FINANCIAL MANAGEMENT
CA INTERMEDIATE

FM THEORY QUESTIONS COMPILER

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NOV 2022 EXAM & ONWARDS

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Kyuki hum humare parents ke bina, Kuch bhi nahi hai"

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INDEX

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CHAPTER 1- SCOPE AND OBJECTIVES OF FINANCIAL MANAGEMENT

Q. 1.1 **PYQ Dec 21**

Explain in brief the phases of the evolution of financial management.

Ans.

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

The three stages of its evolution are:

1) **The Traditional Phase:** During this phase, financial management was considered necessary only during **occasional events** such as **takeovers, mergers, expansion, liquidation**, etc. Also, when taking financial decisions in the organisation, **the needs of outsiders** (investment bankers, people who lend money to the business and other such people) to the business **was kept in mind**.

2) **The Transitional Phase:** During this phase, the **day-to-day problems** that financial managers faced were given importance. The general problems related to **funds analysis, planning and control** were given more attention in this phase.

3) **The Modern Phase:** Modern phase is **still going on**. The scope of financial management has greatly increased now. It is important to carry out financial analysis for a company. This analysis helps in decision making. During this phase, **many theories have been developed** regarding efficient markets, **capital budgeting**, option pricing, **valuation models** and also in several other important fields in financial management. Here, financial management is viewed as a **supportive and facilitative function**, not only for top management but **for all levels of management**.

Q. 1.2 **PYQ May 18, Nov 19, MTP Oct 18, Oct 21**

What are the two main aspects of the Finance Function?
OR
Explain three finance function decisions.
OR
DISCUSS three major decisions taken by a finance manager to maximize wealth of shareholders.

Ans.

Value of a firm will **depend on various finance functions/decisions**. It can be expressed as:

V = f (I, F, D)

The finance functions are divided into long term and short term functions/decisions

Long term Finance Function Decisions

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	• **Investment decisions (I):** These decisions relate to the **selection of assets in which funds will be invested** by a firm. Funds procured from different sources have to be invested in various kinds of assets. Long term funds are used in a project for various **fixed assets** and also for **current assets.** • **Financing decisions (F):** These decisions relate to **acquiring the optimum finance to meet financial objectives** and seeing that fixed and working capital are **effectively managed**. • **Dividend decisions(D):** These decisions relate to the determination as to **how much** and **how frequently cash can be paid out of the profits** of an organisation as income **for its owners/shareholders**. The **owner** of any profit-making organization looks for **reward** for his investment in **two ways**, the **growth of the capital invested** and the **cash paid out as income**; for a sole trader this income would be termed as drawings and for a limited liability company the term is dividends. **Short- term Finance Decisions/Function** **Working capital Management (WCM):** Generally **short term decision** are reduced to **management** of **current asset** and **current liability** (i.e., working capital Management)

Q. 1.3	**MTP Oct 19, RTP May 19, Nov 19**
	DISCUSS the Inter relationship between investment, financing and dividend decisions. **OR** **Inter relationship between investment, financing and dividend decisions.**
Ans.	➢ The finance functions are divided into three major decisions, viz., investment, financing and dividend decisions. ➢ It is correct to say that these decisions are **inter-related** because the **underlying objective** of these three decisions is the **same**, i.e. **maximisation of shareholders' wealth**. ➢ One has to **consider the joint impact** of these decisions o**n the market price of the company's shares** and these decisions should also be **solved jointly**. ➢ The decision to **invest in a new project** needs the **finance** for the investment. The **financing decision**, in turn, is **influenced by** and influences **dividend decision** because **retained earnings used in internal financing deprive shareholders of their dividends**. An **efficient financial management** can **ensure optimal joint decisions**. The above three decisions are briefly examined below in the light of their inter-relationship and to see how they can help in maximising the shareholders' wealth i.e. market price of the company's shares.

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	• Explain the 3 functions in short like in previous question.

Q. 1.4	**PYQ Jan 21, RTP Nov 21**
	State four tasks involved to demonstrate the importance of good Financial Management **OR** **DISCUSS the points that demonstrates the Importance of good financial management.**
Ans.	**The best way to demonstrate the importance of good financial management is to describe some of the tasks that it involves:** • Taking care **not to over-invest in fixed assets** • **Balancing** cash-**outflow** with cash-**inflows** • Ensuring that there is a **sufficient level of short-term working capital** • **Setting sales revenue targets** that will deliver growth • **Increasing gross profit** by setting the **correct pricing** for products or services • **Controlling** the level of **general and administrative expenses** by **finding more cost-efficient ways** of running the day-to-day business operations, and • **Tax planning** that will **minimize the taxes** a business has to pay.

Q. 1.5	**PYQ Nov 18, MTP Oct 21**
	Write two main objectives of Financial Management
Ans.	i. **Profit Maximisation** It has traditionally been argued that the **primary objective** of a company is to earn profit; hence the objective of financial management is also profit maximisation. ii. **Wealth / Value Maximization** **Shareholders wealth** is result of **cost benefit analysis** adjusted with their timing & risk i.e. time value of money. This is **real objective** of Financial Mgt. So, Wealth = Present Value of benefits – Present Value of Costs

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Q. 1.6	RTP May 20, May 21, May 22
	"The profit maximization is not an operationally feasible criterion." IDENTIFY. OR Profit Maximization cannot be the sole objective of a company".

Ans.

The profit maximisation is not an operationally feasible criterion. This statement is true because **profit maximisation** can be a **short-term objective** for any organisation and **cannot be its sole objective**. Profit maximization **fails to serve as an operational criterion for maximizing the owner's economic welfare**.

It suffers from the following limitations:

a) **The term profit is vague. It does not clarify what exactly it means.** It conveys a **different meaning to different people**. For example, profit may be in **short-term** or **long-term** period; it may be **total profit** or **rate of profit**.

b) **Profit maximisation has to be attempted with a realisation of risks involved** There is a **direct relationship** between **risk** and **profit**. **Higher the risk**, **higher is the possibility** of profits. If **profit maximisation is the only goal**, then **risk** factor is altogether **ignored**. This implies that finance manager will **accept highly risky proposals also**, if they give high profits.

c) **Profit maximisation as an objective does not take into account the time pattern of returns.** **Proposal A** may give a **higher amount of profits** as compared to proposal **B**, **yet** if the **returns of proposal A** begin to **flow say 10 years later**, proposal **B may be preferred** which may have lower overall profit but the **returns flow is more early and quick**.

d) **Profit maximisation as an objective is too narrow.** It **fails** to **take into account the social considerations** as also the **obligations to various interests of workers, consumers, society,** as well as ethical trade practices. If these **factors are ignored**, a **company cannot survive for long**. Profit maximization at the cost of social and moral obligations is a short-sighted policy

Q. 1.7	MTP Mar 19
	EXPLAIN as to how the wealth maximisation objective is superior to the profit maximization objective What is the cost of these sources?

Ans.

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

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

The value maximisation objective of a firm is superior to its profit maximisation objective due to following reasons:

1. The value maximisation objective of a firm **considers all future cash flows**, **dividends**, **earning per share**, **risk of a decision** etc. whereas profit

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	maximisation objective does not consider the effect of EPS, dividend paid or any other returns to shareholders or the wealth of the shareholder. 2. A firm that wishes to maximise the shareholders wealth may **pay regular dividends** whereas a firm with the objective of profit maximisation may refrain from dividend payment to its shareholders. 3. **Shareholders would prefer** an **increase in the firm's wealth** against its generation of increasing flow of profits. 4. The **market price** of a share **reflects the shareholders expected return**, considering the **long-term prospects** of the firm, reflects the differences in timings of the returns, considers risk and recognizes the importance of distribution of returns.

