

Theory Trend Analysis

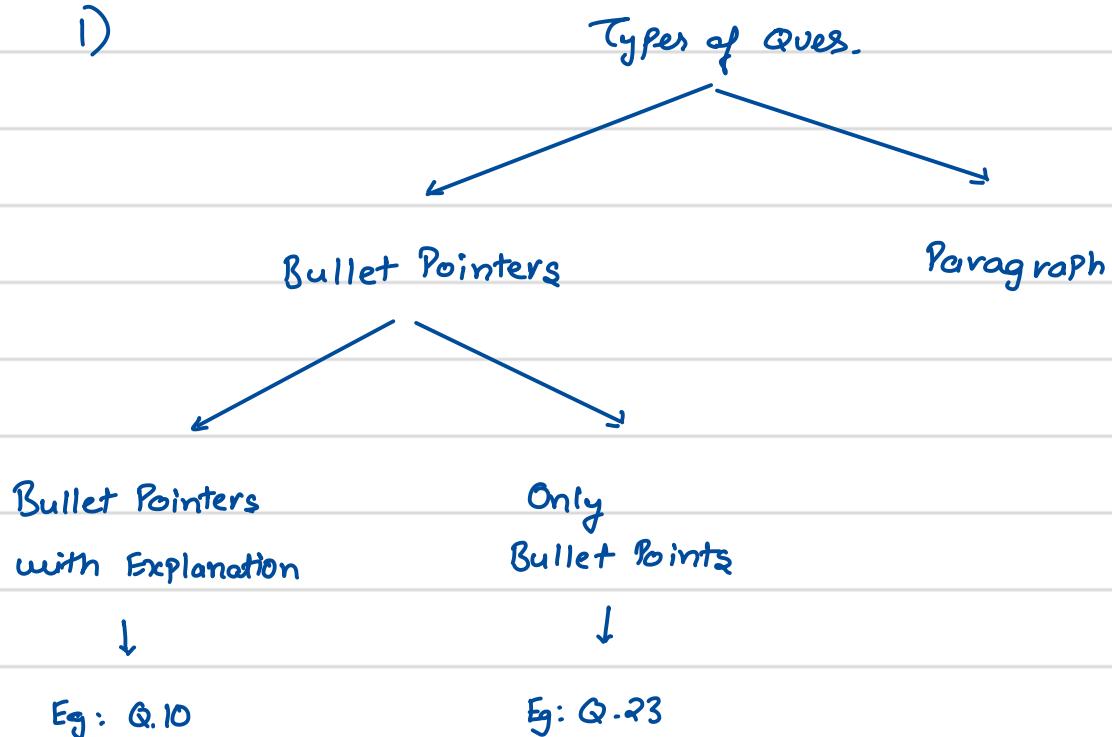
Attempt	Type	Q. No.	Chapter	Question	Marks
Sep-25	SA	4(a)	Dividend	Adv. & Disadv. Of Stock Splits	4
Sep-25	SA	4(b)	TOF	Explain diff types of Bonds	4
Sep-25	SA	4(c)	Scope	Functions of FM	2
Sep-25	SA	4(c)	Scope	Limitations of Profit Max. Objective	2
May-25	SA	4(a)	Scope	Agency Cost, types, how to minimize	4
May-25	SA	4(b)	TOF	Features of Bridge Financing	4
May-25	SA	4(c)	Cap. Structure	Pecking Order Hierarchy	2
May-25	SA	4(c)	Leverage	Best combination of OL and FL	2
Jan-25	SA	4(a)	TOF	ESG Bonds	4
Jan-25	SA	4(b)	Scope	Objectives and Adv. Of Wealth Max.	4
Jan-25	SA	4(c)	WCM	Adv. Of Virtual Banking	2
Jan-25	SA	4(c)	Investment	Exclusion of Financing Cost Principle	2
Sep-24	SA	2(b)	TOF	Angel Financing	2
Sep-24	SA	4(a)	TOF	Adv, Disadv. Of Debentures	4
Sep-24	SA	4(b)	Dividend	Assumptions of Gordon's Model	4
Sep-24	SA	4(c)	TOF	Leveraged Lease	2
Sep-24	SA	4(c)	Cap. Structure	Remedies for Over-Capitalisation	2
May-24	SA	4(a)	Scope	True False Question	4
May-24	SA	4(b)	TOF	Types of Bank Credit	4
May-24	SA	4(c)	Investment	Payback Reciprocal	2
May-24	SA	4(c)	TOF	Crowd Funding	2

1) How to write answers in Theory

2) Should you leave Theory ?

3) How to cover Theory ?

1)



| Section 2A – Theoretical: Descriptive Questions

Question 1

(May 13 SA – 4 Marks)

“Operating risk is associated with cost structure, whereas financial risk is associated with capital structure of a business concern.” Critically examine this statement.

Or

Question 2

(MTP 1 Nov 23 – 4 marks)

EXPLAIN the difference between Business risk and Financial risk

Solution

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 3

(MTP 1 Sep 24 – 2 marks)

WHAT is the range of DOL?

Solution

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 4

(May 23 SA – 2 Marks)

Briefly explain concept of "Trading on Equity" in financial leverage analysis.

Solution

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 5**(MTP 2 Sep 24 – 2 marks)**

EXPLAIN Financial Leverage as a 'Double edged Sword'

Solution

When the 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. Therefore, financial leverage is also 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

| Section 2A – Theoretical: Descriptive Questions

Question 1

[Nov 19 SA – 4 Marks]

Explain the significance of Cost of Capital.

Solution

Significance of the Cost of Capital: 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 particular project or business. The performance of a project or business is compared against the cost of capital which is known here as cut-off rate or hurdle rate.
- (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

[PM]

What is meant by weighted average cost of capital?

Solution

The composite or overall cost of capital of a firm is the weighted average of the costs of the various sources of funds. Weights are taken to be in the proportion of each source of fund in the capital structure. While making financial decisions this overall or weighted cost is used. Each investment is financed from a pool of funds which represents the various sources from which funds have been raised. Any decision of investment, therefore, has to be made with reference to the overall cost of capital and not with reference to the cost of a specific source of fund used in the investment decision.

The weighted average cost of capital is calculated by:

- (i) Calculating the cost of specific source of fund e.g. cost of debt, equity etc;
- (ii) Multiplying the cost of each source by its proportion in capital structure; and
- (iii) Adding the weighted component cost to get the firm's WACC represented by K_0 .

$$K_0 = K_1 W_1 + K_2 W_2 + \dots$$

Where,

K_1, K_2 are component costs and W_1, W_2 are weights.

Question 3**[PM]**

~~X~~ Discuss the dividend-price approach, and earnings price approach to estimate cost of equity capital.

Solution

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

$$K_e = \frac{D_1}{P_0}$$

Where,

D_1 = Dividend per share in period 1

P_0 = Market price per share today

Whereas, on the other hand, the advocates of earnings price approach co-relate the earnings of the company with the market price of its share. Accordingly, the cost of ordinary share capital would be based upon the expected rate of earnings of a company. This approach is similar to dividend price approach, only it seeks to nullify the effect of changes in dividend policy.

Question 4**[RTP Jan 25]**

~~FM360~~ EXPLAIN any four Methods for Computation of Cost of Equity Capital.

Solution

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.

$$K_e = \frac{D_1}{P_0}$$

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

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

- **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.

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

| Section 2A – Theoretical: Descriptive Questions

Question 1

[Nov 15 – 4 Marks]

Distinguish between Net Present Value (NPV) and Internal Rate of Return (IRR) methods for evaluating projects.

Solution

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**.

Question 2

[Nov 17 – 4 Marks]

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

Solution

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

Mathematically, the desirability factor is calculated as below:

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

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

Limitations of PI

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

Question 3

Recd. 1
 ✓ Highest PI.
 Posn. 2
 Smaller PI
 +
 1/2 in future years

[Nov 19 – 3 marks]

Explain the steps while using the equivalent annualized criterion.

Solution

Equivalent Annualized Criterion: This method involves the following steps-

- (i) Compute NPV using the WACC or discounting rate.
- (ii) Compute Present Value Annuity Factor (PVAF) of discounting factor used above for the period of each project.
- (iii) Divide NPV computed under step (i) by PVAF as computed under step (ii) and compare the values.

Question 4**[Nov 20 – 2 Marks]**

Distinguish between Unsystematic Risk & Systematic Risk.

Solution

- (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 5**[MTP 2 Nov 23 – 4 Marks]**

EXPLAIN the concept of risk adjusted discount rate.

Solution

Risk Adjusted Discount Rate: The use of risk adjusted discount rate (RADR) is based on the concept that investors demands **higher returns from the risky projects**. The required rate of return on any investment should include **risk free rate of return, plus compensation for any kind of risk taken**. If the risk associated with any investment project is higher than risk involved in a similar kind of project, discount rate is adjusted upward in order to compensate this additional risk borne.

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

So Risks adjusted discount rate = Risk free rate + Risk premium

Risk Free Rate: It is the rate of return on Investments that **bear no risk**. For e.g., Government securities yield a return of 6 % and bear no risk. In such case, 6 % is the risk -free rate.

Risk Premium: It is the **rate of return over and above the risk-free rate**, expected by the Investors as a **reward for bearing extra risk**. For high risk project, the risk premium will be high and for low risk projects, the risk premium would be lower.

Question 6**[Nov 20 – 2 Marks]**

What is Risk Adjusted Discount Rate ?

Solution

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

So, Risks adjusted discount rate = Risk free rate + Risk premium.

Question 7**[PM]**

Write a short note on internal rate of return.

Solution

Internal Rate of Return: It is that rate at which discounted cash inflows are equal to the discounted cash outflows. In other words, it is the rate which discounts the cash flows to zero. This rate is to be found by trial and error method. This rate is used in the evaluation of investment proposals. In this method, the discount rate is not known but the cash outflows and cash inflows are known.

In evaluating investment proposals, internal rate of return is compared with a required rate of return, known as cut-off rate. If it is more than cut-off rate the project is treated as acceptable; otherwise project is rejected.

Question 8**[MTP 2 Nov 22 – 2 Marks]**

What do you understand by desirability factor/profitability index?

Solution

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

Mathematically, the desirability factor is calculated as below:

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

Question 9**[MTP 1 May 24 – 2 marks]**

Write a short note on "Cut - off Rate".

Solution

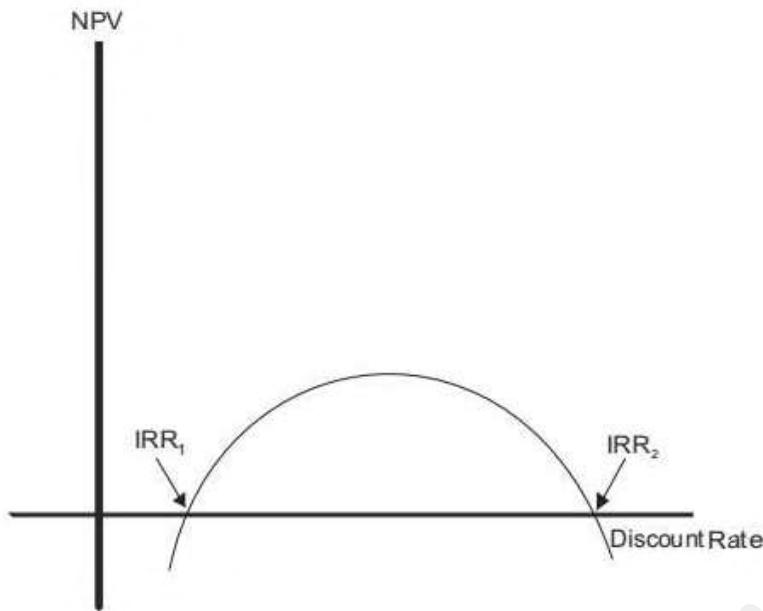
Cut - off Rate: It is the minimum rate which the management wishes to have from any project. Usually this is based upon the cost of capital. The management gains only if a project gives return of more than the cut - off rate. Therefore, the cut - off rate can be used as the discount rate or the opportunity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

Question 10**[Nov 08 – 3 Marks]**

Explain the concept of Multiple Internal Rate of Return.

