational, and information is freely available to everyone.
30. In a growth-oriented company, shareholders can accept lower dividends because the value of their shares would be higher.

ICAI MCQs

Question - 1 :

Strict credit policy with customers may not result in
a. Faster Collections
b. Decline in Sales
c. Increase in Sales
d. Lower Collection Period

Question - 2 :

Gross Working Capital refers to
a. Current Assets - Current Liabilities
b. Current Liabilities - Current Assets
c. Current Assets
d. Current Liabilities

Question - 3 :

Which of the following is not a determinant of working capital
a. Nature of Business
b. Target Profit
c. Type of Product
d. Credit Policy

Question - 4 :

Increase in which of the following shall reduce the net operating cycle
a. Work in Process holding period
b. Raw Material Storage period
c. Receivables collection period
d. Credit period allowed by Suppliers

Question - 5 :

Strict credit policy with customers may not result in
a. Faster Collections
b. Decline in Sales
c. Increase in Sales
d. Lower Collection Period

Question - 6 :

Which of the following is not an example of current assets
a. Accrued Income
b. Cash & Bank
c. Short term advances to creditors
d. Bank Overdraft

Question - 7 :

An organization carrying higher levels of inventory is most probably following which policy of working capital management
a. Conservative
b. Aggressive
c. Moderate
d. Opportunistic

Question - 8 :

Which of these ratios could be a better indicator of Working Capital
a. Current Assets to Fixed Assets
b. Interest Coverage Ratio
c. Debt Equity Ratio
d. Financial Leverage

Question - 9 :
Operating in double shifts may not impact which of the below (in terms of units at least)
a. Work in Process Inventory
b. Raw Material Inventory
c. Finished Goods Inventory
d. Receivables

Question - 10 :
Need for cash can be categorized as any of these except
a. Transaction
b. Entertainment
c. Speculative
d. Precautionary

Question - 11 :
If a company has profits with a certain cash conversion or net operating cycle, considering reducing cash conversion cycle further, with other things remaining the same, would
a. Increase the profits which might not be in the same proportion as the number of days reduced in cash conversion cycle.
b. Reduce the profits in the same proportion as the number of days reduced in cash conversion cycle.
c. Convert profits to losses which might not be in the same proportion as the number of days reduced in cash conversion cycle
d. Increase profits in the same proportion as the number of days reduced in cash conversion cycle

Question - 12 :
How can a company improve its accounts receivable turnover?
a. Extend payment terms for customers
b. Increase credit limits for customers
c. Offer discounts for early payment
d. All of the above

Question - 13 :
As per Miller-Orr cash management model, when cash balance reaches lower limit then
a. It may be invested in securities
b. Loan may be taken
c. Some marketable securities may be liquidated
d. Creditor payments should be put on hold

Question - 14 :
Electronic funds transfer may eliminate most types of floats except
a. Billing Float
b. Mail Float
c. Cheque Processing Float
d. Bank Processing Float

Question - 15 :
Current Liabilities can be settled by
a. Creation of a new current liability
b. Use of Non-current assets
c. Creation of Non-Current Liability
d. Proceeds of Long-Term Investments

Question - 16 :
How is the quick ratio different from the current ratio?
a. The quick ratio includes inventory in its calculation, while the current ratio does not.
b. The quick ratio excludes inventory from its calculation, while the current ratio includes it.
c. The quick ratio measures a companys ability to pay long-term debts, while the current ratio measures its ability to pay short-term debts.

d. The quick ratio measures a companys profitability, while the current ratio measures its liquidity.

Question - 17 :
All of these are methods of cash budgeting except
a. Adjusted Balance Sheet Method
b. Adjusted Income Method
c. Receipts & Payment Method
d. Taxable Income Method

Question - 18 :
What is the relationship between the allowance for doubtful accounts and working capital
a. When bad debts expense is recorded for the period, working capital decreases.
b. When bad debts expense is recorded for the period, cash increases
c. When an account is written off against the allowance, working capital decreases
d. When an account is written off against the allowance, cash decreases

Solution key

Q1	Q2	Q3	Q4	Q5	Q6	Q7	Q8	Q9	Q10	Q11	Q12
c	c	b	d	c	d	a	a	a	b	a	c
Q13	Q14	Q15	Q16	Q17	Q18						
c	a	a	b	d	a						

Description

1. Strict credit policy would mean lesser credit period being allowed to customers. That would result in faster collections but may result in decline in sales as customers may get better credit terms from competitors.

2. Working Capital or Net Working Capital represents difference between Current Assets and Current Liabilities. Total Current Assets is also known as Gross Working Capital

3. The working capital needed in any business may depend on many factors including nature of business & product, credit policy, seasonal fluctuations et. While liquidity and profitability are two sides which need to balance as part of working capital management, target profit is not a determinant of working capital requirements.

4. Operating Cycle = Raw Material Storage Period + Work in Process holding period + Finished Goods storage period + Debtors correction period – Credit period allowed by suppliers Hence, amongst the given options, increase in the credit period allowed by suppliers would reduce the operating cycle while increase in other three options may increase the operating cycle.

