Financial Management – Theory Compiler

Birds Eye View

Particulars		M-18	N-18	M-19	N-19	N-20	J-21	J-21	D-21	M-22	N-22	M-23	N-23	M-24	S-24
Introduction to Financial Management	Th	4	2		3	4	4	2	2	2			2	4	
	Pr														
Financial Analysis throguh Ratio	Th														
	Pr	5	5	5	5	5	5	10	10	5	5	10	5	5	5
Types of Finance	Th	6	4	4	4	4	2	4	4	2	6	6	8	6	8
	Pr														
Cost of Capital	Th				4										
	Pr			5		5	10	5	5	10	11	10	10	6	8
Capital Structure	Th										2		2		2
	Pr	10	15	10	10	10	10	15	10	10	4	10	10	4	5
Leverage	Th											2			
	Pr	5	10	10	10	10	10	10	10	10	10	5	5	5	5
Investment Decisions	Th		4	2		2	2	2		4				2	
	Pr	28	10	10	15	5	10	10	10	10	20	10	10	7	
Dividend Decision	Th									4					4
	Pr		5	5	5	5	5	5	5			5	10	3	
Management of Working Capital	Th											4			
	Pr	10		10		10	5			5			5		5
Receivables Management	Th							4							
	Pr		10					5	5			5		5	5
Cash Management	Th						4				4				
	Pr				10				5		5				
Inventory Management	Th														
	Pr									5					

Scope & Objectives of FM

Question – 1 [May 18] [Nov 19]
What are the two main aspects of the Finance Function?

Answer
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

(a) **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.

(b) **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.

(c) **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)

Question – 2 [RTP May 19] [RTP Nov 19] [RTP Nov 23] [MTP Nov 19] [MTP Nov 21] [MTP May 24]
Write note on inter relationship between investment, financing and dividend decision.

Answer
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., maximization of shareholders' wealth. Since investment, financing and dividend decisions are all interrelated, one has to consider the joint impact of these decisions on the market price of the company's shares and these decisions should also be solved jointly. The decision to invest in a new project needs the finance for the investment. The financing decision, in turn, is influenced by and influences dividend decision because retained earnings used in internal financing deprive shareholders
of their dividends. An efficient financial management can ensure optimal joint decisions. This is possible by evaluating each decision in relation to its effect on the shareholders' wealth.

The above three decisions are briefly examined below in the light of their inter-relationship and to see how they can help in maximizing the shareholders' wealth i.e., market price of the company's shares.

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

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

Dividend decision: The finance manager is also concerned with the decision to pay or declare dividend. He assists the top management in deciding as to what portion of the profit should be paid to the shareholders by way of dividends and what portion should be retained in the business. An optimal dividend pay-out ratio maximizes shareholders' wealth.

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

Question – 3 [Jan 21] [RTP Dec 21] [MTP Jan 25]
State four tasks involved to demonstrate the importance of good Financial Management.

Answer
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.

Question – 4 [Dec 21]
Explain in brief the phases of the evolution of financial management.

Answer
Evolution of Financial Management: 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:
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.

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.

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.

Question – 5 [Nov 18] [MTP Nov 21]
Write two main objectives of Financial Management.

Answer
Two objectives of financial management are:
(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 are the result of cost benefit analysis adjusted with their timing and risk i.e. time value of money. This is the real objective of Financial Management. So,
Wealth = Present Value of benefits – Present Value of Costs

Question – 6 [July 21]
List out the steps to be followed by the manager to measure and maximize the Shareholder's Wealth

Answer
For measuring and maximizing shareholder's wealth, manager should follow:
- Cash Flow approach not Accounting Profit
- Cost benefit analysis
- Application of time value of money.

Question – 7 [May 22]
State advantages of "Wealth Maximization" goals in Financial Management.

Answer

(i) Emphasizes the long-term gains.
(ii) Recognises risk or uncertainty.
(iii) Recognises the timing of returns.
(iv) Considers shareholders' return.

Question – 8 [RTP Sep 24] [MTP May 21]

Explain the advantages and disadvantages of both profit maximization and wealth maximization goals.

Answer

Goal	Advantage	Disadvantages
Profit Maximization	(1) Easy to calculate profits (2) Easy to determine the link between financial decisions and profits.	(1) Emphasizes the short term gains (2) Ignores risk or uncertainty (3) Ignores the timing of returns (4) Requires immediate resources
Wealth Maximization	(1) Emphasizes the long term gains (2) Recognizes risk or uncertainty (3) Recognizes the timing of returns (4) Considers shareholders' return	(1) Offers no clear relationship between financial decisions and share price. (2) Can lead to management anxiety and frustration.

Question – 9 [RTP May 24] [MTP May 19]

Explain as to how the wealth maximization objective is superior to the profit maximization objective.

Answer

The value maximization objective of a firm is superior to its profit maximization objective due to following reasons.

(1) The value maximization objective of a firm considers all future cash flows, dividends, earning per share, risk of a decision etc. whereas profit maximization 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 maximize the shareholders wealth may pay regular dividends whereas a firm with the objective of profit maximization may refrain from dividend payment to its shareholders.
(3) Shareholders would prefer an increase in the firm's wealth against its generation of increasing flow of profits.
(4) The market price of a share reflects the shareholders expected return, considering the long-term prospects of the firm, reflects the differences in timings of the returns, considers risk and recognizes the importance of distribution of returns.

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

Question – 10 [Nov 23] [RTP May 18] [RTP Nov 18] [RTP May 20] [RTP May 21] [RTP May 22] [MTP May 24] [MTP Jan 25]

What are disadvantages of Profit Maximization?

"The profit maximization is not an operationally feasible criterion. Discuss.

Answer

"The profit maximisation is not an operationally feasible criterion." This statement is true because Profit maximisation can be a short-term objective for any organization and cannot be its sole objective. Profit maximization fails to serve as an operational criterion for maximizing the owner's economic welfare. It fails to provide an operationally feasible measure for ranking alternative courses of action in terms of their economic efficiency. It suffers from the following limitations:

(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 etc.

(b) **Profit maximisation has to be attempted with a realisation of risks involved.** There is a direct relationship between risk and profit. Many risky propositions yield high 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. In practice, however, risk is very important consideration and has to be balanced with the profit objective.