Q. 1.8	**PYQ May 22**
	State advantages of "Wealth Maximization" goals in Financial Management
Ans.	(i) Emphasizes the long-term gains. (ii) Recognises risk or uncertainty. (iii) Recognises the timing of returns. (iv) Considers shareholders' return.

Q. 1.9	**PYQ Jul 21**
	List out the steps to be followed by the manager to measure and maximize the Shareholder's Wealth
Ans.	**For measuring and maximising shareholders' wealth, manager should follow:** • **Cash Flow approach** not Accounting Profit • **Cost benefit analysis** • Application of **time value of money**.

Q. 1.10	**RTP May 19**
	Write short notes on - Functions of Finance Manager
Ans.	The Finance Manager's main objective is to **manage funds** in such a way so as to ensure their optimum utilisation and their procurement in a manner that the **risk, cost and control** considerations are **properly balanced** in a given situation. To achieve these objectives the Finance Manager performs the following functions: i. **Estimating the requirement of Funds:** Both for **long-term** purposes i.e. investment in fixed assets and for **short-term** i.e. for working capital. **Forecasting** the requirements of funds involves the use of techniques of **budgetary control** and **long-range planning**.

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	ii. **Decision regarding Capital Structure:** Once the requirement of funds has been estimated, a decision regarding various **sources from which these funds would be raised** has to be taken. A **proper balance** has to be made between the **loan funds** and **own funds**. He has to ensure that he **raises sufficient funds**. iii. **Investment Decision:** The investment of funds, in a project has to be made after **careful assessment of various projects** through **capital budgeting**. **Assets management policies** are to be laid down regarding various items of current assets. For e.g. **receivable** in coordination with **sales manager**, **inventory** in coordination with **production manager**. iv. **Dividend decision:** The finance manager is concerned with the decision as to **how much to retain** and **what portion to pay as dividend** depending on the company's policy. **Trend** of earnings, trend of share market prices, **requirement of funds for future growth**, cash flow situation etc., are to be considered. v. **Evaluating financial performance:** A finance manager has to constantly **review the financial performance** of the **various units of organisation** generally in terms of **ROI** Such a review helps the management in seeing **how the funds have been utilised in various divisions** and what can be done to **improve** it. vi. **Financial negotiation:** The finance manager plays a very important role in carrying out **negotiations with the financial institutions**, **banks** and public depositors for raising of funds on **favourable terms**. vii. **Cash management:** The finance manager lays down the cash management and cash disbursement policies with a view to supply **adequate funds to all units of organisation** and to ensure that there is **no excessive cash**. viii. **Keeping touch with stock exchange:** Finance manager is required to **analyse major trends in stock market** and their **impact on the price** of the company share.

Q. 1.11	**MTP Sep 22**
	A finance executive of an organisation plays an important role in the company's goals, policies, and financial success. WHAT his responsibilities include?
Ans.	A finance executive of an organisation plays an important role in the company's goals, policies, and financial success. His responsibilities include: i. **Financial analysis and planning:** Determining the proper amount of funds to employ in the firm, i.e. designating the size of the firm and its rate of growth. ii. **Investment decisions:** The efficient allocation of funds to specific assets. iii. **Financing and capital structure decisions:** Raising funds on favourable terms as possible i.e. determining the composition of liabilities. iv. **Management of financial resources** (such as working capital). v. **Risk management:** Protecting assets.

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Q. 1.12	PYQ May 18, Nov 20
	What are the roles of Finance Executive in Modern World? **OR** **List out the role of Chief Financial Officer in today's World**
Ans.	**Role of Finance Executive in modern World** Today, the role of Financial Executive, is no longer confined to accounting, financial reporting and risk management. Some of the key activities that highlight the changing role of a Finance Executive are as follows:- • **Budgeting** • **Forecasting** • Managing **M & As** • **Profitability analysis** relating to customers or products • **Pricing Analysis** • Decisions about **outsourcing** • Overseeing the **IT function**. • Overseeing the **HR function**. • **Strategic planning** (sometimes overseeing this function). • **Regulatory compliance**. • **Risk management**.

Q. 1.13	MTP Mar 22
	'Financial distress is a position where Cash inflows of a firm are inadequate to meet all its current obligations.' **Based on above mentioned context, EXPLAIN Financial Distress along with Insolvency.**
Ans.	➢ There are **various factors** like price of the product, demand, price of inputs e.g., raw material, labour etc., which is **to be managed by an organisation on a continuous basis**. **Proportion of debt** also need to be **managed** by an organisation very delicately. ➢ **Higher debt** requires **higher interest** and if the **cash inflow is not sufficient** then it will **put lot of pressure** on the organisation. Both **short term and long-term creditors** will **put stress** to the firm. ➢ If **all the above factors** are **not well managed** by the firm, it can create situation known as **distress**, so **financial distress** is a position where **Cash inflows of a firm are inadequate** to meet all its current obligations. ➢ Now if **distress continues for a long period** of time, firm may have to **sell its asset**, even many times at a lower price. Further when **revenue is inadequate** to revive the situation, firm will **not be able to meet its obligations** and become **insolvent**.

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	➢ So, **insolvency** basically means **inability of a firm to repay various debts** and is a result of **continuous financial distress**.

Q. 1.14	**MTP Aug 18, RTP Nov 20, May 22**
	STATE Agency Cost. DISCUSS the ways to reduce the effect of it. **OR** **DISCUSS Agency problem and its cost. HOW it arises and HOW it can be addressed?**
Ans.	➢ In a sole proprietorship firm, partnership etc., owners participate in management but **in corporate**, **owners are not active in management** so, there is a **separation between shareholders and managers**. ➢ In theory **managers should act in the best interest of shareholders however in reality**, **managers may try to maximise their individual goal** like salary, perks etc., so there is a principal-agent relationship between managers and owners, which is known as **Agency Problem**. ➢ In a nutshell, Agency Problem is the **chances that managers may place personal goals ahead of the goal of owners**. ➢ **Agency Problem leads to Agency Cost**. Agency cost is the **additional cost borne by the shareholders to monitor the manager** and **control their behaviour** so as to maximise shareholders wealth. Generally, Agency Costs are of **four types** **(i) monitoring** **(ii) opportunity** **(iii) bonding** **(iv) structuring** However, following **efforts can be made to address Agency Cost**: 1) **Managerial compensation** to be **linked to profit** of the company to some extent with the long term objectives of the company. 2) **Employees' Stock option plan (ESOP)** is also designed to address the issue with the underlying assumption that maximisation of the stock price is the objective of the investors. 3) Effective **monitoring through corporate governance** can be done

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CHAPTER 2- TYPES OF FINANCING

Q. 2.1 — MTP Oct 21

BRIEFLY describe the financial needs of a business.

Ans.

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

Long-term financial needs: Such needs generally refer to those requirements of funds which are for a **period exceeding 5-10 years**. All investments in **plant, machinery, land, buildings,** etc., are considered as long-term financial needs.

Medium- term financial needs: Such requirements refer to those funds which are required for a **period exceeding one year but not exceeding 5 years**.

Short- term financial needs: Such type of financial needs arises to **finance current assets** such as **stock, debtors, cash**, etc. Investment in these assets is known as **meeting of working capital requirements** of the concern for a period not exceeding one year.

Q. 2.2 — MTP May 20

"Financing a business through borrowing is cheaper than using equity." Briefly EXPLAIN.