5. Strict credit policy would mean lesser credit period being allowed to customers. That would result in faster collections but may result in decline in sales as customers may get better credit terms from competitors

6. Current assets are short-term asset that a company expects to use up, convert into cash, or sell within one fiscal year or operating cycle. While first three are its examples, bank overdraft is an obligation that a company needs to pay and hence is a liability.

7. Conservative working capital policy includes keeping sufficient surplus of required resources for the operations without much relying on the operational efficiencies. Higher level of working capital is an example of conservative working capital policy. In aggressive policy, an organization may prefer to keep lower levels of inventory and other current assets.

8. Amongst the given options, current assets to fixed assets ratio is the only indicator which references one of the two components of working capital i.e. current assets. Higher ratio indicates higher level of current assets in proportion to fixed assets. Other three ratios are indications of long term solvency.

9. When a manufacturing unit decides to operate in double shift from single shift, it shall need more resources in terms of raw materials, labor etc and accordingly the inventory of finished goods and balance of receivables may increase with increase in revenue. However, the number of units that are in progress at the end of first shift shall be picked by workers coming in second shift to complete the same first and then proceed with next lot. Hence, when the second shift workers leave for the day, they would have similar number of units in progress at the end of the second shift.

10. Need for cash in any organization may be based on transaction motive (day to day transactions), speculation motive (taking advantage of temporary speculative opportunity) and precautionary motive (for emergency purposes). Entertainment motive is not the driving factor behind the need for cash

11. Shorter the cash conversion cycle of an entity, lesser is the need for financing, leading to lesser cost of debt and thus improving the process efficiencies and hence profitability of the company. But the profitability cannot be said to increase or decrease in the same proportion as the change in the number of days in the cash conversion cycle. Thus, reducing cash conversion cycle might increase the profits which might not be in the same proportion as the number of days reduced in cash conversion cycle.

12. Offering discounts for early payment is an effective way for a company to improve its accounts receivable turnover. This can incentivize customers to pay their invoices more quickly and efficiently, leading to faster cash flow and improved liquidity. While extending payment terms and increasing credit limits can also impact accounts receivable turnover, they must be done with appropriate risk management measures to avoid harming the company's liquidity. Therefore, offering discounts for early payment is generally the most effective way for a company to improve its accounts receivable turnover

13. The Miller-Orr cash management model attempts to maintain the cash balance of any organization between the two limits – an upper and lower and a middle value. When the level reaches upper limit, it advices to invest some surplus so as to keep the balance around middle value. On the other hand, if the cash balance reaches lower limit, it suggest to liquidate some marketable securities to reinstate the cash balance to the middle or return value.

14. Electronic funds transfer can eliminate the mail float, cheque processing & bank processing floats as there is no cheque that needs to be mailed or deposited in that case. However, billing float that relates to delay in raising of invoice doesn't get impacted by electronic payments.

15. Current Liabilities are those current obligations that will be paid or settled with in one year or operating cycle which ever is longer. Also, current liabilities either require use of current assets or creation of another current liability to be settled. If it uses proceeds from non-current liability then it shall have to be reclassified as a non-current liability.

16. The quick ratio and the current ratio are both financial ratios used to measure a company's liquidity, or its ability to pay its debts. However, the main difference between the two ratios is that the quick ratio excludes inventory from its calculation, while the current ratio includes it. The quick ratio is considered a more conservative measure of liquidity because it only includes assets that can be quickly converted into cash, whereas the current ratio provides a broader view of the company's overall liquidity.

17. Cash budgeting can be done using any of the three methods i.e. receipts & payments method (most common), adjusted balance sheet & adjusted income method. There is no such method called as Taxable Income Methods that may be used.

18. In accrual basis of accounting, a bad debt expense is recorded as an expense for the period, with a corresponding allowance for doubtful debts as a contra account to accounts receivable. As accounts receivable is reduced by the contra entry, it also resulted in a decrease in the working capital. Remember working capital is computed as the difference between current assets and current liabilities. So, a decrease in A/R naturally means a decrease in current assets and working capital. Actual writing off of a debtor shall not have any impact.

Practice MCQs

Question - 1.

What defines current assets?
a. Assets held for long-term investment
b. Assets expected to be realized, sold, or consumed within the operating cycle or twelve months
c. Assets related to fixed assets
d. Assets generated from long-term debts

Question - 2.