Solution

In cases where project cash flows change signs or reverse during the life of a project for example, an initial cash outflow is followed by cash inflows and subsequently followed by a major cash outflow; there may be more than one internal rate of return (IRR). The following graph of discount rate versus net present value (NPV) may be used as an illustration:



In such situations if the cost of capital is less than the two IRRs, a decision can be made easily, however, otherwise the IRR decision rule may turn out to be misleading as the project should only be invested if the cost of capital is between IRR_1 and IRR_2 . To understand the concept of multiple IRRs it is necessary to understand the implicit re-investment assumption in both NPV and IRR techniques.

Question 11

[MTP 2 May 24 – 2 Marks]

Numerical
Explain the concept of discounted payback period.

Solution

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 12

[MTP 1 Jan 25 – 2 marks]

FM360
DEFINE Modified Internal Rate of Return method.

Solution

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

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

Question 13**[May 21 – 2 Marks]**

Explain the limitations of Average Rate of Return.

Solution

Limitations of Average Rate of Return

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

Question 14**[May 22 – 4 Marks]**

Identify the limitations of Internal Rate of Return.

Solution

Limitations of Internal Rate of Return (IRR)

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

Question 15**[May 24 – 2 Marks]**

Discuss the relevance of Payback reciprocal in capital budgeting decisions.

Or

Question 16**[MTP 2 May 22 – 2 Marks]**

Explain the term 'Payback Reciprocal'

Solution

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 = $1 / \text{payback period}$

Question 17

[Jan 25 – 2 Marks]

State the concept of exclusion of Financing Cost Principle.

Solution

The **exclusion** of financing costs principle means that:

- (i) **The interest on long-term debt** is ignored while computing profits and taxes.
- (ii) **The expected dividends** are deemed irrelevant in cash flow analysis.

Question 18

[May 21 – 2 Marks]

List out the steps to be followed by the manager to measure and maximize the Shareholder's Wealth.

Solution

For measuring and maximising shareholders' wealth, manager should follow:

- **Cash Flow approach not Accounting Profit**
- **Cost benefit analysis**
- **Application of time value of money.**

Question 19

[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?

Solution

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:

Particulars	Project A	Project B
PV of Cash inflows	2,00,000	1,00,000
Initial cash outflows	1,00,000	40,000
Net present value	1,00,000	60,000
P.I	$\frac{2,00,000}{1,00,000} = 2$	$\frac{1,00,000}{40,000} = 2.5$

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.

Section 2A – Theoretical: Descriptive Questions

FM360 Question 1

[Sep 24 – 4 Marks]

List any four assumptions of Gorden's Model.

Solution

Gordon's model is based on the following assumptions:

- 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.
- K_e 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.
- $K_e > g$, 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 2

[May 22 – 4 Marks]

Briefly explain the assumptions of Walter's Model.

Solution

Assumptions of Walter's Model

- All investment proposals of the firm are to be financed through retained earnings only.
- 'r' rate of return & ' K_e ' 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 3

[MTP 1 Nov 18 – 2 marks]

STATE two advantages of Walter Model of Dividend Decision.

Solution

Advantages of Walter Model

1. The formula is simple to understand and easy to compute.

2. It can envisage different possible market prices in different situations and considers internal rate of return, market capitalisation rate and dividend payout ratio in the determination of market value of shares.

Question 4**[MTP 1 Sep 24 – 2 marks]**

DISCUSS the parameters of Lintner's Model.

Solution

Lintner's model has two parameters:

- i. The target payout ratio,
- ii. The spread at which current dividends adjust to the target.

Question 5**[MTP 2 May 23 – 5 marks]**

EXPLAIN the determinants of dividend decisions.

Solution

The dividend policy is affected by the following factors:

1. **Availability of funds:** If the business is in requirement of funds, then retained earnings could be a good source. The reason being the saving of floatation cost and prevention of dilution of control which happens in case of new issue of equity shares to public.
2. **Cost of capital:** If the financing requirements are to be executed through debt (relatively cheaper source of finance), then it would be preferable to distribute more dividend. On the other hand, if the financing is to be done through fresh issue of equity shares, then it is better to use retained earnings as much as possible.
3. **Capital structure:** An optimum Debt Equity ratio should also be considered for the dividend decision.
4. **Stock price:** Stock price here means market price of the shares. Generally, higher dividends increase market value of shares and low dividends decrease the value.
5. **Investment opportunities in hand:** The dividend decision is also affected if there are investment opportunities in hand. In that situation, the company may prefer to retain more earnings.
6. **Internal rate of return (IRR):** If the internal rate of return (IRR) is more than the cost of retained earnings (K_r), it is better to distribute the earnings as much as possible. $R > K_r$
7. **Trend of industry:** The investors depend on some industries for their regular dividend income. Therefore, in such cases, the firms have to pay dividend in order to survive in the market.
8. **Expectation of shareholders:** The shareholders can be categorised into two categories:
 - (i) those who invests for regular income, &
 - (ii) those who invests for growth. Generally, the investor prefers current dividend over the future growth.
9. **Legal constraints:** Section 123 of the Companies Act, 2013 which provides for declaration of dividend states that Dividend shall be declared or paid by a company for any financial year only:
 - (a) out of the profits of the company for that year arrived at after providing for depreciation in accordance with the relevant provisions, or

- (b) out of the profits of the company for any previous financial year or years arrived at after providing for depreciation in accordance with the relevant provisions and remaining undistributed, or
- (c) out of both, or
- (d) out of money provided by the Central Government or a State Government for the payment of dividend by the company in pursuance of a guarantee given by that Government.

It may be noted that, while computing the profits for payment of dividends any amount representing unrealised gains, notional gains or revaluation of assets and any change in carrying amount of an asset or of a liability on measurement of the asset or the liability at fair value shall be excluded.

10. **Taxation:** Before 1st April 2020, as per Section 115-O of Income Tax Act, 1961, dividend was subject to dividend distribution tax (DDT) in the hands of the company. Dividend on which DDT was paid, was to be exempted in the hands of the shareholder u/s 10(34). However, as per amendment made by the Finance Act 2020, the exemption u/s 10(34) shall not apply to dividend received on or after 1st April 2020 and the dividend income from shares held as investment shall be taxable under the head of 'Other income' at the applicable slab rate.

Study Note: For a question of 5 marks you only have to write any of the 5 – 6 points from these, additional points have been given only for conceptual understanding of the topic.

Question 6

[May 23 – 4 Marks]

List out the conditions, framed by SEBI, which a company needs to fulfil in order to issue of bonus shares.

Solution

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 7

[MTP 2 Jan 25 – 2 marks]

MENTION any one advantage of stock dividend – to the company as well as to the investor

Solution

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 8**[MTP 2 Nov 18 – 2 marks]**

STATE the advantages of Stock-Splits.

Solution

Various advantages of Stock Spills are as follows:

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

| Section 2A – Theoretical: Descriptive Questions

Question 1

(May 10 – 2 Marks)

What do you understand by Capital structure? How does it differ from Financial structure?

Solution

Capital Structure refers to the combination of debt and equity which a company uses to finance its long-term operations. It is the permanent financing of the company representing long-term sources of capital i.e. owner's equity and long-term debts but excludes current liabilities. On the other hand, Financial Structure is the entire left-hand side of the balance sheet which represents all the long-term and short-term sources of capital. Thus, capital structure is only a part of financial structure.

Question 2

(Nov 13 – 4 Marks)

What do you mean by capital structure? State its significance in financing decision.

Solution

Meaning of Capital Structure

Capital structure refers to the mix of a firm's capitalisation i.e. mix of long-term sources of funds such as debentures, preference share capital, equity share capital and retained earnings for meeting its total capital requirement.

Significance in Financing Decision

The capital structure decisions are very important in financial management as they influence debt – equity mix which ultimately affects shareholders return and risk. These decisions help in deciding the forms of financing (which sources to be tapped), their actual requirements (amount to be funded) and their relative proportions (mix) in total capitalisation. Therefore, such a pattern of capital structure must be chosen which minimises cost of capital and maximises the owners' return.

Question 3

(MTP 1 May 24 – 2 Marks)

WHAT is 'Optimum Capital Structure'?

Solution

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

Question 4

(May 16 – 4 Marks)

State the principles that should be followed while designing the capital structure of a company.

Or

List the fundamental principles governing capital structure.

(Nov 12 – 4 Marks)

Solution

The fundamental principles are:

- (i) **Cost Principle:** According to this principle, an ideal pattern or capital structure is one that minimises cost of capital structure and maximises earnings per share (EPS).
- (ii) **Risk Principle:** According to this principle, reliance is placed more on common equity for financing capital requirements than excessive use of debt. Use of more and more debt means higher commitment in form of interest payout. This would lead to erosion of shareholders value in unfavourable business situation.
- (iii) **Control Principle:** While designing a capital structure, the finance manager may also keep in mind that existing management control and ownership remains undisturbed.
- (iv) **Flexibility Principle:** It means that the management chooses such a combination of sources of financing which it finds easier to adjust according to changes in need of funds in future too.
- (v) **Other Considerations:** Besides above principles, other factors such as nature of industry, timing of issue and competition in the industry should also be considered.

Question 5**(Nov 22 – 2 Marks)**

What are the important factors considered for deciding the source and quantum of capital?

Solution

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 6**(May 06 – 6 Marks)**

Discuss the major considerations in capital structure planning.

Solution

There are three major considerations, i.e. risk, cost of capital and control, which help the finance manager in determining the proportion in which he can raise funds from various sources.

- (i) **Risk:** The finance manager attempts to design the capital structure in such a manner, so that risk and cost are the least and the control of the existing management is diluted to the least extent. However, there are secondary factors also like marketability of the issue, manoeuvrability and flexibility of the capital structure, timing of raising the funds. Risk is of two kinds, i.e., Financial risk and Business risk. Here, we are concerned primarily with the financial risk. Financial risk also is of two types:
 - (a) Risk of cash insolvency
 - (b) Risk of variation in the expected earnings available to equity share-holders
- (ii) **Cost of Capital:** Cost is an important consideration in capital structure decisions. It is obvious that a business should be at least capable of earning enough revenue to meet its cost of capital and finance its growth. Hence, along with a risk as a factor, the finance manager has to consider the cost aspect carefully while determining the capital structure.

(iii) **Control:** Along with cost and risk factors, the control aspect is also an important consideration in planning the capital structure. When a company issues further equity shares, it automatically dilutes the controlling interest of the present owners. Similarly, preference shareholders can have voting rights, in case dividends on such shares are not paid for consecutive years. Financial institutions normally stipulate that they shall have one or more directors on the Boards. Hence, when the management agrees to raise loans from financial institutions, by implication it agrees to forego a part of its control over the company. It is obvious, therefore, that decisions concerning capital structure are taken after keeping the control factor in mind.