Ans.

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

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

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

Q. 2.3 — MTP Nov 21

BRIEF out any four types of Preference shares along with its feature.

Ans.

Sl. No.	Type of Preference Shares	Salient Features
1	Cumulative	**Arrear Dividend** will **accumulate**.
2	Non-cumulative	**No right to arrear dividend**.
3	Redeemable	**Redemption** should be **done**.
4	Participating	**Can participate in the surplus** which remains **after payment to equity** shareholders.
5	Non- Participating	**Cannot participate in the surplus** after payment of fixed rate of Dividend.
6	Convertible	**Option** of **converting into equity Shares**

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Q. 2.4	**RTP May 21**
	DISCUSS the advantages and disadvantages of raising funds by issue of preference shares.
Ans.	**Advantages-** (i) **No dilution in EPS** on enlarged capital base – On the other hand if equity shares are issued it reduces EPS, thus affecting the market perception about the company. (ii) There is also the **advantage of leverage** as it **bears a fixed charge** (because companies are required to pay a **fixed rate of dividend** in case of issue of preference shares).**Non-payment of preference dividends** does **not force a company into liquidity**. (iii) There is **no risk of takeover** as the preference shareholders **do not have voting rights** except where dividend payment are in arrears. (iv) The **preference dividends** are **fixed and pre-decided**. Hence preference shareholders **cannot participate in surplus profits** as the ordinary shareholders can **except** in case of **participating** preference shareholders. (v) Preference capital **can be redeemed after a specified period**. **Disadvantages** (i) **Preference dividend is not tax deductible** and so does not provide a tax shield to the company. Hence, preference shares are **costlier** to the company **than debt** e.g. debenture. (ii) Preference dividends are **cumulative** in nature. This means that if in a **particular year preference dividend** are **not paid** they shall be **accumulated and paid later**. Also, if these dividends are not paid, no dividend can be paid to ordinary shareholders. The non-payment of dividend to ordinary shareholders could seriously impair the reputation of the concerned company.

Q. 2.5	**MTP Nov 21, Mar 22, PYQ Jan 21**
	EXPLAIN: Callable bonds and Puttable bonds.
Ans.	**Callable bonds:** A callable bond has a **call option** which **gives the issuer the right to redeem the bond before maturity** at a **predetermined price** known as the **call price** (Generally at a premium). **Puttable bonds:** Puttable bonds **give the investor a put option** (i.e. the right to sell the bond) back to the company **before maturity**.

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Q. 2.6	MTP Sep 22
	STATE in brief four features of Plain Vanilla Bond.
Ans.	➢ The issuer would pay the **principal** amount along **with** the **interest rate**. ➢ This type of bond would **not have any options**. ➢ This bond can be issued in the form of **discounted bond** or can be issued in the form of **coupon bearing bond**.

Q. 2.7	PYQ Nov 18
	Answer the following: **Explain in brief following Financial Instruments:** i. Euro Bonds ii. Floating Rate Notes iii. Euro Commercial paper iv. Fully Hedged Bond
Ans.	i. **Euro bonds:** Euro bonds are debt instruments which are **not denominated in the currency of the country in which they are issued**. E.g. a Yen note floated in Germany. ii. **Floating Rate Notes:** They are **issued up to seven years** maturity. **Interest rates** are **adjusted to reflect the prevailing exchange rates**. They provide **cheaper money than foreign loans**. iii. **Euro Commercial Paper(ECP):** ECPs are **short term money market instruments**. They are for **maturities less than one year**. They are usually **designated in US Dollars**. iv. **Fully Hedged Bond:** In foreign bonds, the **risk of currency fluctuations** exists. **Fully hedged bonds eliminate the risk** by **selling in forward markets** the **entire stream of principal and interest payments**.

Q. 2.8	MTP Mar 22, RTP Nov 22
	STATE in brief four features of Samurai Bond.
Ans.	➢ Samurai bonds are **denominated in Japanese Yen (JPY)** ➢ Issued in **Tokyo** ➢ **Issuer Non- Japanese Company** ➢ Regulations: Japanese ➢ Purpose: **Access of capital available in Japanese market** ➢ Issue proceeds can be used to **fund Japanese operation** ➢ Issue proceeds can be used to **fund a company's local opportunities**. ➢ It can also be used to **hedge foreign exchange risk**

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Q. 2.9	MTP Nov 21, PYQ Dec 21
	Briefly DESCRIBE bridge finance.
Ans.	➢ Bridge finance refers to **loans taken by a company** normally **from commercial banks for a short period** because of **pending disbursement of loans sanctioned** by financial institutions. ➢ Normally, it **takes time for financial institutions to disburse loans** to companies. However, **once the loans are approved** by the term lending institutions, companies, in order **not to lose further time in starting their projects**, **arrange short term loans** from commercial banks. ➢ The bridge loans are **repaid/ adjusted out of the term loans as and when disbursed** by the concerned institutions. ➢ Bridge loans are normally **secured by hypothecating movable assets**, **personal guarantees and demand promissory notes**. ➢ Generally, the **rate of interest** on bridge finance is **higher** as compared with that on term loans

Q. 2.10	MTP Sep 22
	WHAT is the meaning of Venture Capital Financing? STATE some characteristics.
Ans.	**Venture capital financing** refers to **financing of new high risky venture** promoted by qualified **entrepreneurs** who **lack experience and funds** to give shape to their ideas. Here, venture capitalist make investment to **purchase equity or debt** securities **from inexperienced entrepreneurs** who **undertake risky ventures** with potential to succeed in future. Some of the **characteristics of Venture Capital financing** are: ➢ It is basically an **equity finance** in **new companies**. ➢ It can be viewed as a **long-term investment** in **growth-oriented small/medium firms**. ➢ Apart from providing funds, the investor also **provides support in form of sales strategy**, **business networking** and **management expertise**, **enabling the growth** of the entrepreneur.

Q. 2.11	RTP Nov 21, PYQ Nov 20
	EXPLAIN some common methods of Venture capital financing.
Ans.	**Venture capital (VC)** firms typically **invest in businesses** that have **proven their revenue model**, or if not, at least have a **sizable and rapidly-growing customer base** with a revenue strategy in clear sight. (i) **Equity financing:** The venture capital undertakings generally require funds for a longer period but **may not be able to provide returns** to the investors **during the initial stages**. Therefore, the venture capital **finance** is **generally provided**

	by way of equity share capital. The equity contribution of venture capital firm does not exceed 49% of the total equity capital of venture capital undertakings so that the effective control and ownership remains with the entrepreneur. (ii) **Conditional loan:** A conditional loan is repayable in the form of a royalty after the venture is able to generate sales. No interest is paid on such loans. In India venture capital financiers charge royalty ranging between 2 and 15 per cent; actual rate depends on other factors of the venture such as gestation period, cash flow patterns, risk and other factors of the enterprise. Some Venture capital financiers give a choice to the enterprise of paying a high rate of interest instead of royalty on sales once it becomes commercially sound. (iii) **Income note:** It is a hybrid security which combines the features of both conventional loan and conditional loan. The entrepreneur has to pay both interest and royalty on sales but at substantially low rates. (iv) **Participating debenture:** Such security carries charges in three phases — ➢ in the **start-up phase** no interest is charged, ➢ **next stage**, low rate of interest charged up to particular level of operation, ➢ **after that**, a high rate of interest is required to be paid.