(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.

Question – 11 [May 18] [Nov 20] [RTP May 19] [MTP Nov 22] [MTP Sep 24]

What are the roles of Finance Executive in Modem World?

Answer

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.

<u>Question – 12</u> [RTP Jan 25]

List the emerging issues (any four) affecting the future role of CFO.

<u>Answer</u>

Emerging Issues/Priorities Affecting the Future Role of Chief Financial Officer (CFO)

(i) **Regulation:** Regulation requirements are increasing and CFOs have an increasingly personal stake in regulatory adherence.

(ii) **Globalization:** The challenges of globalization are creating a need for finance leaders to develop a finance function that works effectively on the global stage and that embraces diversity.

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

(iv) **Risk:** The nature of the risks that organisations face are changing, requiring more effective risk management approaches and increasingly CFOs have a role to play in ensuring an appropriate corporate ethos.

(v) **Transformation:** There will be more pressure on CFOs to transform their finance functions to drive a better service to the business at zero cost impact.

(vi) **Stakeholder Management:** Stakeholder management and relationships will become important as increasingly CFOs become the face of the corporate brand.

(vii) **Strategy:** There will be a greater role to play in strategy validation and execution, because the environment is more complex and quick changing, calling on the analytical skills CFOs can bring.

(viii) **Reporting:** Reporting requirements will broaden and continue to be burdensome for CFOs.

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

<u>Question – 13</u> [RTP Nov 20] [RTP May 22] [RTP Nov 23] [MTP Nov 18] [MTP Nov 20] [MTP May 21] [MTP Sep 24]

Explain agency problem and agency cost. How to address the issues of the same.

<u>Answer</u>

There is a principal agent relationship between managers and owners, which is known as Agency Problem. In other words, 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 behavior so as to maximize shareholders wealth. Generally, Agency Costs are of four types (i) monitoring (ii) bonding (iii) opportunity (iv) structuring

Addressing the agency problem

The agency problem arises if manager's interests are not aligned to the interests of the debt lender and equity investors. The agency problem of debt lender would be addressed by imposing negative covenants i.e., the managers cannot borrow beyond a point. This is one of the most important concepts of modern day finance and the application of this would be applied in the Credit Risk Management of Bank, Fund Raising, Valuing distressed companies.

Agency problem between the managers and shareholders can be addressed if the interests of the managers are aligned to the interests of the shareholders. It is easier said than done. However, following efforts have been made to address these issues:

- Managerial compensation is linked to profit of the company to some extent and also with the long-term objectives of the company.
- Employee is also designed to address the issue with the underlying assumption that maximization of the stock price is the objective of the investors.
- Effecting monitoring can be done.

Question – 14 [MTP May 18] [MTP May 22]

Explain Financial Distress and explain its relationship with Insolvency.

Answer

There are various factors like price of the product/ service, 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 needs 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 to 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. So, insolvency basically means inability of a firm to repay various debts and is a result of continuous financial distress.

Question – 15 [May 24]

State with brief reasons whether the following statements are true or false:

(i) Maximizing Market Price Per Share (MPS) as the financial objective which maximizes the wealth of shareholders.

(ii) A combination of lower risk and higher return is known as risk return trade off and at this level of risk-return, profit is maximum.

(iii) Financial distress is a position when accounting profits of a firm are sufficient to meet its long-term obligations.

(iv) Angel investor is one who provides funds for start-up m exchange for an ownership/equity.

Answer

Statement	True or False	Reason
Maximizing Market Price Per Share (MPS) as the financial objective which maximizes the wealth of shareholders.	True	Maximizing MPS or Market value as the financial objective will ensure the maximizing shareholder's wealth.
A combination of lower risk and higher return is known as risk return trade off and at this level of risk-return, profit is maximum.	False	There is a direct relationship between risk and profit. Higher the risk, higher is the possibility of profits. Stockholders expect greater returns from investments of higher risk and vice-versa.
Financial distress is a position when accounting profits of a firm are sufficient to meet its long-term obligations.	False	Financial distress is a position where cash inflows of a firm are inadequate to meet all its current obligations.
Angel investor is one who provides funds for start-up m exchange for an ownership/equity.	True	Angel financing is a form of an equity-financing where an angel investor provides capital for start-up or expansion, in exchange for an ownership/equity in the company.

Types of Finance

Question – 1 [MTP Nov 21]
Briefly describe the financial needs of a business.

Answer
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 buy 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.

Question – 2 [Sep 24] [MTP May 21]
Discuss in brief the characteristics of Debentures.

Answer
Characteristics of Debentures are as follows:
- Normally, debentures are issued on the basis of a debenture trust deed which lists the terms and conditions on which the debentures are floated.
- Debentures are either secured or unsecured.
- May or may not be listed on the stock exchange
- The cost of capital raised through debentures is quite low since the interest payable on debentures can be charged as an expenses before tax.
- From the investors' point of view, debentures offer a more attractive prospect than the preference shares since interest on debentures is payable whether or not the company makes profits.
- Debenture are thus instruments for raising long-term debt capital
- The period of maturity normally varies from 3 to 10 years and may also increase for projects having high gestation period.

Question – 3 [Sep 24] [MTP May 21]
Discuss any 2 advantages and 2 disadvantages of raising finance by issue of debentures.

Answer
Advantages of raising finance by issue of debentures are:
(i) The cost of debentures is much lower than the cost of preference or equity capital as the interest is tax-deductible. Also, investors consider debenture investment safer than equity or preferred investment and, hence, may require a lower return on debenture investment.
(ii) Debenture financing does not result in dilution of control.

(iii) In a period of rising prices, debenture issue is advantageous. The fixed monetary outgo decreases in real terms as the price level increases. In other words, the company has to pay a fixed rate of interest.

Disadvantages of debenture financing are:

(i) Debenture interest and the repayment of its principal amount is an obligatory payment.
(ii) The protective covenants associated with a debenture issue may be restrictive.
(iii) Debenture financing enhances the financial risk associated with the firm.

Question – 4 [RTP May 21]

Discuss the advantages and disadvantages of raising funds by issue of preference shares.