Question 7

(MTP 2 Sep 24 – 2 Marks)

EXPLAIN the Relationship between EBIT-EPS-MPS

Solution

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 8

(PM)

Explain briefly Modigliani and Miller approach (without tax)

Solution

This approach describes, in a perfect capital market where there is no transaction cost and no taxes, the value and cost of capital of a company remain unchanged irrespective of change in the capital structure. The approach is based on further additional assumptions like:

- Capital markets are perfect. All information is freely available and there are no transaction costs.
- All investors are rational.
- Firms can be grouped into 'Equivalent risk classes' on the basis of their business risk.
- Non-existence of corporate taxes.

Based on the above assumptions, Modigliani-Miller derived the following three propositions:

(i) Total market value of a firm is equal to its expected net operating income divided by the discount rate appropriate to its risk class decided by the market.

$$\text{Value of levered firm } (V_g) = \text{Value of unlevered firm } (V_u)$$

$$\text{Value of a firm} = \frac{\text{Net Operating Income (NOI)}}{K_0}$$

(ii) A firm having debt in capital structure has higher cost of equity than an unlevered firm. The cost equity will be include risk premium for the financial risk.

(iii) The structure of the capital (financial leverage) does not effect the overall cost of capital. The cost of capital is only affected by the business risk.

Question 9

(May 07 – 2 Marks)

Explain in brief the assumptions of Modigliani-Miller theory.

Solution

- (a) Capital markets are perfect. All information is freely available and there is no transaction cost.
- (b) All investors are rational.
- (c) No existence of corporate taxes.
- (d) Firms can be grouped into “equivalent risk classes” on the basis of their business risk.

Question 10

(May 04 – 3 Marks)

Discuss the relationship between the financial leverage and firms required rate of return to equity shareholders as per Modigliani and Miller (with tax) Proposition.

Solution

Relationship between the financial leverage and firm's required rate of return to equity shareholders with corporate taxes is given by the following relation :

$$\text{Cost of equity in a levered company } (K_{eg}) = K_{eu} + (K_{eu} - K_d) \frac{\text{Debt } (1-t)}{\text{Equity}}$$

Where,

$$K_{eg} = \text{Cost of equity in a levered company}$$

$$K_{eu} = \text{Cost of equity in an unlevered company}$$

$$K_d = \text{Cost of debt}$$

$$t = \text{Tax rate}$$

Question 11

(May 12 – 4 Marks)

What is Net Operating Income (NOI) theory of capital structure? Explain the assumptions of Net Operating Income approach theory of capital structure.

Solution

Net Operating Income (NOI) Theory of Capital Structure:

According to NOI approach, there is no relationship between the cost of capital and value of the firm i.e. the value of the firm is independent of the capital structure of the firm.

Assumptions:

- (a) The corporate income taxes do not exist.
- (b) The market capitalizes the value of the firm as whole. Thus the split between debt and equity is not important.
- (c) The increase in proportion of debt in capital structure leads to change in risk perception of the shareholders.
- (d) The overall cost of capital (K_o) remains constant for all degrees of debt equity mix.

Question 12

(May 08 – 2 Marks)

Explain the principles of "Trading on equity".

$$ROCE > REd \rightarrow ROE (EPS) \uparrow$$

Solution

The term trading on equity means debts are contracted and loans are raised mainly on the basis of equity capital. Those who provide debt have a limited share in the firm's earning and hence want to be protected in terms of earnings and values represented by equity capital. Since fixed charges do not vary with firms earnings before interest and tax, a magnified effect is produced on earning per share. Whether the leverage is favourable, in the sense, increase in earnings per share more proportionately to the increased earnings before interest and tax, depends on the profitability of investment proposal. If the rate of returns on investment exceeds their explicit cost, financial leverage is said to be positive.

Question 13

(May 09 – 2 Marks)

Discuss the concept of Debt-Equity or EBIT-EPS indifference point, while determining the capital structure of a company.

Solution

The determination of optimum level of debt in the capital structure of a company is a formidable task and is a major policy decision. It ensures that the firm is able to service its debt as well as contain its interest cost. Determination of optimum level of debt involves equalizing between return and risk. EBIT – EPS analysis is a widely used tool to determine level of debt in a firm. Through this analysis, a comparison can be drawn for various methods of financing by obtaining indifference point. It is a point to the EBIT level at which EPS remains unchanged irrespective of debt-equity mix. The indifference point for the capital mix (equity share capital and debt) can be determined as follows:

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

Question 14

(Nov 10 – 4 Marks)

Discuss financial break-even and EBIT-EPS indifference analysis.

Solution**Financial Break-even and EBIT-EPS Indifference Analysis**

Financial break-even point is the minimum level of EBIT needed to satisfy all the fixed financial charges i.e. interest and preference dividend. It denotes the level of EBIT for which firm's EPS equals zero. If the EBIT is less than the financial breakeven point, then the EPS will be negative but if the expected level of EBIT is more

than the breakeven point, then more fixed costs financing instruments can be taken in the capital structure, otherwise, equity would be preferred.

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

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

Where,

EBIT = Indifference point
 E₁ = Number of equity shares in Alternative 1
 E₂ = Number of equity shares in Alternative 2
 I₁ = Interest charges in Alternative 1
 I₂ = Interest charges in Alternative 2
 T = Tax-rate

10 Crore

15 Crore

1 crore

Question 15

(MTP 1 Jan 25 – 4 Marks)

You are a financial consultant for a company that has a very high capital base but low earnings per share (EPS). EXPLAIN over-capitalization. What are the causes and consequences of over-capitalization?"

Solution

It is a situation where a firm has more capital than it needs or in other words assets are worth less than its issued share capital, and earnings are insufficient to pay dividend and interest.

Causes of Over Capitalization

Over-capitalisation arises due to following reasons:

- (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.

Consequences of Over-Capitalisation

Over-capitalisation results in the following consequences:

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

Also cover under capitalisation.

~~Question 16~~

(Nov 22 – 2 Marks)

The firm has more capital than its requirements. What is this situation called? Give two consequences of it.

Solution

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 17~~

1) RE
2) Debt
3) Equity shares

(MTP 1 May 20 – 4 Marks)

EXPLAIN in brief the Pecking order theory.

Solution

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. → Retained Earnings

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

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

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

So briefly under this theory rules are:

Rule 1: Use internal financing first.

Rule 2: Issue debt next

Rule 3: Issue of new equity shares at last

~~Question 18~~

(MTP 2 Nov 21 – 2 Marks)

Pecking order theory suggests manager to use various sources for raising of fund in certain order. BRIEF out that order.

Solution

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.

Question 19**(MTP 1 May 23 – 4 Marks)**

DISCUSS Agency Problem and Agency Cost.

Solution

Agency Problem: Though in a sole proprietorship firm, partnership etc., owners participate in management but incorporates, owners are not active in management so, there is a separation between owner/ shareholders and managers. In theory, managers should act in the best interest of shareholders however in reality, managers may try to maximise their individual goal like salary, perks etc., so there is a principal agent relationship between managers and owners, which is known as Agency Problem. In a nutshell, Agency Problem is the chances that managers may place personal goals ahead of the goal of owners. Agency Problem leads to Agency Cost. Agency cost is the additional cost borne by the shareholders to monitor the manager and control their behaviour to maximise shareholders wealth.

Generally, **Agency Costs** are of four types

- (i) monitoring
- (ii) bonding
- (iii) opportunity
- (iv) structuring.

Question 20**(MTP 2 May 21 – 4 Marks)**

DESCRIBE how agency problem can be addressed.

Solution

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~~ ESOP is also designed to address the issue with the underlying assumption that maximisation of the stock price is the objective of the investors.
- Effecting monitoring can be done.

Question 21

WRITE a note on agency problem and agency cost.

(MTP 2 May 23 – 5 Marks)

Or

The agency problem is one of the key concepts in corporate governance and financial management. On the light of this statement, EXPLAIN agency problem, consequences of agency problem and how to overcome the issue.

(MTP 2 Sep 24 – 4 Marks)

Or

DISCUSS Agency problem and its cost. HOW it arises and HOW it can be addressed?

(RTP Nov 23)

Or

STATE Agency Cost. DISCUSS the ways to reduce the effect of it.

(MTP 1 Nov 18 – 4 Marks)

Solution

Though in a sole proprietorship firm, partnership etc., owners participate in management but in corporates, owners are not active in management so, there is a separation between owner/ shareholders and managers. In theory managers should act in the best interest of shareholders however in reality, managers may try to maximise their individual goal like salary, perks etc., so there is a **principal agent relationship between managers and owners, which is known as Agency Problem**. In a nutshell, Agency Problem is the chances that managers may place personal goals ahead of the goal of owners Agency Problem leads to Agency Cost. Agency cost is the additional cost borne by the shareholders to monitor the manager and control their behaviour so as to maximise shareholders wealth. Generally, Agency Costs are of four types

- (i) monitoring
- (ii) 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 share- holders. It is easier said than done.

However, **following efforts** have been made to address these issues:

- (A) Managerial compensation is linked to profit of the company to some extent and also with the long term objectives of the company.
- (B) Employee is also designed to address the issue with the underlying assumption that maximisation of the stock price is the objective of the investor
- (C) Effecting monitoring can be done.

Section 2A – Theoretical: Descriptive Questions

Question 1

(Nov 04 – 3 Marks)

Discuss any three ratios computed for investment analysis.

Solution

Three ratios computed for investment analysis are as follows:

(i) Earnings per share $= \frac{\text{Net Profit available to equity shareholders}}{\text{Number of equity shares outstanding}}$

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

(iii) Return on capital employed* $= \frac{\text{Earnings before interest and tax (EBIT)} \times 100}{\text{Capital Employed}}$

* It can be pre-tax or post tax

Question 2

(Nov 06 – 4 Marks)

Discuss the financial ratios for evaluating company performance on operating efficiency and liquidity position aspects.

Solution

Financial ratios for evaluating performance on operational efficiency and liquidity position aspects are discussed as:

Operating Efficiency: Ratio analysis throws light on the degree of efficiency in the management and utilization of its assets. The various activity ratios (such as turnover ratios) measure this kind of operational efficiency. These ratios are employed to evaluate the efficiency with which the firm manages and utilises its assets. These ratios usually indicate the frequency of sales with respect to its assets. These assets may be capital assets or working capital or average inventory. In fact, the solvency of a firm is, in the ultimate analysis, dependent upon the sales revenues generated by use of its assets – total as well as its components.

Liquidity Position: With the help of ratio analysis, one can draw conclusions regarding liquidity position of a firm. The liquidity position of a firm would be satisfactory, if it is able to meet its current obligations when they become due. Inability to pay-off short-term liabilities affects its credibility as well as its credit rating. Continuous default on the part of the business leads to commercial bankruptcy. Eventually such commercial bankruptcy may lead to its sickness and dissolution. Liquidity ratios are current ratio, liquid ratio and cash to current liability ratio. These ratios are particularly useful in credit analysis by banks and other suppliers of short-term loans.