Which of the following is a criterion for classifying liabilities as current?
a. Settlement within the operating cycle
b. Settlement using long-term assets
c. Settlement within five years
d. Settlement using future assets

Question - 3.
What is the primary objective of working capital management?
a. Maximize long-term investments
b. Ensure efficient operation by monitoring and utilizing current assets
c. Reduce current liabilities
d. Minimize cash flows for day-to-day expenses

Question - 4.
What is the difference between gross working capital and net working capital?
a. Gross includes long-term assets, while net excludes them
b. Gross is the total of current assets, while net is the difference between current assets and liabilities
c. Gross represents short-term financial health, while net indicates long-term stability
d. Gross includes permanent working capital, while net includes temporary working capital

Question - 5.
What is the characteristic of permanent working capital?
a. Remains unaffected by short-term fluctuations
b. Varies with business cycles
c. Is funded by short-term sources of finance
d. Increases with temporary operational needs

Question - 6.
In working capital management, what is the purpose of temporary working capital?
a. Supports regular business operations
b. Addresses short-term working capital needs arising from fluctuations
c. Remains invested continuously
d. Acts as a base level for day-to-day activities

Question - 7.
What is the risk associated with excessive working capital?
a. Increased insolvency risk
b. Inability to meet financial obligations
c. Idle funds and missed investment opportunities
d. Hindered operational efficiency

Question - 8.
What does a working capital manager need to consider for expansion decisions?
a. Only new asset costs
b. Current assets and liabilities
c. Previous year's financial statements
d. Long-term investment opportunities

Question - 9.
What is the importance of estimating working capital needs in organizations?
a. Affects long-term investments
b. Irrelevant for long-term survival
c. Influences the ability to meet financial obligations
d. Impacts short-term profitability

Question - 10.
What is the optimal benchmark for the current ratio according to widely accepted standards?
a. 1
b. 2
c. 3
d. 4

Question - 11.
What is the primary objective of liquidity and profitability management in working capital?
a. Maximize long-term investments

b. Ensure uninterrupted day-to-day business operations
c. Minimize current assets
d. Increase idle assets

Question - 12.
What is a key advantage of Commercial Papers (CP) as a source of short-term funds?
a. Unsecured basis
b. Maturity of more than 1 year
c. Limited denominations
d. Issued only in tight money market conditions

Question - 13.
In decision tree analysis for credit granting, what is assessed?
a. Average collection period
b. Probability of recovery and default
c. Credit limits
d. Total sales

Question - 14.
What is the significance of the three Es in working capital management?
a. Efficiency, Economy, and Earnings
b. Economy, Effectiveness, and Earnings
c. Economy, Efficiency, and Effectiveness
d. Economy, Efficiency, and Extra earnings

Question - 15.
What influences the policy decision for investment in working capital?
a. Nature of the industry
b. Ignoring trade policies
c. Minimizing volume of sales
d. Ignoring organizational objectives

Solution Key

Q1.	Q2.	Q3.	Q4.	Q5.	Q6.	Q7.	Q8.	Q9.	Q10.
b	a	b	b	a	b	c	b	c	b
Q11.	Q12.	Q13.	Q14.	Q15.					
b	a	b	c	a					

Description
1. **Correct Option: b.** Assets expected to be realized, sold, or consumed within the operating cycle or twelve months
Current assets are those expected to be realized, sold, or consumed within the operating cycle or twelve months.
2. **Correct Option: a.** Settlement within the operating cycle
Liabilities are classified as current when expected to be settled within the normal operating cycle or twelve months.
3. **Correct Option: b.** Ensure efficient operation by monitoring and utilizing current assets
The primary objective of working capital management is to ensure efficient operation by monitoring and utilizing current assets and liabilities.
4. **Correct Option: b.** Gross is the total of current assets, while net is the difference between current assets and liabilities
Gross working capital is the total of current assets, while net working capital is the difference between current assets and liabilities.
5. **Correct Option: a.** Remains unaffected by short-term fluctuations

Permanent working capital remains invested continuously, unaffected by short-term fluctuations.

6. **Correct Option: b.** Addresses short-term working capital needs arising from fluctuations
Temporary working capital addresses short-term working capital needs arising from fluctuations in sales volume or seasonal demand.
7. **Correct Option: c.** Idle funds and missed investment opportunities
Excessive working capital leads to idle funds and incurs costs, missing opportunities for long-term investments.
8. **Correct Option: b.** Current assets and liabilities
Expansion decisions should consider not only new asset costs but also additional current assets required.
9. **Correct Option: c.** Influences the ability to meet financial obligations
Organizations must strategically estimate working capital needs as it influences the ability to meet financial obligations.
10. **Correct Option: b.** 2
According to widely accepted standards, the current ratio should aim for 2 as an optimal benchmark.
11. **Correct Option: b.** Ensure uninterrupted day-to-day business operations
The primary objective of liquidity and profitability management in working capital is to ensure uninterrupted day-to-day business operations.
12. **Correct Option: a.** Unsecured basis
A key advantage of Commercial Papers (CP) as a source of short-term funds is that it is unsecured and lacks restrictive conditions.
13. **Correct Option: b.** Probability of recovery and default
In decision tree analysis for credit granting, the assessment involves determining the chances of recovery and default, forming a probability distribution.
14. **Correct Option: c.** Economy, Efficiency, and Effectiveness
The significance of the three Es in working capital management is Economy, Efficiency, and Effectiveness.
15. **Correct Option: a.** Nature of the industry
Factors influencing the policy decision for investment in working capital include the nature of the industry, types of products, manufacturing vs. trading vs. service orientation, and volume of sales and credit policy.