Answer

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) One of the major disadvantages of preference shares is that preference dividend is not tax deductible and so does not provide a tax shield to the company. Hence, 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 dividends 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.

Question – 5 [RTP Sep 24] [MTP Nov 21]

Explain in brief the features of various types of preference shares.

Answer

	Type of Preference Shares	Salient Features
1.	Cumulative	Arear 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.

Question – 6 [May 18] [Nov 19]
What are the sources of short-term financial requirement of the company?

Answer
There are various sources available to meet short-term needs of finance. The different sources are discussed below:

(i) **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'.

(ii) **Accrued Expenses and Deferred Income:** Accrued expenses represent liabilities which a company has to pay for the services which it has already received like wages, taxes, interest and dividends.

(iii) **Advances from Customers:** Manufacturers and contractors engaged in producing or constructing costly goods involving considerable length of manufacturing or construction time usually demand advance money from their customers at the time of accepting their orders for executing their contracts or supplying the goods. This is a cost free source of finance and really useful.

(iv) **Commercial Paper:** A Commercial Paper is an unsecured money market instrument issued in the form of a promissory note.

(v) **Treasury Bills:** Treasury bills are a class of Central Government Securities. Treasury bills, commonly referred to as T-Bills are issued by Government of India to meet short term borrowing requirements with maturities ranging between 14 to 364 days.

(vi) **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.

(vii) **Bank Advances:** Banks receive deposits from public for different periods at varying rates of interest. These funds are invested and lent in such a manner that when required, they may be called back.

Question – 7
What do you understand by Spontaneous Sources of finance and explain its sources of finance?

Answer
Spontaneous sources of finance are those which naturally arise in the course of business operations. Trade credit, credit from employees, credit from suppliers of services, etc. are some of the examples which may be quoted in this respect.

(i) Trade Credit: Trade credit is a spontaneous source of finance which is normally extended to the purchaser organization by the sellers or services providers. It contributes to about one-third of the total short-term requirements.

(ii) Bills Payable: In the case of "Bills Payable" the purchaser will have to give a written promise to pay the amount of the bill/invoice either on demand or at a fixed future date to the seller or the bearer of the note.

(iii) Accrued Expenses: The accrued expenses refer to the services availed by the firm, but the payment for which has yet to be made. It is a built in and an automatic source of finance as most of the services like wages, salaries, taxes, duties etc., are paid at the end of the period.

Question – 8 [May 24]
ABC Ltd. is approaching the banks for financing its business activity. You are required to describe any four forms of bank credit for the consideration of the company.

Answer

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

(ii) Bank Overdraft: It is a short-term borrowing facility made available to the companies in case of urgent need of funds. The banks will impose limits on the amount they can lend. When the borrowed funds are no longer required they can quickly and easily be repaid. The banks issue overdrafts with a right to call them in at short notice.

(iii) Bills Discounting: The Company which sells goods on credit will normally draw a bill on the buyer who will accept it and sends it to the seller of goods. The seller, in turn discounts the bill with his banker. The banker will generally earmark the discounting bill limit.

(iv) Bills Acceptance: To obtain finance under this type of arrangement a company draws a bill of exchange on bank. The bank accepts the bill thereby promising to pay out the amount of the bill at some specified future date.

(v) Line of Credit: Line of Credit is a commitment by a bank to lend a certain amount of funds on demand specifying the maximum amount.

(vi) Letter of Credit: It is an arrangement by which the issuing bank on the instructions of a customer or on its own behalf undertakes to pay or accept or negotiate or authorizes another bank to do so against stipulated documents subject to compliance with specified terms and conditions.
(vii) Bank Guarantees: Bank guarantee is one of the facilities that the commercial banks extend on behalf of their clients in favour of third parties who will be the beneficiaries of the guarantees.

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

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

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

(xi) Usance bills maturing at a future date or sight are discounted by the banks for approved parties. The borrower is paid the present worth and the bank collects the full amount on maturity.

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

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

Question – 9 [RTP May 24] [MTP Nov 18] [MTP Sep 24]
Explain the importance of trade credit and accruals as source of working capital. What is the cost of these sources?

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

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.

Question – 10 [MTP July 20]
Explain in short the term Letter of Credit.

Answer
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.

Question – 11 [MTP Nov 20] [MTP Nov 21] [MTP Nov 22]
Explain in brief the features of Commercial Papers.

Answer
A Commercial Paper is an unsecured money market instrument issued in the form of a promissory note. The Reserve Bank of India introduced the commercial paper scheme in the year 1989 with a view to enabling highly rated corporate borrowers to diversify their sources of short- term borrowings and to provide an additional instrument to investors. Subsequently, in addition to the Corporate, Primary Dealers and All India Financial Institutions have also been allowed to issue Commercial Papers. Commercial papers are issued in denominations of ` 5 lakhs or multiples thereof and the interest rate is generally linked to the yield on the one-year government bond.

All eligible issuers are required to get the credit rating from Credit Rating Info rmation Services of India Ltd, (CRISIL), or the Investment Information and Credit Rating Agency of India Ltd (ICRA) or the Credit Analysis and Research Ltd (CARE) or the FITCH Ratings India Pvt. Ltd or any such other credit rating agency as is specified by the Reserve Bank of India.

Question – 12 [Dec 21] [MTP Nov 21]
Write short notes on Bridge Finance and Clean Packing Credit.

Answer
Bridge Finance: 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. Though it is of short-term nature but since it is an important step in the facilitation of long-term loan, therefore it is being discussed along with the long term sources of funds. 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.

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.

Question – 13 [July 21]
Explain in brief the forms of Post Shipment Finance.

Answer
It takes the following forms:

(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. Such advances are of clean nature; hence necessary precaution should be exercised.

Question – 14 [MTP Nov 21] [MTP May 22]
Explain any four type of packing credit.

Answer

(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 pledge able interest and the goods are hypothecated to the bank as security with stipulated margin. At the time of utilising the advance, the exporter is required to submit, along with the firm export order or letter of credit relative stock statements and thereafter continue submitting them every fortnight and/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.

Question – 15 [MTP Nov 22]
Brief out certain sources of finance – Inter corporate deposit and Certificate of Deposit.