Question 3

What do you mean by Stock Turnover ratio, Gearing ratio and Debt Service Coverage Ratio

Solution

Stock Turnover Ratio helps to find out if there is too much inventory build-up. An increasing stock turnover figure or one which is much larger than the "average" for an industry may indicate poor stock management. The formula for the Stock Turnover Ratio is as follows:

$$\text{Stock Turnover ratio} = \frac{\text{Cost of Sales}}{\text{Average Inventory}} \text{ or } \frac{\text{Turnover}}{\text{Average Inventory}}$$

Gearing Ratio indicates how much of the business is funded by borrowing. In theory, the higher the level of borrowing (gearing), the higher are the risks to a business, since the payment of interest and repayment of debts are not "optional" in the same way as dividends. However, gearing can be a financially sound part of a business's capital structure particularly if the business has strong, predictable cash flows. The formula for the Gearing Ratio is as follows:

$$\text{Gearing Ratio} = \frac{\text{Borrowings (all long term debts including normal overdraft)}}{\text{Net Assets or Shareholders fund}}$$

Debt Service Coverage Ratio indicates the capacity of a firm to service a particular level of debt i.e. repayment of principal and interest. High credit rating firms target DSCR to be greater than 2 in its entire loan life. High DSCR facilitates the firm to borrow at the most competitive rates. Lenders are interested in this ratio to judge the firm's ability to pay off current interest and installments.

The debt service coverage ratio can be calculated as under:

$$\text{DSCR} = \frac{\text{Earnings available for Debt Service}}{\text{Interest} + \text{Installment}}$$

Question 4

(May 09 – 3 Marks)

Discuss the composition of Return on Equity (ROE) using the DuPont model.

Numerical

Solution

Composition of Return on Equity using the DuPont Model: There are three components in the calculation of return on equity using the traditional DuPont model- the net profit margin, asset turnover, and the equity multiplier. By examining each input individually, the sources of a company's return on equity can be discovered and compared to its competitors.

(a) **Net Profit Margin:** The net profit margin is simply the after-tax profit a company generates for each rupee of revenue.

$$\text{Net profit margin} = \text{Net Income} \div \text{Revenue}$$

Net profit margin is a safety cushion; the lower the margin, lesser the room for error.

(b) **Asset Turnover:** The asset turnover ratio is a measure of how effectively a company converts its assets into sales. It is calculated as follows:

$$\text{Asset Turnover} = \text{Revenue} \div \text{Assets}$$

The asset turnover ratio tends to be inversely related to the net profit margin; i.e., the higher the net profit margin, the lower the asset turnover.

(c) **Equity Multiplier:** It is possible for a company with terrible sales and margins to take on excessive debt and artificially increase its return on equity. The equity multiplier, a measure of financial leverage, allows the investor to see what portion of the return on equity is the result of debt. The equity multiplier is calculated as follows:

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

Calculation of Return on Equity

To calculate the return on equity using the DuPont model, simply multiply the three components (net profit margin, asset turnover, and equity multiplier.)

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

Question 5

(May 12 – 4 Marks)

Explain the important ratios that would be used in each of the following situations:

- (i) A bank is approached by a company for a loan of ₹ 50 lakhs for working capital purposes.
- (ii) A long term creditor interested in determining whether his claim is adequately secured.
- (iii) A shareholder who is examining his portfolio and who is to decide whether he should hold or sell his holding in the company.
- (iv) A finance manager interested to know the effectiveness with which a firm uses its available resources.

Solution

- (i) **Liquidity Ratios-** Here Liquidity or short-term solvency ratios would be used by the bank to check the ability of the company to pay its short-term liabilities. A bank may use Current ratio and Quick ratio to judge short terms solvency of the firm.
- (ii) **Capital Structure/Leverage Ratios-** Here the long-term creditor would use the capital structure/leverage ratios to ensure the long term stability and structure of the firm. A long term creditors interested in the determining whether his claim is adequately secured may use Debt-service coverage and interest coverage ratio.
- (iii) **Profitability Ratios-** The shareholder would use the profitability ratios to measure the profitability or the operational efficiency of the firm to see the final results of business operations. A shareholder may use return on equity, earning per share and dividend per share.
- (iv) **Activity Ratios-** The finance manager would use these ratios to evaluate the efficiency with which the firm manages and utilises its assets. Some important ratios are (a) Capital turnover ratio (b) Current and fixed assets turnover ratio (c) Stock, Debtors and Creditors turnover ratio.

Question 6

(MTP 2 May 22 – 4 marks)

 DISCUSS the limitations of financial ratios

Solution

The limitations of financial ratios are listed below:

- (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.

| Section 2A – Theoretical: Descriptive Questions

➤ Estimation of Working Capital

Question 1

(Nov 15 – 4 Marks)

Discuss the risk-return considerations in financing current assets.

Solution

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.

Question 2

(May 23 – 4 Marks)

“Permanent working capital and fluctuating (temporary) working capital, both are necessary to facilitate production and sales through the operating cycle.” - Describe.

Solution

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 3**(Nov 20 – 2 marks)**

STATE any four factors which need to be considered while planning for working capital requirement.

Solution

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

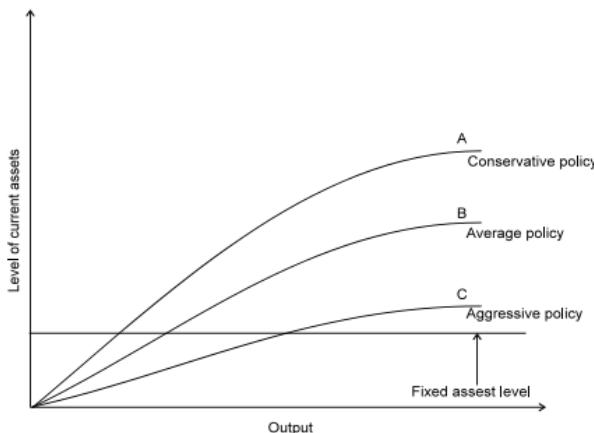
- (i) **Need for Cash:** Identify the cash balance which allows for the business to **meet day-to-day expenses**, but reduces cash holding costs.
- (ii) **Desired level of Inventory:** Identify the level of inventory which allows for **uninterrupted production** but reduces the **investment in raw materials** 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 throughout 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 4**(MTP 2 May 24 – 4 marks)**

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

Solution

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 5

(Nov 10 – 4 Marks)

Discuss the estimation of working capital need based on operating cycle process.

Solution

Estimation of Working Capital Need based on Operating Cycle

One of the methods for forecasting working capital requirement is based on the concept of operating cycle. The determination of operating capital cycle helps in the forecast, control and management of working capital. The length of operating cycle is the indicator of performance of management. The net operating cycle represents the time interval for which the firm has to negotiate for Working Capital from its Bankers. It enables to determine accurately the amount of working capital needed for the continuous operation of business activities. The duration of working capital cycle may vary depending on the nature of the business.

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

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

Where,

- R = Raw material storage period.
- W = Work-in-progress holding period.
- F = Finished goods storage period.
- D = Debtors collection period.
- C = Credit period availed.

Question 6

(May 16 – 4 Marks)

State, which of the following would result in inflow/outflow of funds, if the funds were defined as working capital.

- (i) Purchase of a fixed asset on credit of two months.
- (ii) Sale of a fixed asset (book value ₹ 8,000) at a loss of ₹ 7,000.
- (iii) Payment of final dividend already declared.

(iv) Writing off Bad debts against a provision for doubtful debts.

Solution

Sl. No.	Result in inflow/ outflow of funds
(i)	Outflow, Total current liabilities are increased but total current assets remain unchanged.
(ii)	Inflow, current assets are increased but total current liabilities remain unchanged.
(iii)	No effect, Both the total current assets and current liabilities remain unchanged. OR If examinees assumed that proposed dividend as Non- current liability then payment of final dividend is considered as out flow of fund.
(iv)	No effect, Neither the total current assets nor the total current liabilities are affected.

➤ **Management of Receivables**

Question 7

(Nov 04 – 3 Marks)

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

Solution

Ageing Schedule: An important means to get an insight into the collection pattern of debtors is the preparation of their 'Ageing Schedule'. Receivables are classified according to their age from the date of invoicing e.g. 0 – 30 days, 31 – 60 days, 61 – 90 days, 91 – 120 days and more. The ageing schedule can be compared with earlier month's figures or the corresponding month of the earlier year.

This classification helps the firm in its collection efforts and enables management to have a close control over the quality of individual accounts. The ageing schedule can be compared with other firms also.

Question 8

(May 10 – 2 Marks)

 Explain briefly the accounts receivable systems.

Solution

Manual systems of recording the transactions and managing receivables are cumbersome and costly. The automated receivable management systems automatically update all the accounting records affected by a transaction. This system allows the application and tracking of receivables and collections to store important information for an unlimited number of customers and transactions, and accommodate efficient processing of customer payments and adjustments.

Question 9

(May 17 – 4 Marks)

Explain the meaning and advantages of Factoring.

Solution

Factoring is a specialised service related with receivable management which involves credit investigation, sales ledger management, purchase and collection of debts, credit protection as well as provision of finance against receivables. In factoring, accounts receivables are generally sold to a financial institution, known as factor, who charges commission and bears the credit risks associated with the accounts receivables purchased by it.

The factor takes the responsibility of monitoring, follow-up, collection and risk management related with receivables (debts).

Advantages of Factoring:

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

Question 10**(Nov 17 – 4 Marks)**

What is 'Bill discounting'? How does it differ from 'Factoring'? Explain.

Solution

Bills Discounting: Advances are allowed by banks against security of bills. When a bill is discounted, the borrower is paid the present worth.

The differences between Factoring and Bills discounting are as follows:

- Factoring is called as 'Invoice factoring' whereas bills discounting is known as "Invoice discounting".
- In factoring the parties are known as client, factor and debtor whereas in bills discounting they are known as Drawer, Drawee and Payee.
- Factoring is a sort of management of book debts whereas bills discounting is a sort of borrowing from commercial banks.
- For Factoring there is no specific Act, whereas in the case of bills discounting, the Negotiable Instrument Act is applicable.

Question 11**(May 21 – 4 Marks)**

Describe the salient features of FORFAITING.

Solution

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 12**(MTP 2 Jan 25 – 4 Marks)**

EXPLAIN the difference between factoring and forfaiting

Solution

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 forfaiter 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

➤ Treasury & Cash Management**Question 13****(Nov 15 – 4 Marks)**

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

Solution

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

The various role of cash budgets in Cash Management System are:-

- Coordinate the timings of cash needs. It identifies the period(s) when there might either be a shortage of cash or an abnormally large cash requirement;
- It also helps to pinpoint period(s) when there is likely to be excess cash;

- (iii) It enables firm which has sufficient cash to take advantage like cash discounts on its accounts payable; and
- (iv) Lastly it helps to plan/arrange adequately needed funds (avoiding excess/shortage of cash) on favorable terms.

Question 14**(Nov 22 – 4 Marks)**

Elucidate the fundamental tasks of treasury department of a firm.

Or

Explain briefly the functions of Treasury Department.

(RTP Nov 19)**Solution**

Fundamental tasks of treasury department of a firm:

- (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 15**(Nov 13 – 4 Marks)**

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

Solution

"Management of Marketable Securities is an Integral Part of Investment of Cash"

Management of marketable securities is an integral part of investment of cash as it serves both the purposes of liquidity and cash, provided choice of investment is made correctly. As the working capital needs are fluctuating, it is possible to invest excess funds in some short term securities, which can be liquidated when need for cash is felt. The selection of securities should be guided by three principles namely safety, maturity and marketability.

Question 16**(May 16 – 4 Marks)**

Describe the three principles relating to selection of marketable securities

Solution

Three principles relating to selection of marketable securities are as follows

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

Maturity: Matching of maturity and forecasted cash needs is essential. Prices of long term securities fluctuate more with changes in interest rates and are therefore, more risky.