Q. 2.12	PYQ May 19, MTP Oct 19, RTP May 19, May 20
	What is the process of Debt Securitisation? OR What is debt securitisation? EXPLAIN the basics of debt securitisation process. OR Write short notes on Debt securitization.
Ans.	It is a method of recycling of funds. It is especially beneficial to financial intermediaries to support the lending volumes. Assets generating steady cash flows are packaged together and against this asset pool, market securities can be issued, e.g. housing finance, auto loans, and credit card receivables. i. **The origination function –** A borrower seeks a loan from a finance company or bank. The credit worthiness of borrower is evaluated and contract is entered into with repayment schedule structured over the life of the loan. ii. **The pooling function –** Similar loans on receivables are clubbed together to create an underlying pool of assets. The pool is transferred in favour of Special purpose Vehicle (SPV), which acts as a trustee for investors. iii. **The securitisation function –** SPV will structure and issue securities on the basis of asset pool. The securities carry a coupon and expected maturity which can be asset based/ mortgage based. These are generally sold to investors through merchant bankers. Investors are – pension funds, mutual funds, insurance funds.

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	The process of securitization is generally **without recourse** i.e. **investors bear the credit risk** and **issuer** is under an **obligation to pay** to investors **only if** the **cash flows are received by him** from the collateral. The **benefits to the originator** are that **assets are shifted off the balance sheet**, thus giving the originator recourse to **off-balance sheet funding**.

Q. 2.13	RTP Nov 20, Nov 22
	COMPARE between Financial Lease and Operating Lease. OR Under financial lease, lessee bears the risk of obsolescence; while under operating lease, lessor bears the risk of obsolescence. In view of this, you are required to COMPARE the financial lease and operating lease.
Ans.	

	Finance Lease	Operating Lease
1.	The **risk and reward incident to ownership** are **passed on to the lessee**. The **lessor** only remains the **legal owner** of the asset	The **lessee** is **only provided the use of the asset** for a certain time. **Risk** incident to ownership **belong wholly to the lessor**.
2.	The **lessee** bears the **risk of obsolescence**	The **lessor** bears the risk of obsolescence.
3.	The **lessor** is **interested in his rentals** and **not in the asset**. He must get his principal back along with interest. Therefore, the lease is non-cancellable by either party	As the **lessor does not have difficulty in leasing** the **same asset to other willing lessor**, the lease is kept **cancelable by the lessor**.
4.	The **lessor enters into the transaction** only as **financier**. He **does not bear the cost of repairs, maintenance or operations**	Usually, the **lessor bears** cost of repairs, maintenance or operations
5.	The **lease is usually full payout**, that is, the sin**gle lease repays the cost of the asset** together **with** the **interest**	The **lease** is usually **non-payout**, since the **lessor expects to lease the same asset** over and over again **to several users**

Q. 2.14	PYQ Nov 18
	Discuss the Advantages of Leasing.
Ans.	i. **Lease may low cost alternative:** Leasing is **alternative to purchasing**. As the lessee is to make a series of payments for using an asset, a lease arrangement is similar to a debt contract. The **benefit of lease** is based on a **comparison between leasing and buying an asset**. Many lessees find lease more attractive because of low cost.

ii. **Tax benefit:** In certain cases **tax benefit of depreciation** available for owning an asset may be **less than** that available for **lease payment**

iii. **Working capital conservation:** When a firm buy an equipment by borrowing from a **bank** (or financial institution), they **never provide 100% financing**. But **in case of lease one gets normally 100% financing**. This enables conservation of working capital.

iv. **Preservation of Debt Capacity:** So, **operating lease does not matter in computing debt equity ratio**. This enables the lessee to go for debt financing more easily. The **access to and ability** of a firm to **get debt financing** is called **debt capacity** (also, reserve debt capacity).

v. **Obsolescence and Disposal:** After purchase of leased asset there may be technological obsolescence of the asset. To **retain competitive advantage** the lessee as user may have to **go for the upgraded asset**

Q. 2.15	PYQ May 19
	Give any two limitations of leasing.
Ans.	1) The **lease rentals** become **payable soon after the acquisition** of assets and **no moratorium period** is permissible as in case of term loans from financial institutions. The lease arrangement may, therefore, **not be suitable for setting up of the new projects** as it would entail cash outflows even before the project comes into operation. 2) The leased assets are purchased by the lessor who is the owner of equipment. The **seller's warranties for satisfactory operation of the leased assets may sometimes not be available to lessee**. 3) **Lessor** generally **obtains credit facilities from banks** etc. to **purchase the leased equipment** which are subject to **hypothecation charge in favour of the bank**. **Default in payment by the lessor** may sometimes result in **seizure of assets** by banks **causing loss to the lessee**. 4) Lease financing has a **very high cost of interest** as compared to interest charged on term loans by financial institutions/bank

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Q. 2.16	MTP Apr 22
	DISCUSS in briefly any two long term sources of finance for a partnership firm
Ans.	The two sources of long-term finance for a partnership firm are as follows: **Loans from Commercial Banks:** ➢ Commercial banks provide long term loans for the purpose of **expansion or setting up of new units**. Their **repayment** is usually **scheduled over a long period of time**. The **liquidity** of such loans is said to **depend on anticipated income** of borrowers. ➢ As part of long-term funding for partnership firm, banks **also fund long-term working capital requirement** (it is also called WCTL i.e., working capital term loan). **Lease financing:** ➢ Leasing is a general contract between the owner and user of the asset over a specified period of time. The **asset is purchased initially by the lessor** (leasing company) and **thereafter leased to the user** (lessee firm) which **pays a specified rent at periodical intervals**. ➢ Thus, leasing is an **alternative** to the **purchase of an asset** out of own or borrowed funds. Moreover, lease finance can be **arranged much faster** as compared to term loans from financial institutions.

Q. 2.17	PYQ May 18, Nov 19
	What are the sources of short-term financial requirement of the company? **Or** **Briefly describe any four sources of short-term finance.**
Ans.	1) **Trade Credit:** It represents **credit granted by suppliers of goods**, etc., **as an incident of sale**. The usual duration of such credit is 15 to 90 days. It generates automatically in the course of business and is common to almost all business operations. It can be in the form of an **'open account'** or **'bills payable'**. 2) **Accrued Expenses:** Accrued expenses represent **liabilities** which **a company has to pay for the services** which it has **already received** like wages, taxes, interest and dividends. Such expenses **arise out of the day-to-day activities** of the company and hence represent a **spontaneous source of finance**. 3) **Deferred Income:** These are the **amounts received by a company** in lieu of **goods and services to be provided in the future**. These receipts **increase a company's liquidity** thus can be used as short-term finance. 4) **Advances from Customers:** Manufacturers and contractors engaged in producing or constructing costly **goods involving considerable length of manufacturing or construction time** usually **demand advance money from their customers** at the

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	time of accepting their orders for executing their contracts or supplying the goods. This is a **cost-free source** of finance and really useful. 5) **Commercial Paper:** A Commercial Paper is an **unsecured money market instrument** issued in the form of a **promissory note**. It enables highly rated corporate borrowers to diversify their sources of short-term borrowings. 6) **Treasury Bills:** Treasury bills are **Central Government Securities**. They are also known as **T-Bills** & are issued by Government of India to **meet short term borrowing** requirements with maturities ranging between **14 to 364 days**. 7) **Certificates of Deposit (CD):** A certificate of deposit (CD) is basically **a savings certificate with a fixed maturity date** of not less than **15 days up to a maximum of one year**. i. **Bank Advances:** Facilities provided by banks are **Short Term Loans**, **Overdraft**, **Cash Credits**, Advances against goods, Bills Purchased/Discounted.