Answer
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.

Question – 16 [[MTP Nov 22]
State in brief four features of Plain Vanilla Bond.

Answer
Features of Plain Vanilla Bond:
- 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.

Question – 17 [MTP Jan 25]
Explain the concept of Drop-lock bond (DL bonds).

Answer
A drop lock is an arrangement whereby the interest rate on a floating- rate note becomes fixed if it falls to a specified level. Above that level the rate floats based on a benchmark market rate, typically with a semi- annual reset. In other words, drop lock bonds marry the attributes of both floating-rate securities and fixed-rate securities. The drop lock effectively sets a floor on the rate and a guaranteed minimum return to the investor.

Question – 18 [May 18] [MTP May 21]
What are Masala Bonds?

Answer

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

Question – 19 [Nov 18]

Explain in brief following Financial Instruments:

(i) Euro Bonds
(ii) Floating Rate Notes
(iii) Euro Commercial paper
(iv) Fully Hedged Bond

Answer

(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:** Floating Rate Notes: 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.

Question – 20 [Jan 21] [MTP Nov 21] [MTP May 22]

Explain in brief the following bonds:

(i) Callable Bonds
(ii) Puttable Bonds

Answer

(i) **Callable bonds:** A callable bond has a call option which gives the issuer the right to redeem the bond before maturity at a predetermined price known as the call price (Generally at a premium).

(ii) **Puttable bonds:** Puttable bonds give the investor a put option (i.e. the right to sell the bond) back to the company before maturity.

Question – 21 [Nov 22]

These bonds are issued by non-US Banks and non-US corporations in US. What this bond is called and what are the other features of this Bond?

Answer

The Bond is called as Yankee Bond.

Features of the bond:

- These bonds are denominated in Dollars
- Bonds are to be registered in SEC (Securities and Exchange Commission)
- Bonds are issued in tranches
- Time taken can be up to 14 weeks

Question – 22 [Nov 23]

Write the main features of Bulldog Bond.

Answer

- It is denominated in Bulldog Pound Sterling/Great Britain Pound (GBP)
- Issued in London
- Issuer Non- UK Company
- Regulations: Great Britain
- Purpose: Access of capital available in UK market
- Issue proceeds can be used to fund UK operation
- Issue proceeds can be used to fund a company's local opportunities

Question – 23 [RTP Nov 22] [MTP May 22]
Brief out salient features of Samurai Bond.

Answer

- Samurai bonds are denominated in Japanese Yen JPY
- Issued in Tokyo
- Issuer Non- Japanese Company
- Regulations: Japanese
- Purpose: Access of capital availsable 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.

Question – 24 [RTP May 23]
Highlight the similarities and differences between Samurai Bond and Bull Dog Bond.

Answer
Samurai Bond – Refer question 23

Bulldog Bond

- It is denominated in Bulldog Pound Sterling/Great Britain Pound (GBP)
- Issued in London
- Issuer Non- UK Company
- Regulations: Great Britain
- Purpose: Access of capital available in UK market
- Issue proceeds can be used to fund UK operation
- Issue proceeds can be used to fund a company's local opportunities

Question – 25 [May 23] [MTP May 21]
Discuss features of Secured Premium Notes.

Answer

- SPN instruments are issued with a detachable warrant.
- These instruments are redeemable after a notified period of say 4 to 7 years.
- No interest is paid during the lock in period.
- The conversion of detachable warrant into equity shares will have to be done within time period notified by the company.

Question – 26 [RTP May 18]
Explain the followings:

(a) Bridge Finance
(b) Floating Rate Bonds
(c) Packing Credit

Answer

(a) **Bridge finance** – Refer Question – 12

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

(c) **Packing Credit –** Refer Question - 12

Question – 27 [MTP Sep 24]

Explain the following:
(a) Fully Hedged Bonds
(b) Medium Term Notes
(c) Floating Rate Notes
(d) Euro Commercial Papers

Answer

(a) **Fully Hedged Bonds -** 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.

(b) **Medium Term Notes -** Certain issuers need frequent financing through the Bond route including that of the Euro bond. However, it may be costly and ineffective to go in for frequent issues. Instead, investors can follow the MTN programme. Under this programme, several lots of bonds can be issued, all having different features e.g. different coupon rates, different currencies etc. The timing of each lot can be decided keeping in mind the future market opportunities. The entire documentation and various regulatory approvals can be taken at one point of time.

(c) **Floating Rate Notes** – Refer Question – 26

(d) **Euro Commercial Papers** – Refer Question – 19

Question – 28 [MTP May 24]

Name the various financial instruments dealt with in the International market.

Answer

Some of the various financial instruments dealt with in the international market are:
(a) Euro Bonds
(b) Foreign Bonds
(c) Fully Hedged Bonds
(d) Medium Term Notes
(e) Floating Rate Notes
(f) External Commercial Borrowings
(g) Foreign Currency Futures
(h) Foreign Currency Option
(i) Euro Commercial Papers

Question – 29 **[May 19] [RTP May 19] [RTP May 20] [RTP May 23] [RTP Nov 23] [MTP Nov 19] [MTP May 21]**
What is the process of Debt Securitization?

Answer
It is a method of recycling of funds. It is especially beneficial to financial intermediaries to support the lending volumes. Assets generating steady cash flows are packaged together and against this asset pool, market securities can be issued, e.g. housing finance, auto loans, and credit card receivables.

Process of Debt Securitization

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

(ii) **The pooling function –** Similar loans on receivables are clubbed together to create an underlying pool of assets. The pool is transferred in favor of Special purpose Vehicle (SPV), which acts as a trustee for investors.

(iii) **The securitization function –** SPV will structure and issue securities on the basis of asset pool. The securities carry a coupon and expected maturity which can be asset based/ mortgage based. These are generally sold to investors through merchant bankers. Investors are – pension funds, mutual funds, insurance funds. The process of securitization is generally without recourse i.e. investors bear the credit risk and issuer is under an obligation to pay to investors only if the cash flows are received by him from the collateral. The benefits to the originator are that assets are shifted off the balance sheet, thus giving the originator recourse to off-balance sheet funding.

Question – 30 **[MTP Nov 22]**
What is the meaning of venture capital financing State some characteristics of it.