Marketability: It refers to the convenience, speed and cost at which a security can be converted into cash. If the security can be sold quickly without loss of time and price it is highly liquid or marketable.

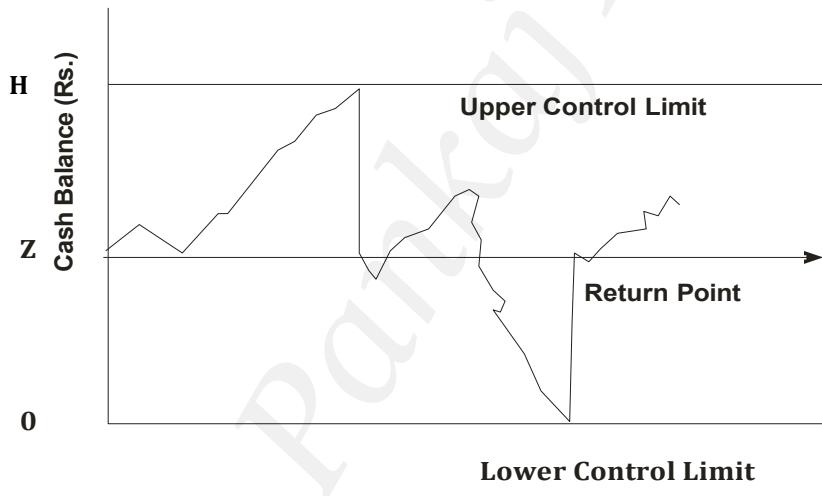
Question 17

(May 15 – 4 Marks)

Explain 'Miller-Orr Cash Management model'.

Solution

Miller – Orr Cash Management Model: According to this model the net cash flow is completely stochastic. When changes in cash balance occur randomly, the application of control theory serves a useful purpose. The Miller – Orr model is one of such control limit models. This model is designed to determine the time and size of transfers between an investment account and cash account. In this model control limits are set for cash balances. These limits may consist of 'h' as upper limit, 'z' as the return point and zero as the lower limit.



When the cash balance reaches the upper limit, the transfer of cash equal to ' $h - z$ ' is invested in marketable securities account. When it touches the lower limit, a transfer from marketable securities account to cash account is made. During the period when cash balance stays between (h, z) and $(z, 0)$ i.e. high and low limits, no transactions between cash and marketable securities account is made. The high and low limits of cash balance are set up on the basis of fixed cost associated with the securities transaction, the opportunities cost of holding cash and degree of likely fluctuations in cash balances. These limits satisfy the demands for cash at the lowest possible total costs.

Question 18

(May 11 – 4 Marks)

Write short note on William J. Baumol vs. Miller-Orr cash management model.

Solution

William J Baumal vs Miller- Orr Cash Management Model: According to William J Baumal's Economic order quantity model optimum cash level is that level of cash where the carrying costs and transactions costs are the minimum. The carrying costs refer to the cost of holding cash, namely, the interest foregone on marketable securities. The transaction costs refer to the cost involved in getting the marketable securities converted into cash. This happens when the firm falls short of cash and has to sell the securities resulting in clerical, brokerage, registration and other costs.

The optimim cash balance according to this model will be that point where these two costs are equal. The formula for determining optimum cash balance is:

$$c = \sqrt{\frac{2U \times P}{S}}$$

Where,

- C = Optimum cash balance
- U = Annual (monthly) cash disbursements
- P = Fixed cost per transaction
- S = Opportunity cost of one rupee p.a. (or p.m)

Miller-Orr cash management model is a net cash flow stochastic model. This model is designed to determine the time and size of transfers between an investment account and cash account. In this model control limits are set for cash balances. These limits may consist of h as upper limit, z as the return point, and zero as the lower limit.

When the cash balances reach the upper limit, the transfer of cash equal to h-z is invested in marketable securities account. When it touches the lower limit, a transfer from marketable securities account to cash account is made. During the period when cash balance stays between (h,z) and (z, 0) i.e high and low limits no transactions between cash and marketable securities account is made. The high and low limits of cash balance are set up on the basis of fixed cost associated with the securities transactions, the opportunity cost of holding cash and the degree of likely fluctuations in cash balances. These limits satisfy the demands for cash at the lowest possible total costs.

Question 19

(May 13 – 4 Marks)

State the advantage of Electronic Cash Management System.

Solution

Advantages of Electronic Cash Management System

- (i) Significant saving in time.
- (ii) Decrease in interest costs.
- (iii) Less paper work.
- (iv) Greater accounting accuracy.
- (v) More control over time and funds.
- (vi) Supports electronic payments.
- (vii) Faster transfer of funds from one location to another, where required.
- (viii) Speedy conversion of various instruments into cash.
- (ix) Making available funds wherever required, whenever required.
- (x) Reduction in the amount of 'idle float' to the maximum possible extent.

- (xi) Ensures no idle funds are placed at any place in the organization.
- (xii) It makes inter-bank balancing of funds much easier.
- (xiii) It is a true form of centralised 'Cash Management'.
- (xiv) Produces faster electronic reconciliation.
- (xv) Allows for detection of book-keeping errors.
- (xvi) Reduces the number of cheques issued.
- (xvii) Earns interest income or reduce interest expense.

(Note: Students may answer any four of the above advantages).

Question 20

(MTP 1 Nov 21 – 2 Marks)

Write a short note on electronic fund transfer.

Solution

Electronic Fund Transfer: With the developments which took place in the information technology, the present banking system has switched over to the computerization of banks branches to offer efficient banking services and cash management services to their customers. The network will be linked to the different branches, banks. This helped the customers in the following ways:

- (i) Instant updating of accounts.
- (ii) Quick transfer of funds.
- (iii) Instant information about foreign exchange rates.

Question 21

(Nov 14 – 4 Marks)

Explain four kinds of float with reference to management of cash.

Solution

Four Kinds of Float with reference to Management of Cash

The four kinds of float are:

- (i) **Billing Float:** The time between the sale and the mailing of the invoice is the billing float.
- (ii) **Mail Float:** This is the time when a cheque is being processed by post office, messenger service or other means of delivery.
- (iii) **Cheque processing float:** This is the time required for the seller to sort, record and deposit the cheque after it has been received by the company.
- (iv) **Bank processing float:** This is the time from the deposit of the cheque to the crediting of funds in the seller's account.

Question 22

(Nov 20 – 2 Marks)

EXPLAIN Billing float and Mail float with reference to management of cash.

Solution

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.

Question 23

(Nov 17 – 4 Marks)

 Explain 'Concentration Banking' and 'Lock Box System'.

Solution

Concentration Banking: In concentration banking the company establishes a number of strategic collection centres in different regions instead of a single collection centre at the head office. This system reduces the period between the time a customer mails in his remittances and the time when they become spendable funds with the company. Payments received by the different collection centers are deposited with their respective local banks which in turn transfer all surplus funds to the concentration bank of head office. The concentration bank with which the company has its major bank account is generally located at the headquarters. Concentration banking is one important and popular way of reducing the size of the float.

Lock Box System: Another means to accelerate the flow of funds is a lock box system. While in concentration banking, remittances are received by a collection centre and deposited in the bank after processing. The purpose of lock box system is to eliminate the time between the receipts of remittances by the company and deposited in the bank. A lock box arrangement usually is on regional basis which a company chooses according to its billing patterns.

Question 24

(PM)

 Explain Electronic Cash Management System.

Solution

Electronic Cash Management System: 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 25

(MTP 2 May 19 – 4 Marks)

STATE Virtual Banking? DISCUSS its advantages.

Solution

Virtual Banking and its Advantages

Virtual banking refers to the provision of banking and related services through the use of information technology without direct recourse to the bank by the customer.

The advantages of virtual banking services are as follows:

- Lower cost of handling a transaction.
- The increased speed of response to customer requirements.
- The lower cost of operating branch network along with reduced staff costs leads to cost efficiency.

- Virtual banking allows the possibility of improved and a range of services being made available to the customer rapidly, accurately and at his convenience.

➤ Management of Payables

Question 26

(MTP 1 Sep 24 – 4 Marks)

DISCUSS the Costs of Availing Trade Credit

Solution

Normally it is considered that the trade credit does not carry any cost. However, it carries the following costs:

- (i) **Price:** There is often a discount on the price that the firm undergoes when it uses trade credit, since it can take advantage of the discount only if it pays immediately. This discount can translate into a high implicit cost.
- (ii) **Loss of goodwill:** If the credit is overstepped, suppliers may discriminate against delinquent customers if supplies become short. As with the effect of any loss of goodwill, it depends very much on the relative market strengths of the parties involved.
- (iii) **Cost of managing:** Management of creditors involves administrative and accounting costs that would otherwise be incurred.
- (iv) **Conditions:** Sometimes most of the suppliers insist that for availing the credit facility the order should be of some minimum size or even on regular basis.

Question 27

(RTP May 24)

 EXPLAIN the importance of trade credit and accruals as source of working capital. What is the cost of these sources?

Solution

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.

➤ Financing of Working Capital

Question 28

(Nov 23 – 4 Marks)

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

Solution

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.

Spontaneous Sources of Finance

- (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 29 *→ Same as Q.1.*

(MTP 1 Jan 25 – 4 Marks)

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?

Solution

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.

Chapter 8 – Scope & Objectives of FM

| Section 1A – Theoretical: Descriptive Questions

Question 1

(Nov 09 – 2 Marks)



Explain two basic functions of Financial Management.

Solution

Two Basic Functions of Financial Management

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

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

Question 2

(Nov 18 – 2 Marks)

Write two main objectives of Financial Management.

Solution

Two Main Objective 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, $\text{Wealth} = \text{Present Value of benefits} - \text{Present Value of Costs}$.

Question 3

(May 15, May 17 – 4 Marks)

Discuss the conflicts in Profit versus Wealth maximization principle of the firm.

Or

Distinguish between 'Profit Maximization' and 'Wealth Maximization' objective of a firm.

Solution

Profit maximisation is a short-term objective and cannot be the sole objective of a company. It is at best a

limited objective. If profit is given undue importance, a number of problems can arise like the term profit is vague, profit maximisation has to be attempted with a realisation of risks involved, it does not take into account the time pattern of returns and as an objective it is too narrow.

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

Question 4

(MTP 1 Jan 25 – 2 Marks)

"XYZ Corp. has adopted a strategy to maximize short-term profits by increasing product prices significantly. ANALYZE why this might not be a feasible operational criterion for sustainable growth."

Or

"The profit maximization is not an operationally feasible criterion." Comment on it.

(RTP May 20)

Solution

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

- (i) **Vague term:** The definition of the term profit is ambiguous. Does it mean short term or long term profit? Does it refer to profit before or after tax? Total profit or profit per share?
- (ii) **Timing of Return:** The profit maximization objective does not make distinction between returns received in different time periods. It gives no consideration to the time value of money, and values benefits received today and benefits received after a period as the same.
- (iii) It ignores the risk factor.
- (iv) The term maximization is also vague.

Question 5

(MTP 1 May 24 – 4 Marks)

EXPLAIN the limitations of profit maximization objective of Financial Management.

Or

"Profit Maximization cannot be the sole objective of a company". COMMENT.

(RTP May 21)

Or

'Profit maximisation is not the sole objective of a company. It is at best a limited objective. If profit is given undue importance, a number of problems can arise.' DISCUSS four of such problems.

(RTP May 22)

Solution

Limitations of Profit Maximisation objective of financial management.