Q. 2.18	MTP Aug 18
	EXPLAIN the importance of trade credit and accruals as source of short-term finance. DISCUSS the cost of these sources?
Ans.	• Trade credit and accruals as source of short-term finance, refers to **credit facility given by suppliers** of goods **during the normal course of trade**. • **Micro small and medium enterprises (MSMEs)** in particular are heavily **dependent** on this source for financing their working capital needs. • The major **advantages of trade credit** are ➢ **easy availability**, ➢ **flexibility** and ➢ **informality**. • There can be an argument that trade credit is a **cost-free source of finance**. But it is **not**. It involves **implicit cost**. The **supplier extending trade credit** incurs cost in the form of **opportunity cost of funds** invested in trade receivables. Generally, the **supplier passes on these costs to the buyer** by **increasing the price of the goods** or alternatively by **not extending cash discount** facility.

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Q. 2.19	MTP Nov 21, Mar 22, PYQ Dec 21
	EXPLAIN any four types of Packing Credit. **OR** **Write short note on Clean Packing Credit (Write only 1st point)**
Ans.	Packing credit is a **loan granted to an exporter** for **financing the purchase, processing, manufacturing or packing** of goods **prior to shipment**. i. **Clean packing credit:** This is an advance made available to an exporter **only on production of a firm export order** or a letter of credit **without exercising any charge or control over raw material** or finished goods. It is a clean type of export advance. Each proposal is weighed according to particular requirements of the trade and credit worthiness of the exporter. A **suitable margin has to be maintained**. Also, **Export Credit Guarantee Corporation (ECGC) cover** should be **obtained** by the bank. ii. **Packing credit against hypothecation of goods:** Export finance is made available on certain terms and conditions where the exporter has pledgeable interest and the **goods are hypothecated to the bank as security** with stipulated margin. At the time of utilising the advance, the **exporter is required to submit**, along with the firm **export order** or **letter of credit relative stock statements** and thereafter **continue submitting them every fortnight** and/or whenever there is any movement in stocks. iii. **Packing credit against pledge of goods:** Export finance is made available on certain terms and conditions where the **exportable finished goods are pledged to the banks** with approved clearing agents who will **ship the same from time to time as required by the exporter**. The **possession** of the goods so pledged **lies with the bank** and is **kept under its lock and key**. iv. **E.C.G.C. guarantee:** Any loan given to an exporter for the manufacture, processing, purchasing, or packing of goods meant for export against a firm order qualifies for the packing credit guarantee issued by Export Credit Guarantee Corporation. v. **Forward exchange contract:** Another requirement of packing credit facility is that **if the export bill** is to be **drawn in a foreign currency**, the **exporter should enter into a forward exchange contact** with the bank, thereby **avoiding risk involved** in a possible **change in the rate of exchange**.

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Q. 2.20	PYQ July 21
	Explain in brief the forms of Post Shipment Finance
Ans.	Post-shipment finance is **loan given to exporters by banks against a shipment of goods sent to overseas buyers**. Since **exporters don't wait for importers** to deposit funds against large shipments, they often **seek assistance as post-shipment finance** a. **Purchase/discounting of documentary export bills:** Finance is provided to exporters by **purchasing export bills drawn payable at sight** or **by discounting usance export bills** covering confirmed sales and **backed by documents** including documents of the title of goods such as bill of lading, post parcel receipts, or air consignment notes. b. **E.C.G.C. Guarantee:** Post-shipment finance, given to an exporter by a bank **through purchase, negotiation or discount** of an **export bill** against an order, **qualifies for** post shipment export **credit guarantee**. It is necessary, however, that exporters should obtain a shipment or contracts **risk policy of E.C.G.C. Banks insist on the exporters** to **take a contracts shipments** (comprehensive risks) **policy** covering both **political and commercial risks**. The **Corporation**, on **acceptance of the policy**, will **fix credit limits for individual exporters** and the Corporation's liability will be limited to the extent of the limit so fixed for the exporter concerned irrespective of the amount of the policy. c. **Advance against export bills sent for collection:** Finance is **provided by banks** to exporters by way of **advance against export bills** forwarded through them for collection, **taking into account the creditworthiness** of the party, **nature of goods exported, usance, standing of drawee**, etc. d. **Advance against duty draw backs, cash subsidy, etc.:** To finance export losses sustained by exporters, **bank advance against duty draw-back, cash subsidy**, etc., **receivable by them against export performance**.

Q. 2.21	MTP Sep 22
	BRIEF OUT certain sources of finance- Inter Corporate Deposits and Certificate of Deposit.
Ans.	**Inter Corporate Deposits:** The companies can **borrow funds for a short period**, say 6 months, **from other companies** which have **surplus liquidity**. The **rate of interest** on inter corporate deposits **varies** depending upon the **amount** involved and the **time** period. **Certificate of Deposit (CD):** The certificate of deposit is a **document of title** similar to a time deposit receipt issued by a bank except that there is **no prescribed interest rate on such funds**. The main advantage of CD is that **banker is not required to encash the deposit before maturity period** and the **investor is assured of liquidity** because he can **sell the CD in secondary market**.

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Q. 2.22	PYQ May 22
	Distinguish between American Depository Receipts and Global Depository Receipts.

Ans.

Basis	American Depository Receipts	Global Depository Receipts
Meaning	It is a negotiable instrument which is issued by US bank, which represent the non-US Company stock that is being traded in US stock Exchange	It is a negotiable instrument which is issued by the international depository bank that represent the foreign company's stock trading world-wide.
Issued where	In the US domestic capital market.	European capital market.
Listed in	In the American Stock Exchange	In the Non-US Stock Exchange
Relevance	Foreign companies are able to trade in the US Stock Market.	Foreign companies can trade in any country's stock market other than that of the US.

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CHAPTER 3 - FINANCIAL ANALYSIS & PLANNING: RATIO ANALYSIS

Q. 3.1	MTP Apr 22
	DISCUSS the limitations of financial ratios
Ans.	1) Diversified product lines: Many businesses operate a large number of divisions in quite different industries. In such cases ratios calculated on the basis of aggregate data cannot be used for inter-firm comparisons. 2) Financial data are badly distorted by inflation: Historical cost values may be substantially different from true values. Such distortions of financial data are also carried in the financial ratios. 3) Seasonal factors may also influence financial data. 4) To give a good shape to the popularly used financial ratios (like current ratio, debt - equity ratios, etc.): The business may make some year-end adjustments. Such window dressing can change the character of financial ratios which would be different had there been no such change. 5) Differences in accounting policies and accounting period: It can make the accounting data of two firms non-comparable as also the accounting ratios. 6) There is no standard set of ratios against which a firm's ratios can be compared: Sometimes a firm's ratios are compared with the industry average. But if a firm desires to be above the average, then industry average becomes a low standard. On the other hand, for a below average firm, industry averages become too high a standard to achieve. 7) Financial ratios provide clues but not conclusions. These are tools only in the hands of experts because there is no standard ready-made interpretation of financial ratios

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CHAPTER 4 - COST OF CAPITAL

Q. 4.1	PYQ Nov 19
	Explain the significance of Cost of Capital.
Ans.	The cost of capital is important to arrive at correct amount and helps the management or an investor to take an appropriate decision. The correct cost of capital helps in the following decision making: (i) **Evaluation of investment options:** The **estimated benefits (future cashflows) from available investment opportunities** (business or project) are **converted into the present value** of benefits by **discounting them with the relevant cost of capital**. Every investment option may have different cost of capital hence it is very important to use relevant cost of capital. Here Internal Rate of Return (IRR) is treated as cost of capital for evaluation of two options (projects). (ii) **Performance Appraisal:** Cost of capital is used to **appraise the performance of a particulars project or business**. The **performance** of a project or business in **compared against the cost of capital** which is known here as **cut-off rate or hurdle rate**. (iii) **Designing of optimum credit policy:** While **appraising the credit period** to be **allowed to the customers**, the **cost of allowing credit period** is **compared against the benefit/ profit** earned by providing credit to customer of segment of customers. Here **cost of capital** is used to arrive at the **present value of cost and benefits** received.