Answer
The 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. In broad sense, under venture capital financing, venture capitalist make investment to purchase equity or debt securities from inexperienced entrepreneurs who undertake highly risky ventures with 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.

Question – 31 **[Nov 20] [RTP Dec 21] [MTP May 24]**
Explain in brief the methods of Venture Capital Financing.

Answer

(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 (which could be well above 20 percent) instead of royalty on sales once it becomes commercially sound.

(iii) **Income note:** It is a hybrid security which combines the features of both conventional loan and conditional loan. The entrepreneur has to pay both interest and royalty on sales but at substantially low rates. IDBI's VCF provides funding equal to 80 – 87.50% of the projects cost for commercial application of indigenous technology.

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

Question – 32 [Sep 24]
Explain Angel Financing.

Answer
Angel Financing is a form of an equity-financing in which individual or a group of individuals provides capital to entrepreneurs and early-stage businesses, or start-ups, in exchange for an ownership/equity in the company.

They may provide a one-time investment or an ongoing capital injection via a series of investments, Angel investors are looking for a higher rate of return than what is given by traditional investment.

Question – 33 [MTP Nov 22]
Write a short note on seed capital assistance.

Answer
The seed capital assistance has been designed by IDBI for professionally or technically qualified entrepreneurs. All the projects eligible for financial assistance from IDBI, directly or indirectly through refinance are eligible under the scheme. The project cost should not exceed ` 2 crores and the maximum assistance under the project will be restricted to 50% of the required promoter's contribution or ` 15 lacs whichever is lower.

The seed capital assistance is interest free but carries a security charge of one percent per annum for the first five years and an increasing rate thereafter.

Question – 34 [Sep 24]
What is Leveraged Lease? Explain.

Answer
Under this lease, a third party is involved besides lessor and the lessee. The lessor borrows a part of the purchase cost (say 80%) of the asset from the third party i.e., lender and asset so purchased is held as security against the loan. The lender is paid off from the lease rentals directly by the lessee and the surplus after meeting the claims of the lender goes to the lessor. The lessor is entitled to claim depreciation allowance.

Question – 35 [RTP Nov 18] [RTP Nov 20] [RTP Nov 22]
Explain the difference between Financial Lease and Operating Lease.

Answer

	Financial 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 single 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.

Question – 36 [Nov 18]

Discuss the Advantages of Leasing.

Answer

(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. That means a technologically upgraded asset with better capacity may come into existence after purchase. To retain competitive advantage the lessee as user may have to go for the upgraded asset.

Question – 37 [MTP Sep 24]

Operating leases and financial leases are traditionally the most important types of leases in financial management. However, in recent years, other types of leases have also gained significance due to their unique benefits and applications. Identify and explain at least four other types of leases that have become increasingly important in modern business practices.

Answer

(a) **Sales and Lease Back:** Under this type of lease, the owner of an asset sells the asset to a party (the buyer), who in turn leases back the same asset to the owner in consideration of a lease rentals. Under this arrangement, the asset is not physically exchanged but it all happen in records only. The main advantage of this method is that the lessee can satisfy himself completely regarding the quality of an asset and after possession of the asset convert the sale into a lease agreement.

Under this transaction, the seller assumes the role of lessee (as the same asset which he has sold came back to him in the form of lease) and the buyer assumes the role of a lessor (as asset purchased by him was leased back to the seller). So, the seller gets the agreed selling price and the buyer gets the lease rentals.

(b) **Leveraged Lease:** Under this lease, a third party is involved besides lessor and the lessee. The lessor borrows a part of the purchase cost (say 80%) of the asset from the third party i.e., lender and asset so purchased is held as security against the loan. The lender is paid off from the lease rentals directly by the lessee and the surplus after meeting the claims of the lender goes to the lessor. The lessor is entitled to claim depreciation allowance.

(c) **Sales-aid Lease:** Under this lease contract, the lessor enters into a tie up with a manufacturer for marketing the latter's product through his own leasing operations, it is called a sales-aid lease. In consideration of the aid in sales, the manufacturer may grant either credit or a commission to the lessor. Thus, the lessor earns from both sources i.e. From lessee as well as the manufacturer.

(d) **Close-ended and Open-ended Leases:** In the close-ended lease, the assets get transferred to the lessor at the end of lease, the risk of obsolescence, residual value etc., remain with the lessor being the legal owner of the asset. In the open-ended lease, the lessee has the option of purchasing the asset at the end of the lease period.

Question – 38 [[MTP May 24]

Explain the concept of Indian Depository Receipts.

Answer

The concept of the depository receipt mechanism which is used to raise funds in foreign currency has been applied in the Indian capital market through the issue of Indian Depository Receipts (IDRs). Foreign companies can issue IDRs to raise funds from Indian market on the same lines as an Indian company uses ADRs/GDRs to raise foreign capital. The IDRs are listed and traded in India in the same way as other Indian securities are traded.

Question – 39 [May 22]

Distinguish between American Depository Receipts and Global Depository Receipts.

Answer

	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 tat 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

Question – 40 [May 24]
Explain the features of crowd funding.

Answer
Crowdfunding means raising money for an individual or organisation from a group of people to fund a project, typically via internet (social media and crowdfunding websites). It generally involves collecting funds from family, friends, strangers, corporates and many more in exchange of equity (known as Equity funding), loans (known as P2P lending) or nothing at all (i.e. donation). This source of funding also helps start-up to substantiate demand for their product before entering into production.

In the crowdfunding process, three parties are involved i.e. fund raiser, mediator and fund investor. The platforms (mediator) may also charge certain fees in the form of processing fee, transaction fee, etc. either as a fixed amount or a percentage or in combination of both.

Cost of Capital

Question – 1 [Nov 19]
Explain the significance of Cost of Capital.

Answer
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. Here it is pertinent to mention that every investment option may have different cost of capital hence it is very important to use the cost of capital which is relevant to the options available. Here Internal Rate of Return (IRR) is treated as cost of capital for evaluation of two options (projects).

(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.

Question – 2 [Nov 22]
What are the important factors considered for deciding the source and quantum of capital?