- (i) **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.
- (ii) **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.

- (iii) **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.
- (iv) **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 6

(RTP May 24, 25)

EXPLAIN as to how the wealth maximisation objective is superior to the profit maximisation objective.

Solution

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

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

The maximisation of profit is often considered as an implied objective of a firm. To achieve the aforesaid objective various type of financing decisions may be taken. Options resulting into maximisation of profit may be selected by the firm's decision makers. They even sometime may adopt policies yielding exorbitant profits in short run which may prove to be unhealthy for the growth, survival and overall interests of the firm. The profit of the firm in this case is measured in terms of its total accounting profit available to its shareholders.

The value/wealth of a firm is defined as the market price of the firm's stock. The market price of a firm's stock represents the focal judgment of all market participants as to what the value of the particular firm is. It takes into account present and prospective future earnings per share, the timing and risk of these earnings, the dividend policy of the firm and many other factors that bear upon the market price of the stock.

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

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

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

Question 7**(RTP Sep 24)**

EXPLAIN the advantages and disadvantages of both profit maximization and wealth maximization goals

Solution

The table below highlights some of the advantages and disadvantages of both profit maximization and wealth maximization goals:



Goal	Objective	Advantages	Disadvantages
Profit Maximization	Large amount of profits	<ul style="list-style-type: none"> (i) Easy to calculate profits (ii) Easy to determine the link between financial decisions and profits. 	<ul style="list-style-type: none"> (i) Emphasizes the short term gains (ii) Ignores risk or uncertainty (iii) Ignores the timing of returns (iv) Requires immediate resources.
Shareholders Wealth Maximization	Highest market value of shares.	<ul style="list-style-type: none"> (i) Emphasizes the long term gains (ii) Recognises risk or uncertainty (iii) Recognises the timing of returns (iv) Considers shareholders' return. 	<ul style="list-style-type: none"> (i) Offers no clear relationship between financial decisions and share price. (ii) Can lead to management anxiety and frustration.

Question 8**(Jan 25 – 4 Marks)**

Discuss the objectives and advantages of wealth maximization goal of Financial Management.

Or

State advantages of "Wealth Maximization" goals in Financial Management.

(May 22 – 2 Marks)**Solution**

Objective of Wealth Maximisation: Highest market value of shares.

Advantages of Wealth Maximisation:

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

Question 9**(Nov 23 – 2 Marks)**

What are disadvantages of Profit Maximization?

Solution

Disadvantages of Profit Maximisation objective of financial management.

- (i) Emphasizes the short-term gains
- (ii) Ignores risk or uncertainty
- (iii) Ignores the timing of returns

(iv) Requires immediate resources.

~~Question 10~~

(MTP 1 May 21 – 4 Marks)

DISCUSS the advantages and disadvantages of Wealth maximization principle.

Solution

Advantages:

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

Disadvantages:

- (i) Offers no clear relationship between financial decisions and share price.
- (ii) Can lead to management anxiety and frustration.

Question 11

(Nov 21 – 2 Marks)

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

Solution

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 12

(May 18 – 2 Marks)

What are the two main aspects of the Finance Function?

Or

Briefly explain the three finance function decisions.

(Nov 19 – 3 Marks)

Solution

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. *Proper balance between Equity & Debt.*
- (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 *Short term funds.*

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 13

(MTP 1 Nov 21 – 4 Marks)

~~BRIEFLY explain the three finance function decisions.~~

Solution

The three finance function decisions are as follows:

Investment decisions: 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. The investment of funds in a project has to be made after careful assessment of the various projects through capital budgeting. A part of long-term funds is also to be kept for financing the working capital requirements.

Financing decisions: These decisions relate to acquiring the optimum finance to meet financial objectives and seeing that fixed and working capital are effectively managed. The financial manager needs to possess a good knowledge of the sources of available funds and their respective costs and needs to ensure that the company has a sound capital structure, i.e. a proper balance between equity capital and debt. Such managers also need to have a very clear understanding as to the difference between profit and cash flow, bearing in mind that profit is of little use unless the organisation is adequately supported by cash to pay for assets and sustain the working capital cycle.

Dividend decisions: These decisions relate to the determination as to how much and how frequently cash can be paid out of the profits of an organization as income for its owners/shareholders. The dividend decision thus has two elements – the amount to be paid out and the amount to be retained to support the growth of the organization, the latter being also a financing decision. The level and regular growth of dividends represent a significant factor in determining a profit-making company's market value, i.e. the value placed on its shares by the stock market.

Question 14**(MTP 2 May 24 – 4 Marks)**

Write short note on Inter relationship between investment, financing and dividend decisions.

Solution

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

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

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

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

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

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

Question 15**(MTP 2 Nov 23 – 2 Marks)**

Write a short note on role of finance controller.

Solution

The role of financial controller has undergone changes over the years. Until the middle of this century, its scope was limited to procurement of funds under major events in the life of the enterprise such as promotion, expansion, merger, etc. In the modern times, the role of financial controller includes besides procurement of funds, the three different kinds of decisions as well, namely, investment, financing and dividend.

The financial controller, in a bid to maximize shareholders' wealth, should strive to maximize returns in relation to the given risk; he should seek courses of actions that avoid unnecessary risks. To ensure maximum return, funds flowing in and out of the firm should be constantly monitored to assure that they are safeguarded and properly utilized.

Question 16**(MTP 1 Sep 24 – 2 Marks)**

DISCUSS the role of a chief financial officer. */ Finance Executive.*

Or

What are the main responsibilities of a Chief Financial Officer of an organisation?

(Nov 11 – 4 Marks)**Solution**

Responsibilities of Chief Financial Officer (CFO): The chief financial officer of an organisation plays an important role in the company's goals, policies, and financial success. His main responsibilities include:

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

Question 17 *S² R³ G1T.***(RTP Jan 25)**

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

Solution

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) **Globalisation:** The challenges of globalisation are creating a need for finance leaders to develop a finance function that works effectively on the global stage and that embraces diversity.
- (iii) **Technology:** Technology is evolving very quickly, providing the potential for CFOs to reconfigure finance processes and drive business insight through 'big data' and analytics.
- (iv) **Risk:** The nature of the risks that organisations face 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.

Question 18**(Nov 20 – 4 Marks)**

List out the role of Chief Financial Officer in today's World.

Or

What are the roles of Finance Executive in Modern World?
 ↳ CFO

(May 18 – 2 Marks)

Solution

Role of Chief Financial Officer (CFO) in Today's World: Today, the role of chief financial officer, or CFO, is no longer confined to accounting, financial reporting and risk management. It's about being a strategic business partner of the chief executive officer, or CEO. Some of the role of a CFO in today's world are as follows-

- Planning & related Budgeting
- Forecasting
- Managing M&As
- Profitability analysis (for example, by customer or product)
- Pricing analysis
- Decisions about outsourcing
- Overseeing the IT function.
- Overseeing the HR function.
- Strategic planning (sometimes overseeing this function).
- Regulatory compliance.
- Risk management

Question 19

(RTP May 19)

Write short notes on Functions of Finance Manager.

Solution

Functions of Finance Manager

The Finance Manager's main objective is to manage funds in such a way so as to ensure their optimum utilisation and their procurement in a manner that the risk, cost and control considerations are properly balanced in a given situation. To achieve these objectives the Finance Manager performs the following functions:

- (i) **Estimating the requirement of Funds:** Both for long-term purposes i.e. investment in fixed assets and for short-term i.e. for working capital. Forecasting the requirements of funds involves the use of techniques of budgetary control and long-range planning.
- (ii) **Decision regarding Capital Structure:** Once the requirement of funds has been estimated, a decision regarding various sources from which these funds would be raised has to be taken. A proper balance has to be made between the loan funds and own funds. He has to ensure that he raises sufficient long term funds to finance fixed assets and other long term investments and to provide for the needs of working capital.
- (iii) **Investment Decision:** The investment of funds, in a project has to be made after careful assessment of various projects through capital budgeting. Assets management policies are to be laid down regarding various items of current assets. For e.g. receivable in coordination with sales manager, inventory in coordination with production manager.
- (iv) **Dividend decision:** The finance manager is concerned with the decision as to how much to retain and what portion to pay as dividend depending on the company's policy. Trend of earnings, trend of

share market prices, requirement of funds for future growth, cash flow situation etc., are to be considered.

(v) **Evaluating financial performance:** A finance manager has to constantly review the financial performance of the various units of organisation generally in terms of ROI Such a review helps the management in seeing how the funds have been utilised in various divisions and what can be done to improve it.

(vi) **Financial negotiation:** The finance manager plays a very important role in carrying out negotiations with the financial institutions, banks and public depositors for raising of funds on favourable terms.

(vii) **Cash management:** The finance manager lays down the cash management and cash disbursement policies with a view to supply adequate funds to all units of organisation and to ensure that there is no excessive cash.

(viii) **Keeping touch with stock exchange:** Finance manager is required to analyse major trends in stock market and their impact on the price of the company share.

Question 20

Discuss the functions of a Chief Financial Officer.

(May 04 – 3 Marks)

Solution

Functions of a Chief Financial Officer: The twin aspects viz procurement and effective utilization of funds are the crucial tasks, which the CFO faces. The Chief Finance Officer is required to look into financial implications of any decision in the firm. Thus all decisions involving management of funds comes under the purview of finance manager. These are namely

- Estimating requirement of funds
- Decision regarding capital structure
- Investment decisions
- Dividend decision
- Cash management
- Evaluating financial performance
- Financial negotiation
- Keeping touch with stock exchange quotations & behaviour of share prices.

Question 21

(Nov 17 – 4 Marks)

Explain 'Finance Function'.

Solution

The finance function is most important for all business enterprises. It remains a focus of all activities. It starts with the setting up of an enterprise. It is concerned with raising of funds, deciding the cheapest source of finance, utilization of funds raised, making provision for refund when money is not required in the business, deciding the most profitable investment, managing the funds raised and paying returns to the providers of funds in proportion to the risks undertaken by them. Therefore, it aims at acquiring sufficient funds, utilizing them properly, increasing the profitability of the organization and maximizing the value of the organization and ultimately the shareholder's wealth.

Question 22**(MTP 2 Jan 25 – 4 Marks)**

DESCRIBE some of the tasks that demonstrate the importance of good financial management

Solution

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 23**(May 24 – 4 Marks)**

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

- (i) Maximising Market Price Per Share (MPS) as the financial objective which maximises 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 in exchange for an ownership/equity.

Solution

True or False	Statement	Reason
Maximising Market Price Per Share (MPS) as the financial objective which maximises 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 in exchange for an ownership/equity.	True	Debentures are instrument for raising long term capital with a period of maturity.

Question 24**(Nov 09 – 2 Marks)**

Differentiate between Financial Management and Financial Accounting.

Solution

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

Treatment of Funds: In accounting, the measurement of funds is based on the accrual principle. The accrual based accounting data do not reflect fully the financial conditions of the organisation. An organisation which has earned profit (sales less expenses) may be said to be profitable in the accounting sense but it may not be able to meet its current obligations due to shortage of liquidity as a result of say, uncollectible receivables. Whereas, the treatment of funds, in financial management is based on cash flows. The revenues are recognised only when cash is actually received (i.e. cash inflow) and expenses are recognised on actual payment (i.e. cash outflow). Thus, cash flow based returns help financial managers to avoid insolvency and achieve desired financial goals.