Q. 4.2	MTP Mar 19
	DISCUSS the dividend-price approach to estimate cost of equity capital.
Ans.	In dividend price approach, cost of equity capital is computed by **dividing the expected dividend by market price per share**. This ratio expresses the cost of equity capital in relation to **what yield the company should pay to attract investors**. It is computed as: $K_e = \frac{D_1}{P_0}$ Where, D_1 = Dividend per share in period 1 P_0 = Market price per share today.

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CHAPTER 5 - FINANCING DECISIONS-CAPITAL STRUCTURE

Q. 5.1 — **MTP May 20**

EXPLAIN in brief the Pecking order theory.

Ans.

This theory states that **firms prefer to issue debt** when they are **positive about future earnings**. **Equity is issued** when they are **doubtful** and **internal finance is insufficient**.

The pecking order theory argues that the **capital structure decision** is **affected by manager's choice of a source of capital** that gives **higher priority to sources** that **reveal the least amount of information**.

Pecking order theory suggests that managers may use various sources for raising of fund in the following order.

1. Managers **first** choice is to use **internal finance**
2. In absence of internal finance they can use **secured debt, unsecured debt, hybrid debt** etc.
3. Managers may issue **new equity shares** as a **last option**.

So briefly under this theory rules are-

- **Rule 1:** Use internal financing first.
- **Rule 2:** Issue debt next
- **Rule 3:** Issue of new equity shares at last

Q. 5.2 — **MTP May 20**

EXPLAIN Over-capitalisation. STATE its causes and consequences

Over-Capitalisation

- It is a situation where a firm has **more capital than it needs** or in other words **assets are worth less than its issued share capital**, and **earnings are insufficient to pay dividend and interest**.
- This situation mainly arises when **existing capital is not effectively utilized** on account of **fall in earning capacity** of the company while company has raised funds more than its requirements. The **chief sign** of over-capitalisation is the **fall in payment of dividend and interest** leading to **fall in value of the shares** of the company.

Causes of Over-Capitalisation

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

(ii) **Borrowing huge amount** at **higher rate** than rate at which company can **earn**.

(iii) **Excessive payment** for **acquisition of fictitious assets** such as goodwill etc.

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

(v) **Wrong estimation** of **earnings** and **capitalisation**.

Consequences of Over-Capitalisation

(i) Considerable **reduction in the rate of dividend** and **interest** payments.

(ii) **Reduction** in the **market price** of shares.

(iii) Resorting to "**window dressing**".

(iv) Some companies may opt for **reorganization**. However, sometimes the matter gets worse and the company may go into **liquidation**.

Remedies of Over-Capitalisation

(i) Company should go for thorough **reorganization**.

(ii) **Buyback** of shares.

(iii) **Reduction in claims of debenture-holders** and creditors.

(iv) **Value of shares** may also be **reduced**. This will result in **sufficient funds for the company** to carry out **replacement of assets**.

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Under-Capitalisation

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

Causes of Under-Capitalisation

i. The **dividend rate** will be **higher** in comparison to similarly situated companies.

ii. **Market value of shares** will be **higher** than value of shares of other similar companies because their **earning rate being considerably more** than the prevailing rate on such securities.

iii. **Real value of shares** will be **higher** than **book value**.

Effects of Under-Capitalisation

i. It **encourages acute competition**. High profitability **encourages new entrepreneurs** to come into same type of business.

ii. **High rate of dividend** encourages the **workers' union** to **demand high wages**.

iii. Normally **common people** (consumers) start feeling that they are being **exploited**.

iv. **Management** may resort to **manipulation of share values**.

v. Invite **more government control** and **regulation** on the company and **higher taxation** also.

Remedies of Under-Capitalisation

i. The **shares** of the company should be **split up**. This will **reduce dividend per share**, though EPS shall remain unchanged.

ii. **Issue of Bonus Shares** is the most appropriate measure as this will **reduce both dividend per share** and the **average rate of earning**.

iii. By **revising upward the par value** of shares in exchange **of the existing shares** held by them.

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CHAPTER 6 - FINANCING DECISIONS-LEVERAGES

Q. 6.1	MTP Mar 19 **EXPLAIN the difference between Business risk and Financial risk.**
Ans.	**Business risk** ➢ It refers to the **risk associated with the firm's operations**. It is an **unavoidable risk** because of the environment in which the firm has to operate and the business risk is represented by the **variability of earnings before interest and tax (EBIT)**. ➢ The variability in turn is **influenced by revenues and expenses**. ➢ Revenues and expenses are **affected by-** • **demand of firm's products**, • **variations in prices** and • **proportion of fixed cost** in total cost. **Financial risk** ➢ It refers to the **additional risk placed on firm's shareholders** as a result of **debt use in financing**. ➢ Companies that **issue more debt** instruments would **have higher financial risk** than companies financed mostly by equity. ➢ Financial risk can be **measured by ratios** such as firm's **financial leverage multiplier**, **total debt to assets ratio** etc.

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CHAPTER 7 - INVESTMENT DECISIONS

Q. 7.1	RTP Nov 2019, MTP Apr 22
	Write short notes on the following: **STATE the meaning of Payback Reciprocal.**
Ans.	➢ As the name indicates it is the **reciprocal of payback period**. A major drawback of the payback period method of capital budgeting is that it **does not indicate any cut off period** for the purpose of investment decision. ➢ It is, however, argued that the **reciprocal of the payback** would be a **close approximation of the Internal Rate of Return** if the **life of the project is at least twice the payback period** and the **project generates equal amount of the annual cash inflows**. ➢ In practice, the payback reciprocal is a helpful tool for **quick estimation of rate of return** of a project provided its life is at least twice the payback period. The payback reciprocal can be calculated as follows: $\text{Payback Reciprocal} = \dfrac{\text{Average annual cash in flow}}{\text{Initial investment}}$

Q. 7.2	PYQ Jul 21
	Explain the limitations of Average Rate of Return.
Ans.	➢ The accounting rate of return technique, like the payback period technique, **ignores the time value of money** and considers the value of all cash flows to be equal. ➢ The technique uses accounting numbers that are dependent on the organization's **choice of accounting procedures,** and different accounting procedures, e.g., depreciation methods, can lead to substantially different amounts for an investment's net income and book values. ➢ The method **uses net income rather than cash flows;** while net income is a useful measure of profitability, the net cash flow is a better measure of an investment's performance. ➢ Furthermore, **inclusion of only the book value of the invested asset** ignores the fact that a project can require commitments of working capital and other outlays that are not included in the book value of the project.

Q. 7.3	PYQ Jan 21
	Define Internal Rate of Return (IRR)
Ans.	Internal rate of return for an investment proposal is the **discount rate that equates the present value of the expected cash** inflows **with** the **initial cash outflow**.