Answer
The source and quantum of capital is decided keeping in mind the following factors:

(i) **Control:** Capital structure should be designed in such a manner that existing shareholders continue to hold majority stake

(ii) **Risk:** Capital structure should be designed in such a manner that financial risk of a company does not increase beyond tolerable limit.

(iii) **Cost:** Overall cost of capital remains minimum.

Question – 3 [Nov 20]
Distinguish between Unsystematic Risk & Systematic Risk.

Answer
(i) **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.

(ii) **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.

Question – 4 [RTP Jan 25] [MTP May 19]
Explain any four Methods for Computation of Cost of Equity Capital.

Answer

Cost of equity capital is the rate of return which equates the present value of expected dividends with the market share price.

Methods for Computation of Cost of Equity Capital

• **Dividend Price Approach:** Here, cost of equity capital is computed by dividing the expected dividend by market price per share.

$$Ke = \frac{D1}{P0}$$

• **Earning/ Price Approach:** The advocates of this approach co-relate the earnings of the company with the market price of its share.

$$Ke = \frac{E}{P}$$

• **Realized Yield Approach:** According to this approach, the average rate of return realized in the past few years is historically regarded as 'expected return' in the future. The yield of equity for the year is:

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

• **Capital Asset Pricing Model Approach (CAPM):** CAPM model describes the risk-return trade-off for securities. It describes the linear relationship between risk and return for securities.

$$Ke = Rf + ß\,(Rm - Rf)$$

Question – 5 [MTP July 20]

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

Answer

(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.

Leverage

Question – 1 [MTP May 19]
Explain the difference between Business risk and Financial risk.

Answer
Business risk refers to the risk associated with the firm's operations. It is an unavoidable risk because of the environment in which the firm has to operate and the business risk is represented by the variability of earnings before interest and tax (EBIT). The variability in turn is influenced by revenues and expenses. Revenues and expenses are affected by demand of firm's products, variations in prices and proportion of fixed cost in total cost.

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

Question – 2 [MTP Sep24]
What is the range of DOL?

Answer
DOL can never be between zero and one. It can be zero or less or it can be one or more.

When Sales is much higher than BEP sales, DOL will be slightly more than one. With decrease in sales, DOL will increase. At BEP, DOL will be infinite. When sales is slightly less than BEP, DOL will be negative infinite. With further reduction in sale, DOL will move towards zero. At zero sales, DOL will also be zero.

Question – 3 [May 23] [MTP May 21] [MTP May 24]
Briefly explain concept of "Trading on Equity" in financial leverage analysis.

Answer
Financial leverage indicates the use of funds with fixed cost like long term debts and preference share capital along with equity share capital which is known as trading on equity. The basic aim of financial leverage is to increase the earnings available to equity shareholders using fixed cost fund. A firm is known to have a positive/favourable leverage when its earnings are more than the cost of debt. If earnings are equal to or less than cost of debt, it will be a negative/unfavourable leverage. When the quantity of fixed cost fund is relatively high in comparison to equity capital it is said that the firm is 'trading on equity".

Question – 4 [RTP May 18] [MTP Sep 24]
"Financial Leverage is a double-edged sword". Discuss.

Answer
On one hand when cost of 'fixed cost fund' is less than the return on investment financial leverage will help to increase return on equity and EPS. The firm will also benefit from the saving of tax on interest on debts etc. However, when cost of debt will be more than the return it will affect return

of equity and EPS unfavourably and as a result firm can be under financial distress. This is why financial leverage is known as “double edged sword”.

Effect on EPS and ROE:
When, ROI > Interest – Favourable – Advantage
When, ROI < Interest – Unfavourable – Disadvantage
When, ROI = Interest – Neutral – Neither advantage nor disadvantage.

Capital Structure

Question – 1 **[Nov 22]** **[MTP July 20]**
The firm has more capital than its requirements. What is this situation called? Give two consequences of it.

Answer
The situation is called as Over Capitalization.
Consequences of Over Capitalization:
- Considerable reduction in the rate of dividend and interest payments.
- Reduction in the market price of shares
- Resorting to "Window dressing"
- Some companies may opt for reorganization. However, sometimes the matter gets worse and the company may go into liquidation.

Question – 2 **[MTP May 24]**
What is optimum capital structure?

Answer
The capital structure is said to be optimum when the firm has selected such a combination of equity and debt so that the wealth of firm is maximum. At this capital structure, the cost of capital is minimum and the market price per share i.e. value of the firm is maximum.

Question – 3 **[MTP Sep 24]**
Explain the Relationship between EBIT-EPS-MPS.

Answer
The basic objective of financial management is to design an appropriate capital structure which can provide the highest wealth, i.e., highest MPS, which in turn depends on EPS.

Given a level of EBIT, EPS will be different under different financing mix depending upon the extent of debt financing. The effect of leverage on the EPS emerges because of the existence of fixed financial charge i.e., interest on debt, financial fixed dividend on preference share capital. The effect of fixed financial charge on the EPS depends upon the relationship between the rate of return on assets and the rate of fixed charge. If the rate of return on assets is higher than the cost of financing, then the increasing use of fixed charge financing (i.e., debt and preference share capital) will result in increase in the EPS. This situation is also known as favourable financial leverage or Trading on Equity. On the other hand, if the rate of return on assets is less than the cost of financing, then the effect may be negative and, therefore, the increasing use of debt and preference share capital may reduce the EPS of the firm. The fixed financial charge financing may further be analysed with reference to the choice between the debt financing and the issue of preference shares. Theoretically, the choice is tilted in favour of debt financing for two reasons: (i) the explicit cost of debt financing i.e., the rate of interest payable on debt instruments or loans is generally lower than the rate of fixed dividend payable on preference shares, and (ii) interest on debt financing is tax-deductible and therefore the real cost (after-tax) is lower than the cost of preference share capital.

Question – 4 **[Nov 23]** **[MTP Jan 25]**
What are the causes of over-capitalization?

Answer

(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 the 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 capitalization

Question – 5 [Sep 24]

What are the remedies for over-capitalisation?

Answer

Following steps may be adopted to avoid the negative consequences 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.

Question – 6 [MTP July 20]

Explain in brief the Pecking order theory.

Answer

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.