Decision-making: The chief focus of an accountant is to collect data and present the data while the financial manager's primary responsibility relates to financial planning, controlling and decision- making. Thus, in a way it can be stated that financial management begins where financial accounting ends.

Question 25**(MTP 1 May 22 – 4 Marks)**

'Financial distress is a position where Cash inflows of a firm are inadequate to meet all its current obligations.' Based on above mentioned context, EXPLAIN Financial Distress along with Insolvency.

Solution

Financial Distress and Insolvency: 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 need to be managed by an organisation very delicately. Higher debt requires higher interest and if the cash inflow is not sufficient then it will put lot of pressure 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.

→ 1.5 Days Planner → Exam Day Marathon.
 → Mistakes to avoid.

Chapter 9 – Types of Financing

| Section 1A – Theoretical: Descriptive Questions

➤ Debt vs Equity vs Preference

Question 1

(MTP 1 Nov 21 – 2 Marks)

BRIEFLY describe the financial needs of a business.

Solution

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

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. **5-10.**

Medium- term financial needs: Such requirements refer to those funds which are required for a period exceeding one year but not exceeding 5 years. **1-5**

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. **< 1**

Question 2

(PM)

Discuss the advantages of raising funds by issue of equity shares.

Solution

Advantages of Raising Funds by Issue of Equity Shares

- (i) It is a permanent source of finance. Since such shares are not redeemable, the company has no liability for cash outflows associated with its redemption.
- (ii) Equity capital increases the company's financial base and thus helps further the borrowing powers of the company.
- (iii) The company is not obliged legally to pay dividends. Hence in times of uncertainties or when the company is not performing well, dividend payments can be reduced or even suspended.
- (iv) The company can make further issue of share capital by making a right issue.

Question 3 Covered in Q.6-

(MTP 1 Nov 23 – 2 Marks)

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

Solution

"Financing a business through borrowing is cheaper than using equity"

- (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.

Question 4**(Nov 09 – 2 Marks)**

Explain the term 'Ploughing back of Profits'.

Solution

Ploughing back of Profits: Long-term funds may also be provided by accumulating the profits of the company and ploughing them back into business. Such funds belong to the ordinary shareholders and increase the net worth of the company. A public limited company must plough back a reasonable amount of its profits each year keeping in view the legal requirements in this regard and its own expansion plans. Such funds also entail almost no risk. Further, control of present owners is also not diluted by retaining profits.

Question 5**(MTP 1 May 21 – 4 Marks)**

DISCUSS in brief the characteristics of Debentures.

Solution

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 expense 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.
- Debentures 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 6**(Sep 24 – 4 Marks)**

Discuss any 2 advantages and 2 disadvantages of raising finance by issue of debentures.

Solution

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 because of the reasons given in point (i).
- (iv) Since debentures need to be paid at the time of maturity, a large amount of cash outflow is needed at that time.

Question 7

(RTP Sep 24)

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

Solution

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

Question 8

(RTP May 21)

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

Solution

Advantages

Cost < Equity.

- (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 9

(Nov 15 – 4 Marks)

Distinguish between the Preference Shares and Debentures.

Solution

Criteria	Preference shares	Debentures
Ownership	Preference Share Capital is a special kind of share	Debenture is a type of loan which can be raised from the public
Payment of Dividend/ Interest	its holders enjoy priority both as regard to the payment of a fixed amount of dividend and also towards repayment of capital in case of winding up of a company	It carries fixed percentage of interest.
Nature	Preference shares are a hybrid form of financing with some characteristic of equity shares and some attributes of Debt Capital.	Debentures are instrument for raising long term capital with a period of maturity.

➤ Leases

Question 10

(Nov 18 – 4 Marks)

Discuss the Advantages of Leasing.

Solution

- (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) **No risk of 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 11

(MTP 2 May 19 – 4 Marks)

EXPLAIN the limitations of Leasing?

Solution

Limitations are:

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

Despite all these disadvantages, the flexibility and simplicity offered by lease finance is bound to make it popular. Lease operations will find increasing use in the near future.

Question 12

(May 16 – 4 Marks)

Distinguish between operating lease and finance lease.

Solution

Criteria	Operating Lease	Finance Lease
Ownership	The lessee is only provided the use of the asset for a certain time. Risk incident to ownership belongs only to the lessor.	The risk and reward incidental to ownership are passed on to the lessee. The lessor only remains the legal owner of the asset.
Bearing risk	The lessor bears the risk of obsolescence.	The lessee bears the risk of obsolescence.
Purchase option	The lessee does not have any option to buy the asset during the lease period.	It allows the lessee to have a purchase option during the lease period.
Expenses borne	Usually, the lessor bears the cost of repairs, maintenance or operations.	The lessor does not bear the cost of repairs, maintenance or operations.
Treatment	Lease payment is treated like operating expenses like rent.	Finance lease is generally treated like a loan.

Bajaj Finance Sonu Mobile. Monu.

Question 13**(MTP 2 Sep 24 – 4 Marks)**

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.

Solution

(i) **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. *Additional finance*
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.

(ii) **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.

(iii) **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.

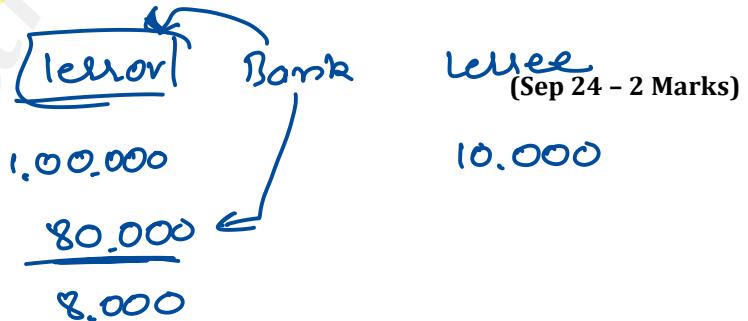
(iv) **Close-ended and Open-ended Leases:** In the close-ended lease, the assets get transferred to the lessor at the end of lease, the risk of obsolescence, residual value etc., remain with the lessor being the legal owner of the asset. In the open-ended lease, the lessee has the option of purchasing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

Question 14

What is Leveraged Lease? Explain.

Or

State the main elements of leveraged lease.

**Solution**

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 15**(May 15 – 4 Marks)**

 Explain 'Sales and Lease Back'.

Solution

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.

➤ Various types of Bonds & Other Financial Instruments

Question 16**(Nov 18 – 1 × 4 = 4 Marks)**

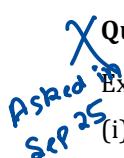
Explain in brief following Financial Instruments:

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

Solution

- (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:** These are issued up to seven years maturity. Interest rates are adjusted to reflect the prevailing exchange rates. They provide cheaper money than foreign loans.
- (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 17**(MTP 1 May 22 – 2 Marks)**

 Asked in
Sep 25

Explain in brief the following bonds:

- (i) Callable Bonds
- (ii) Puttable Bonds

Solution

- (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 18**(Nov 22 – 4 Marks)**

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?

Solution

↗ US.

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 19**(May 23 – 2 Marks)**

Discuss features of Secured Premium Notes.

Solution

Features of Secured Premium Notes:

- 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 20****(Nov 23 – 4 Marks)**

Write the main features of Bulldog Bond. ↗ UK

Solution

- 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 21**(Jan 25 – 4 Marks)**

Explain the Environmental, Social and Governance linked Bonds.

Solution

Environmental, Social and Governance-linked bonds (ESG): These bonds carry a responsibility of the issuer company to prioritize optimal environmental, social and governance (ESG) factors. Investing in ESG bonds is

considered as socially responsible investing. ESG bonds can be project- based - green bonds and social bonds; and target-based - sustainability- linked bonds (SLBs).

- **Green bonds:** These are the most popular ESG bonds that are issued by a financial, non-financial or public institution, where the bond proceeds are used to finance “green projects”. Green projects are aimed at positive environmental and/or climate impact including the cultivation of eco-friendly technology.
- **Social bonds:** These bonds finance the socially impactful projects. The projects here are related to the social concerns such as Human rights, Equality, animal welfare etc.
- **Sustainability-linked bonds (SLBs):** These bonds are combination of green bonds and social bonds. Proceeds of SLBs are not meant for a specific project but for general corporate purpose to achieve Key Performance Indicator (KPIs).

Question 22

Write short notes on the following:

- Euro Convertible Bonds.
- Deep Discount Bonds vs. Zero Coupon Bonds
- Floating Rate Bonds

Solution

(a) **Euro Convertible Bond:** Euro Convertible bonds are quasi-debt securities (unsecured) which can be converted into depository receipts or local shares. ECBs offer the investor an option to convert the bond into equity at a fixed price after the minimum lock in period. The price of equity shares at the time of conversion will have a premium element. The bonds carry a fixed rate of interest. These are bearer securities and generally the issue of such bonds may carry two options viz. call option and put option. A call option allows the company to force conversion if the market price of the shares exceeds a particular percentage of the conversion price. A put option allows the investors to get his money back before maturity. In the case of ECBs, the payment of interest and the redemption of the bonds will be made by the issuer company in US dollars. ECBs issues are listed at London or Luxemburg stock exchanges.

An issuing company desirous of raising the ECBs is required to obtain prior permission of the Department of Economic Affairs, Ministry of Finance, Government of India, Companies having 3 years of good track record will only be permitted to raise funds. The condition is not applicable in the case of projects in infrastructure sector. The proceeds of ECBs would be permitted only for following purposes:

- Import of capital goods
- Retiring foreign currency debts
- Capitalising Indian joint venture abroad
- 25% of total proceedings can be used for working capital and general corporate restructuring.

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

(b) **Deep Discount Bonds vs. Zero Coupon Bonds:** Deep Discount Bonds (DDBs) are in the form of zero interest bonds. These bonds are sold at a discounted value and on maturity face value is paid to the investors. In such bonds, there is no interest payout during lock- in period.

IDBI was first to issue a Deep Discount Bonds (DDBs) in India in January 1992. The bond of a face value of Rs 1 lakh was sold for Rs 2,700 with a maturity period of 25 years.

A zero coupon bond (ZCB) does not carry any interest but it is sold by the issuing company at a discount. The difference between discounted value and maturing or face value represents the interest to be earned by the investor on such bonds.

(c) **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.

Question 23

(MTP 2 May 24 – 2 Marks)

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

Solution

Financial Instruments in the International Market

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

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

Question 24

(May 18 – 2 Marks)

DEFINE Masala bond.

Solution

Masala bond: 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 Rs. 2,000 crore via masala bonds for its capital expenditure in the year 2016.

Question 25

(MTP 1 May 22 – 2 Marks)

STATE in brief four features of Samurai Bond.

Solution

Features of Samurai Bond:

- Samurai bonds are denominated in Japanese Yen (JPY)

- Issued in Tokyo
- Issuer Non- Japanese Company
- Regulations: Japanese
- Purpose: Access of capital available in Japanese market
- Issue proceeds can be used to fund Japanese operation
- Issue proceeds can be used to fund a company's local opportunities.
- It can also be used to hedge foreign exchange risk

Question 26**(MTP 1 Nov 22 – 2 Marks)**

STATE in brief four features of Plain Vanilla Bond.

Solution**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 27**(MTP 1 Sep 24 – 4 Marks)**

Briefly EXPLAIN the following –

- Fully Hedged Bonds
- Medium Term Notes
- Floating Rate Notes
- Euro Commercial Papers

Solution

- 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.
- Medium Term Notes (MTN):** 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.
- Floating Rate Notes (FRN):** These are issued up to seven years maturity. Interest rates are adjusted to reflect the prevailing exchange rates. They provide cheaper money than foreign loans.
- Euro Commercial Papers (ECP):** ECPs are short term money market instruments. They have maturity period of less than one year. They are usually designated in US Dollars.