Q. 7.4	PYQ May 22
	Identify the limitations of Internal Rate of Return.
Ans.	**Limitations of Internal Rate of Return (IRR)** ➢ The calculation **process is tedious** if there is more than one cash outflow interspersed between the cash inflows; there can be multiple IRR, the interpretation of which is difficult. ➢ The IRR approach **creates a peculiar situation** if we compare two projects with different inflow/outflow patterns. ➢ It is assumed that under this method all the future cash inflows of a proposal are reinvested at a rate equal to the IRR. It **ignores a firm's ability to re-invest in portfolio of different rates**. ➢ If mutually exclusive projects are considered as investment options which have considerably different cash outlays. A project with a larger fund commitment but lower IRR contributes more in terms of absolute NPV and increases the shareholders' wealth. In such situation **decisions based only on IRR criterion may not be correct**

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Q. 7.5	MTP Oct 19
	EXPLAIN the concept of discounted payback period.
Ans.	➢ **Payback period** is **time taken to recover the original investment** from project cash flows. It is also termed as **break even period**. The focus of the analysis is on **liquidity aspect** and it suffers from the **limitation of ignoring time value** of money and profitability. ➢ **Discounted payback period considers present value of cash flows**, discounted at company's cost of capital to estimate breakeven period i.e. it is that period in which future discounted cash flows equal the initial outflow. The **shorter the period, better it is**. It also **ignores post** discounted payback period **cash flows**.

Q. 7.6	PYQ Nov 19
	Explain the steps while using the equivalent annualized criterion.
Ans.	i. **Compute NPV** using the WACC or discounting rate. ii. Compute **Present Value Annuity Factor (PVAF)** of discounting factor used above for the **period of each project**. iii. **Divide NPV** computed under step (i) **by PVAF** as computed under step (ii) and **compare the values**.

Q. 7.7	**PYQ May 19**
	Explain any two steps involved in Decision tree Analysis. (Not in syllabus now, can skip this question)
Ans.	**Step 1- Define Investment:** Decision tree analysis can be **applied to a variety of business decision-making scenarios**. **Step 2- Identification of Decision Alternatives:** It is very essential to **clearly identity decision alternatives**. For example, if a company is planning to introduce a new product, it may be local launch, national launch or international launch. **Step 3- Drawing a Decision Tree:** After identifying decision alternatives, at the relevant data such as the **projected cash flows, probability distribution expected present value** etc. should be put in **diagrammatic form** called decision tree. **Step 4- Evaluating the Alternatives:** After drawing out the decision the next step is the **evaluation** of alternatives.

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CHAPTER 8 - RISK ANALYSIS IN CAPITAL BUDGETING

Q. 8.1	PYQ Nov 18, Dec 21
	Write two main reasons for considering risk in Capital Budgeting decisions. **OR** **Adjustment of risk is required in capital budgeting decision, give reasons for it.**
Ans.	1. There is an **opportunity cost** involved **while investing in a project** for the level of risk. **Adjustment of risk** is necessary to help **make the decision** as to whether the **returns out of the project** are **proportionate with** the **risks borne** and whether it is worth investing in the project over the other investment options available. 2. Risk adjustment is required to know the **real value of the Cash Inflows**. **Higher risk** will lead to **higher risk premium** and also the **expectation of higher return**.

Q. 8.2	PYQ MAY 2018
	What is certainty Equivalent?
Ans.	➢ It is a coefficient used to deal with risk in a capital budgeting context. It **expresses risky future cash flows** in **terms of the certain cash flows** which would be considered by the decision maker, as their equivalent. ➢ That is the **decision maker** would be **indifferent** between the **risky amount** and the (Lower) **riskless amount** considered to be its equivalent. ➢ It is a **guaranteed return** that the **management would accept** rather than accepting a higher but uncertain return. ➢ Calculation of this equivalent involves the following **three steps**: **Step 1:** **Remove risks** by substituting equivalent **certain cash flows** in the place of risky cash flows. This can be done by mul**tiplying each risky cash flow by the appropriate CE Coefficient**. **Step 2:** Obtain **discounted value of cash flow** by **applying riskless rate of interest**. **Step 3:** Apply normal capital budgeting method to **calculate NPV** by using the firm's required rate of return. $NPV = \sum_{t=0}^{n} \frac{NCF_t}{(1+k_f)^t} - I$ Where, NCF_t =the forecasts of net cash flow without risk-adjustment α_t= the risk-adjustment factor or the certainly equivalent coefficient. K_f= risk-free rate assumed to be constant for all periods. Certainty Coefficient lies between 0 and 1.

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Q. 8.3	MTP Oct 18 **STATE the disadvantages of the Certainty equivalent Method. EXPLAIN its differences with Risk Adjusted discount rate.**
Ans.	**Disadvantages of Certainty Equivalent Method** 1. There is **no Statistical or Mathematical model** available to **estimate certainty Equivalent**. Certainty Equivalent are **subjective** and **vary as per each individual's estimate**. 2. Certainty equivalents are **decided by the management** based on **their perception of risk**. However the **risk perception of the shareholders** who are the money lenders for the project is **ignored**. Hence it is **not used often** in corporate decision making. **Risk-adjusted Discount Rate Vs. Certainty-Equivalent** ➢ **Certainty Equivalent Method** is **superior** to Risk Adjusted Discount Rate Method as it does **not assume** that **risk increases with time at constant rate**. ➢ Each year's Certainty Equivalent Coefficient is **based on level of risk impacting its cash flow**. ➢ Despite its soundness, it is **not preferable** like Risk Adjusted Discount Rate Method. It is **difficult to specify a series of Certainty Equivalent Coefficients** but **simple to adjust discount rates**.

Q. 8.4	PYQ Nov 20 **What is Risk Adjusted Discount Rate?**
Ans.	A risk adjusted discount rate is a **sum of risk-free rate** and **risk premium**. The **Risk Premium depends on the perception of risk by the investor** of a particular investment and **risk aversion** of the Investor. So, **Risks adjusted discount rate = Risk free rate+ Risk premium.**

Q. 8.5	MTP Oct 21, PYQ May 19 **EXPLAIN sensitivity analysis and its various steps.** **OR** **Explain the steps of Sensitivity Analysis.**
Ans.	**Sensitivity Analysis** It is a modeling technique which is used in Capital Budgeting decisions which is used to study the **impact of changes in the variables on the outcome of the project**. In a project, several variables like weighted average cost of capital, consumer demand, price of the product, cost price per unit etc. operate simultaneously.

CA Mohnish Vora (MV Sir)

	The changes in these variables impact the outcome of the project. It therefore becomes very difficult to assess change in which variable impacts the project outcome in a significant way. In Sensitivity Analysis, the project outcome is studied after taking into **change in only one variable**. The **more sensitive is the NPV**, the **more critical is that variable**. So, Sensitivity analysis is a way of finding impact in the project's NPV (or IRR) for a given change in one of the variables. **Steps of Sensitivity Analysis** 1. **Finding variables**, which have an **influence on the NPV** (or IRR) of the project. 2. Establishing **mathematical relationship** between the variables. **Analysis the effect of the change** in each of the variables **on the NPV** (or IRR) of the project.