Working Capital Management

Question – 1 **[May 23]**
"Permanent working capital and fluctuating (temporary) working capital, both are necessary to facilitate production and sales through the operating cycle." - Describe.

Answer
Both kinds of working capital i.e. permanent and fluctuating (temporary) are necessary to facilitate production and sales through the operating cycle:

Permanent working capital refers to the base working capital, which is the minimum level of investment in the current assets that is carried by the entity at all times to carry its day to day activities. It generally stays invested in the business unless the operations are scaled up or down permanently which would also result in increase or decrease in permanent working capital. It is generally financed by long term sources of finance.

Temporary working capital refers to that part of total working capital, which is required by an entity in addition to the permanent working capital. It is also called variable or fluctuating working capital which is used to finance the short-term working capital requirements which arises due to fluctuation in sales volume. For instance, an organization would maintain increased levels of inventory to meet increased seasonal demand.

Question – 2 **[MTP Nov 20]**
State any four factors which need to be considered while planning for working capital requirement.

Answer
Some of the factors which need to be considered while planning for working capital requirement are-

(i) **Cash:** Identify the cash balance which allows for the business to meet day- to-day expenses, but reduces cash holding costs.
(ii) **Inventory:** Identify the level of inventory which allows for uninterrupted production but reduces the investment in raw materials and hence increases cash flow; the techniques like Just in Time (JIT) and Economic order quantity (EOQ) are used for this.
(iii) **Receivables:** Identify the appropriate credit policy, i.e., credit terms which will attract customers, such that any impact on cash flows and the cash conversion cycle will be offset by increased revenue and hence Return on Capital (or vice versa). The tools like Discounts and allowances are used for this.
(iv) **Short-term Financing Options:** Inventory is ideally financed by credit granted by the supplier; dependent on the cash conversion cycle, it may however, be necessary to utilize a bank loan (or overdraft), or to "convert debtors to cash" through "factoring" in order to finance working capital requirements.
(v) **Nature of Business:** For e.g. in a business of restaurant, most of the sales are in Cash. Therefore, need for working capital is very less.
(vi) **Market and Demand Conditions:** For e.g. if an item's demand far exceeds its production, the working capital requirement would be less as investment in finished goods inventory would be very less.

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

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

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

Question – 3

Discuss the liquidity vs. profitability issue in management of working capital.

Answer

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

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

Question – 4 [MTP Jan 25]

A company is evaluating two options for financing its current assets: using short-term loans or long-term loans. How should the company balance risk and return in making this decision, and what factors should it consider to ensure optimal financing?

Answer

The financing of current assets involves a trade off between risk and return. A firm can choose from short or long term sources of finance. Short term financing is less expensive than long term financing but at the same time, short term financing involves greater risk than long term financing.

Depending on the mix of short term and long term financing, the approach followed by a company may be referred as matching approach, conservative approach and aggressive approach.

In matching approach, long-term finance is used to finance fixed assets and permanent current assets and short term financing to finance temporary or variable current assets. Under the conservative plan, the firm finances its permanent assets and also a part of temporary current assets with long term financing and hence less risk of facing the problem of shortage of funds.

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

Receivables Management

Question – 1 [July 21]
Describe the salient features of FORFAITING.

Answer
The Salient features of forfaiting are:
- 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.

Question – 2 [MTP Jan 25]
Explain the difference between factoring and forfaiting.

Answer

Particulars	Factoring	Forfaiting
Meaning	Factoring involves sales of receivables to the financial institution called factor in exchange for immediate cash payment.	Forfaiting is a form of export financing where the exporter sells the rights to trade receivables to a forfeiter and receives instant cash.
Recourse or Non-recourse	May be on Recourse or Non-recourse basis.	Always non-recourse.
Amount paid	Firms are generally paid 80% to 90% upfront	100% on the value of exported goods is paid
Type of receivables	Receivables may either domestic or international	Receivables are international
Cost	Factoring cost in the form of factor commission or fees is to be borne by the seller	Overseas buyer bears the forfaiting cost, if any
Secondary market	Factoring does not involve a secondary market for the receivables, meaning that the transaction is complete once the receivables are sold to the factor.	Forfaiting has a secondary market where the receivables can be traded, enhancing liquidity and providing additional opportunities for investors.

Cash Management

Question – 1 [Jan 21]
Explain Electronic Cash Management System.

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

Question – 2 [Nov 22] [RTP Nov 19]
Elucidate the fundamental tasks of treasury department of a firm.

Answer
(i) **Cash management:** It involves efficient cash collection process and managing payment of cash both inside the organization and to third parties. Treasury will also manage surplus funds in an investment portfolio.
(ii) **Currency management:** The treasury department manages the foreign currency risk exposure of the company. In a large multi-national company, 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 and will save the organization from any unfavorable exchange movement.
(iii) **Fund management:** Treasury department is responsible for planning and sourcing the company's short, medium and long-term cash needs. It also facilitates temporary investment of surplus funds by mapping the time gap between funds inflow and outflow.
(iv) **Banking:** It is important that a company maintains a good relationship with its bankers. Treasury department carry out negotiations with bankers with respect to interest rates, foreign exchange rates etc. and act as the initial point of contact with them.
(v) **Corporate finance:** Treasury department is involved with both acquisition and divestment activities within the group. In addition, it will often have responsibility for investors' relations.

Question – 3 [MTP Nov 20]
Explain Billing float and Mail float with reference to management of cash.

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

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

Investment Decisions

Question – 1 [Dec 21]
Adjustment of risk is required in capital budgeting decision, give reasons for it.

Answer
(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 cash Inflows. Higher risk will lead to higher risk premium and also the expectation of higher return.

Question – 2 [MTP Nov 22]
Write a short note on Cut-oof rate.

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

Question – 3 [July 21]
Explain the limitations of Average Rate of Return.

Answer
- 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., 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.

Question – 4 [May 24] [RTP Nov 19] [MTP May 22]
Discuss the relevance of Payback reciprocal in capital budgeting decisions.

Answer
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.

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. It may be calculated as follows:

Payback Reciprocal = Average annual cash flows/initial Investment

Or
Payback Reciprocal = 1 / payback period

Question – 5 [MTP Nov 19] [MTP May 24]
Explain the concept of discounted payback period.