Q. 8.6	**PYQ Dec 21**
	Distinguish between Scenario Analysis & Sensitivity Analysis.
Ans.	**Scenario Analysis Vs Sensitivity Analysis** **Sensitivity analysis** calculates the **impact of the change of a single input variable** on the **outcome of the project viz., NPV or IRR**. The sensitivity analysis thus enables to **identify that single critical variable** which can impact the outcome in a huge way and the range of outcomes of the project given the change in the input variable. **Scenario analysis**, on the other hand, is based on a scenario. The scenario may be recession or a boom wherein depending on the scenario, **all input variables change**. Scenario Analysis calculates the **outcome of the project** considering this scenario where the **variables have changed simultaneously**. Similarly, the outcome of the project would also be considered for the **normal** and **recessionary** situation. The variability in the outcome under the three different scenarios would help the management to assess the risk a project carries. **Higher deviation in the outcome** can be assessed as **higher risk** and lower to medium deviation can be assessed accordingly. **Scenario analysis** is far **more complex** than sensitivity analysis because in scenario analysis **all inputs are changed simultaneously**, considering the situation in hand while in sensitivity analysis, only one input is changed, and others are kept constant.

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CHAPTER 9 - DIVIDEND DECISIONS

Q. 9.1	MTP Aug 18
	STATE two advantages of Walter Model of Dividend Decision.
Ans.	1. The formula is **simple to understand** and **easy to compute**. 2. It can envisage **different possible market prices** in **different situations** and **considers internal rate of return**, **market capitalisation rate** and **dividend payout ratio** in the determination of market value of shares.

Q. 9.2	PYQ May 2022
	Briefly explain the assumptions of Walter's Model.
Ans.	1. All investment proposals of firm to be **financed through retained earnings only**. 2. '**r**' rate of return & '**Ke**' cost of capital are **constant**. 3. **Perfect capital markets**: The firm operates in a market in which all investors are rational and information is freely available to all. 4. **No taxes or no tax discrimination** between dividend income and capital appreciation (capital gain). It means there is no difference in taxation of dividend income or capital gain. This assumption is necessary for the universal applicability of the theory, since, the tax rates may be different in different countries. 5. **No floatation or transaction cost**: Similarly, these costs may differ country to country or market to market. 6. The **firm** has **perpetual life**.

Q. 9.3	PYQ Nov 20
	Distinguish between Unsystematic Risk & Systematic Risk
Ans.	**Unsystematic Risk:** This is also called **company specific risk** as the risk is **related with the company's performance**. This type of risk **can be reduced or eliminated** by **diversification** of the securities portfolio. This is also known as **diversifiable risk**. **Systematic Risk:** It is the **macro-economic** or **market specific risk** under which a company operates. This type of risk **cannot be eliminated by the diversification** hence, it is **non-diversifiable**. The examples are **inflation**, **Government policy**, **interest rate** etc.

Q. 9.4	MTP Oct 18
	STATE the advantages of Stock-Splits.
Ans.	1. It **makes the share affordable** to small investors. 2. Number of shares may **increase the number of shareholders**; hence the **potential of investment may increase**.

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CHAPTER 10 - MANAGEMENT OF WORKING CAPITAL

Q. 10.1	RTP Nov 19
	STATE the functions of treasury department.
Ans.	1. **Cash Management:** It involves **efficient cash collection process** and **managing payment of cash** both inside the organisation and to third parties. There may be **complete centralization** within a group treasury **or** the treasury may simply **advise subsidiaries and divisions** on policy matter viz., collection/payment periods, discounts, etc. Treasury will also **manage surplus funds** in an investment portfolio. **Investment policy** will consider **future needs for liquid funds** and **acceptable levels of risk** as determined by company policy. 2. **Currency Management:** The treasury department manages the **foreign currency risk exposure** of the company. In a large multinational company (MNC) the first step will usually be to **set off intra-group indebtedness**. The use of **matching receipts and payments** in the **same currency** will **save transaction costs**. Treasury might **advise on the currency to be used** when **invoicing overseas sales**. The treasury will manage any net exchange exposures in accordance with company policy. If risks are to be minimized then forward contracts can be used either to buy or sell currency forward. 3. **Fund Management:** Treasury department is responsible for **planning and sourcing** the company's **short, medium and long-term cash needs**. Treasury department will also **participate in the decision on capital structure** and **forecast future interest and foreign currency rates**. 4. **Banking:** It is important that a company **maintains a good relationship with its bankers**. Treasury department **carry out negotiations with bankers** and act as the **initial point of contact** with them. Short-term finance can come in the form of bank loans or through the sale of commercial paper in the money market. 5. **Corporate Finance:** Treasury department is involved with both **acquisition and divestment activities** within the group. In addition, it will often have responsibility for **investor relations**. The latter activity has assumed increased importance in markets where **share-price performance** is regarded as **crucial** and may **affect the company's ability to undertake acquisition activity** or, if the **price falls drastically**, render it **vulnerable to a hostile bid**.

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Q. 10.2	PYQ Jan 21
	Explain Electronic Cash Management System.
Ans.	➢ Most of the cash management systems nowadays are electronically based, since '**speed**' is the **essence of any cash management system**. ➢ Electronically, **transfer of data** as well as **funds** play a key role in any cash management system. ➢ Various elements in the process of cash management are **linked through a satellite**. ➢ **Various places** that are **interlinked** may be- • the **place where the instrument is collected**, • the **place where cash is to be transferred** in company's account, • the **place where the payment is to be transferred** etc.

Q. 10.3	PYQ Jul 21
	Describe the salient features of FORFAITING.
Ans.	**Forfaiting** is an arrangement of **bill discounting** in which **bank buys the trade bills** (invoices) **from exporters** of goods, where the **exporter relinquish his right to receive payment from importer**. It is on '**without recourse**' basis, where **risk and rewards** related with bills **transferred to the banks**. **Features of Forfaiting** ➢ It motivates exporters to **explore new geographies** as **payment is assured**. ➢ An **overseas buyer (importer) can import** goods and services on **deferred payment terms**. ➢ The **exporter enjoys reduced transaction costs** and **complexities** of international trade transactions. ➢ The **exporter** gets to **compete in the international market** and can continue to put his working capital to good use to **scale up operations**. ➢ While **importers avail of forfaiting facility** from international financial institutions in order to **finance their imports at competitive rates**.

Q. 10.4	MTP mar 19
	STATE Virtual Banking? DISCUSS its advantages.
Ans.	**Virtual Banking** Virtual banking refers to the **provision of banking** and related services **through the use of information technology without direct recourse to the bank** by the customer. **Advantages of Virtual Banking** 1) **Lower cost of handling a transaction**.

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	2) The **increased speed** of response to customer requirements. 3) The **lower cost of operating branch** network along with **reduced staff costs** leads to **cost efficiency**. 4) Virtual banking allows the possibility of **improved** and a **range of services** being made available to the customer **rapidly, accurately and at his convenience**.

Q. 10.5	MTP Mar 19
	EXPLAIN Concentration Banking
Ans.	➢ In concentration banking the company establishes a number **of strategic collection centres** in **different regions** instead of a single **collection centre at the head office**. ➢ This system **reduces the period** between the **time a customer mails in his remittances** and the **time when they become spendable funds** with the company. ➢ **Payments received by the different collection centers** are **deposited** with their **respective local banks** which in turn **transfer all surplus funds** to the **concentration bank of head office**.

Q. 10.6	MTP May 20
	EXPLAIN in short the term "Letter of Credit".
Ans.	It is an arrangement by which the **issuing bank** on the **instructions of a customer** or on its own behalf **undertakes to pay** or **accept** or **negotiate** or **authorizes another bank** to do so **against stipulated documents** subject to compliance with specified terms and conditions. A letter of credit, is a **letter** from a bank **guaranteeing** that a **buyer's payment** to a **seller** will be **received on time** and for the correct amount. If the **buyer is unable to make the payment** on the purchase, the **bank will be required to pay the remaining amount** of purchase.

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