Answer
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.

Question – 6 [MTP Nov 22]
What do you understand by desirability factor or profitability index?

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

Mathematically, the desirability factor is calculated as below:

$$\frac{Sum\ of\ discounted\ cash\ inflows}{Initial\ cash\ outlay\ OR\ total\ discounted\ cash\ outflow}$$

Question – 7 [RTP Jan 25]
Do the profitability index and the NPV criterion of evaluating investment proposals lead to the same acceptance-rejection and ranking decisions? In what situations will they give conflicting results?

Answer
In the most of the situations the Net Present Value Method (NPV) and Profitability Index (PI) yield same accept or reject decision. In general items, under PI method a project is acceptable if profitability index value is greater than 1 and rejected if it less than 1. Under NPV method a project is acceptable if Net present value of a project is positive and rejected if it is negative. Clearly a project offering a profitability index greater than 1 must also offer a net present value which is positive. But a conflict may arise between two methods if a choice between mutually exclusive projects has to be made. Consider the following example:

	Project A	**Project B**
PV of cash inflows	3,00,000	80,000
Initial cash outflows	1,00,000	40,000
NPV	2,00,000	40,000
PI	$\frac{3,00,000}{1,00,000} = 3$	$\frac{80,000}{40,000} = 2$

According to NPV method, project A would be preferred, whereas according to profitability index method project B would be preferred.

This is because Net present value gives ranking on the basis of absolute value of rupees, whereas, profitability index gives ranking on the basis of ratio. Although PI method is based on NPV, it is a better evaluation technique than NPV in a situation of capital rationing.

Question – 8 [Jan 21]
Define Internal Rate of Return (IRR)

Answer
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.

Question – 9 [May 22]
Identify the limitations of Internal Rate of Return.

Answer
- 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.

Question – 10 [MTP May 18] [MTP Jan 25]
State Modified Internal Rate of Return.

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

Under this method, all cash flows, apart from the initial investment, are brought to the terminal value using an appropriate discount rate (usually the cost of capital). This results in a single stream of cash inflow in the terminal year. The MIRR is obtained by assuming a single outflow in the zeroth year and the terminal cash inflow as mentioned above. The discount rate which equates the present value of the terminal cash in flow to the zeroth year outflow is called the MIRR.

Question – 11 [MTP Nov 22]
Distinguish between Net Present Value and Internal Rate of Return.

Answer
NPV and IRR methods differ in the sense that the results regarding the choice of an asset under certain circumstances are mutually contradictory under two methods. In case of mutually exclusive investment projects, in certain situations, they may give contradictory results such that if the NPV method finds one proposal acceptable, IRR favours another. The different rankings given by the NPV and IRR methods could be due to size disparity problem, time disparity problem and unequal expected lives.

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

In the net present value cash flows are assumed to be re-invested at cost of capital rate. In IRR reinvestment is assumed to be made at IRR rates.

Dividend Decisions

Question – 1 [May 22]
Briefly explain the assumptions of Walter's Model.

Answer
- All investment proposals of the firm are to be financed through retained earnings only.
- 'r' rate of return & 'Ke' cost of capital are constant.
- Perfect capital markets: The firm operates in a market in which all investors are rational and information is freely available to all.
- 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.
- No floatation or transaction cost: Similarly, these costs may differ country to country or market to market.
- The firm has perpetual life.

Question – 2 [MTP Nov 18]
State two advantages of Walter Model of Dividend Decision.

Answer
(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.

Question – 3 [MTP Jan 25]
Mention any one advantage of stock dividend – to the company as well as to the investor.

Answer
Advantage to the Company - Stock dividends are suitable in the situation of cash crunch and deficiency faced by the company and suitable when restrictions are imposed by lenders to pay the cash dividend

Advantage to the investor – Improves liquidity in the hands of the investors as bonus shares leads to breaking down of higher priced shares into lower priced shares and hence give a choice to shareholders to sell some of the lower priced shares and get some liquidity

Question – 4 [May 23]
List out the conditions, framed by SEBI, which a company needs to fulfil in order to issue of bonus shares.

Answer
To issue Bonus shares, a Company needs to fulfill all the conditions given by Securities Exchange Board of India (SEBI):
(i) As per SEBI, the bonus shares are issued not in lieu of cash dividends.

(ii) A bonus issue should be authorized by Article of Association (AOA) and not to be declared unless all partly paid-up shares have been converted into fully paid-up shares.
(iii) The Company should not have defaulted on re-payment of loan, interest, and any statutory dues.
(iv) Bonus shares are to be issued only from share premium and free reserves and not from capital reserve on account of fixed assets revaluation.

Question – 5 [Sep 24]
List any four assumptions of Gorden's Model.

Answer
- Firm is an all equity firm i.e. no debt.
- IRR will remain constant, because change in IRR will change the growth rate and consequently the value will be affected. Hence this assumption is necessary.
- Ke will remain constant, because change in discount rate will affect the present value.
- Retention ratio (b), once decide upon, is constant i.e. constant dividend payout ratio will be followed.
- Growth rate (g = br) is also constant, since retention ratio and IRR will remain unchanged and growth, which is the function of these two variable will remain unaffected.
- Ke> g, this assumption is necessary and based on the principles of series of sum of geometric progression for 'n' number of years.
- All investment proposals of the firm are to be financed through retained earnings only.

Question – 6 [MTP Sep 24]
Discuss the parameters of Linter's Model.

Answer
Lintner's model has two parameters:
i. The target payout ratio,
ii. The spread at which current dividends adjust to the target.

Ratio Analysis

<u>Question – 1</u> [MTP May 22]
Discuss the limitations of financial ratios.

<u>Answer</u>
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.

(i) **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.

(ii) **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.

(iii) Seasonal factors may also influence financial data.

(iv) 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.

(v) Differences in accounting policies and accounting period: It can make the accounting data of two firms non-comparable as also the accounting ratios.

(vi) 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.

(vii) Financial ratios are inter-related, not independent: Viewed in isolation one ratio may highlight efficiency. But when considered as a set of ratios they may speak differently. Such interdependence among the ratios can be taken care of through multivariate analysis.