Question 28**(MTP 2 Jan 25 – 2 Marks)**

EXPLAIN the concept of Drop – Lock Bond (DL Bonds)

Solution

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 provides a guaranteed minimum return to investor.

Question 29**(RTP May 23)**

HIGHLIGHT the similarities and differences between Samurai Bond and Bull Dog Bond.

Solution**Samurai Bond***Japan*

- Samurai bonds are denominated in Japanese Yen JPY
- Issued in Tokyo
- Issuer Non- Japanese Company
- Regulations: Japanese
- Purpose: Access of capital available in Japanese market
- Issue proceeds can be used to fund Japanese operation
- Issue proceeds can be used to fund a company's local opportunities.
- It can also be used to hedge foreign exchange risk

*↳ uses***Bulldog Bond**

- It is denominated in Bulldog Pound Sterling/Great Britain Pound (GBP)
- Issued in London
- Issuer Non- UK Company
- Regulations: Great Britain /UK.
- 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 30**(Nov 20 – 4 Marks)**

EXPLAIN in brief the features of Commercial Papers.

Solution

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 Rs 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 Information 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 31

(May 05 – 3 Marks)

Discuss the eligibility criteria for issue of commercial paper.

Solution

- The companies satisfying the following conditions are eligible to issue commercial paper.
- The tangible net worth of the company is Rs 5 crores or more as per audited balance sheet of the company.
- The fund base working capital limit is not less than Rs 5 crores.
- The company is required to obtain the necessary credit rating from the rating agencies such as CRISIL, ICRA etc.
- The issuers should ensure that the credit rating at the time of applying to RBI should not be more than two months old.
- The minimum current ratio should be 1.33:1 based on classification of current assets and liabilities.
- For public sector companies there are no listing requirement but for companies other than public sector, the same should be listed on one or more stock exchanges.
- All issue expenses shall be borne by the company issuing commercial paper.

Question 32

(May 08 – 3 Marks)

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

Solution

External Commercial Borrowings are loans taken from non-resident lenders in accordance with exchange control regulations. These loans can be taken from:

- International banks
- Capital markets
- Multilateral financial institutions like IFC, ADB, IBRD etc.
- Export Credit Agencies
- Foreign collaborators
- Foreign Equity Holders.

ECBs can be accessed under automatic and approval routes depending upon the purpose and volume.

In automatic there is no need for any approval from RBI / Government while approval is required for areas such as textiles and steel sectors restructuring packages.

~~Question 33~~

(MTP 1 Nov 23 – 2 Marks)

~~EXPLAIN in short the term Letter of Credit.~~**Solution**

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.

~~Question 34~~

(MTP 1 Nov 22 – 2 Marks)

~~BRIEF OUT certain sources of finance- Inter Corporate Deposits and Certificate of Deposit.~~**Solution**

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.

➤ Venture Capital and Angel Financing

Shark Tank.**Question 35**

(MTP 1 Nov 22 – 4 Marks)

WHAT is the meaning of Venture Capital Financing. STATE some characteristics of it.

Solution

Venture Capital Financing: 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 36

(Nov 20 – 4 Marks, RTP May 25)

Explain some common methods of Venture Capital Financing.

Or

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

Solution

Meaning of Venture Capital: The venture capital financing refers to financing and funding of the small scale enterprises, high technology and risky ventures.

Methods of Venture Capital financing: Some common methods of venture capital financing are as follows:

- (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 per cent) instead of royalty on sales once it becomes commercially sound.
- (iii) **Income note:** It is a hybrid security which combines the features of both conventional loan and conditional loan. The entrepreneur has to pay both interest and royalty on sales but at substantially low rates. IDBI's 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 37**(May 12 – 4 Marks)**

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

Solution

Factors to be considered by a Venture Capitalist before Financing any Risky Project:

- (i) Quality of the management team is a very important factor to be considered. They are required to show a high level of commitment to the project.
- (ii) The technical ability of the team is also vital. They should be able to develop and produce a new product / service.
- (iii) Technical feasibility of the new product / service should be considered.
- (iv) Since the risk involved in investing in the company is quite high, venture capitalists should ensure that the prospects for future profits compensate for the risk.
- (v) A research must be carried out to ensure that there is a market for the new product.
- (vi) The venture capitalist himself should have the capacity to bear risk or loss, if the project fails.
- (vii) The venture capitalist should try to establish a number of exist routes.
- (viii) In case of companies, venture capitalist can seek for a place on the Board of Directors to have a say on all significant matters affecting the business.

Question 38**(Sep 24 – 2 Marks)**

Explain Angel Financing.

Solution

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.

*Export Financing***➤ Export Financing***Order → Goods → Export done → Collection***Question 39****(May 21 – 4 Marks)**

Explain in brief the forms of Post Shipment Finance.

Solution

Post-shipment Finance: 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 40**(MTP Nov 23 – 4 Marks)**

State the different types of Packing Credit.

Solution

Packing credit may be of the following types:

- (i) **Clean Packing credit:** This is an advance made available to an exporter only on production of a firm export order or a letter of credit without exercising any charge or control over raw material or finished goods. It is a clean type of export advance. Each proposal is weighted according to particular

requirements of the trade and credit worthiness of the exporter. A suitable margin has to be maintained. Also, Export Credit Guarantee Corporation (ECGC) cover should be obtained by the bank.

- (ii) **Packing credit against hypothecation of goods:** Export finance is made available on certain terms and conditions where the exporter has pledgeable interest and the goods are hypothecated to the bank as security with stipulated margin. At the time of utilising the advance, the exporter is required to submit alongwith the firm export order or letter of credit, relative stock statements and thereafter continue submitting them every fortnight and whenever there is any movement in stocks.
- (iii) **Packing credit against pledge of goods:** Export finance is made available on certain terms and conditions where the exportable finished goods are pledged to the banks with approved clearing agents who will ship the same from time to time as required by the exporter. The possession of the goods so pledged lies with the bank and is kept under its lock and key.
- (iv) **E.C.G.C. guarantee:** Any loan given to an exporter for the manufacture, processing, purchasing, or packing of goods meant for export against a firm order qualifies for the packing credit guarantee issued by Export Credit Guarantee Corporation.
- (v) **Forward exchange contract:** Another requirement of packing credit facility is that if the export bill is to be drawn in a foreign currency, the exporter should enter into a forward exchange contact with the bank, thereby avoiding risk involved in a possible change in the rate of exchange.

➤ Debt Securitisation

Question 41

What is debt securitisation? EXPLAIN the basics of debt securitisation process. **(MTP 1 May 23 – 4 Marks)**

Or

What is the process of Debt Securitisation?

(May 19 – 4 Marks)

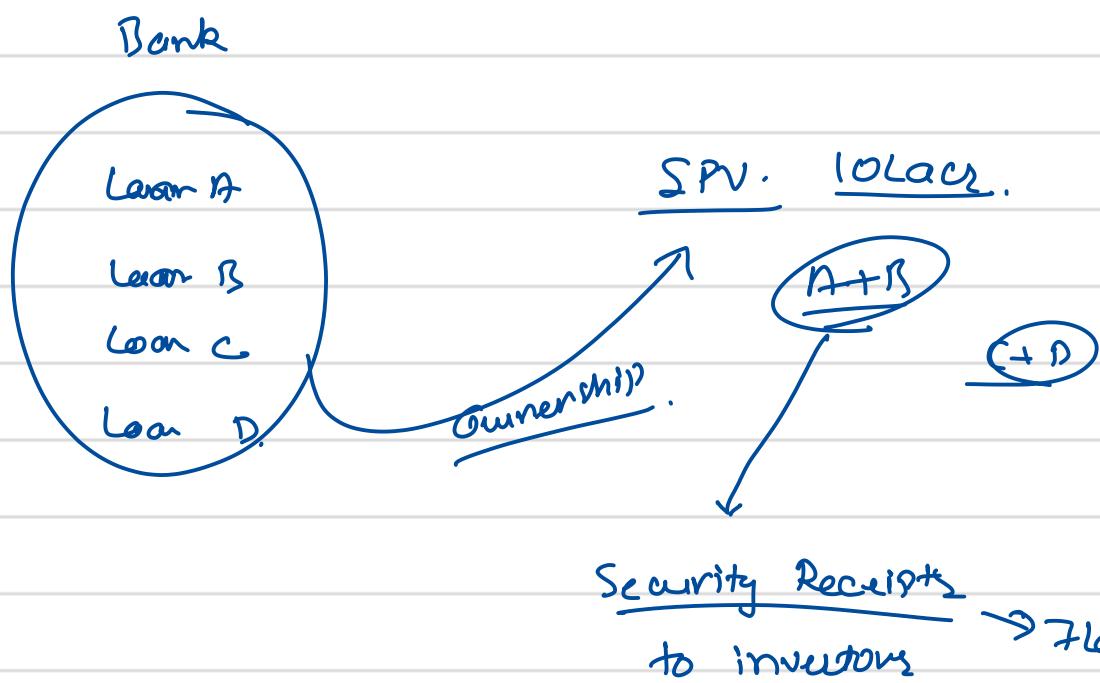
Solution

Debt Securitisation: Debt Securitisation is a process in which illiquid assets are pooled into marketable securities that can be sold to investors. The process leads to the creation of financial instruments that represent ownership interest in, or are secured by a segregated income producing asset or pool of assets. These assets are generally secured by personal or real property such as automobiles, real estate, or equipment loans but in some cases are unsecured.

Process of Debt Securitisation

- (i) **The origination function** – A borrower seeks a loan from a finance company, bank, HDFC. The credit worthiness of borrower is evaluated and contract is entered into with repayment schedule structured over the life of the loan.
- (ii) **The pooling function** – Similar loans on receivables are clubbed together to create an underlying pool of assets. The pool is transferred in favour of Special purpose Vehicle (SPV), which acts as a trustee for investors.
- (iii) **The securitisation function** – SPV will structure and issue securities on the basis of asset pool. The securities carry a coupon and expected maturity which can be asset- based/mortgage based. These are generally sold to investors through merchant bankers. Investors are – pension funds, mutual funds, insurance funds.

The process of securitization is generally without recourse i.e. investors bear the credit risk and issuer is



under an obligation to pay to investors only if the cash flows are received by him from the collateral. The benefits to the originator are that assets are shifted off the balance sheet, thus giving the originator recourse to off-balance sheet funding.

Question 42**(Nov 16 – 4 Marks)**

State advantages of Debt Securitisation.

Solution

The advantages of debt securitisation are as follows:

(a) To the originator:

- (i) The asset is shifted off the Balance Sheet, thus giving the originator recourse to off balance sheet funding.
- (ii) It converts illiquid assets to liquid portfolio.
- (iii) It facilitates better balance sheet management; assets are transferred off balance sheet facilitating satisfaction of capital adequacy norms.
- (iv) The originator's credit rating enhances.

(b) For the investors:

Securitisation opens up new investment avenues. Though the investor bears the credit risk, the securities are tied up to definite assets

➤ GDR, ADR and IDR**Question 43****(May 17 – 4 Marks)**

Explain GDR and ADR.

Solution

Global Depository Receipts (GDRs): It is a negotiable certificate denominated in US dollars which represents a Non-US company's publically traded local currency equity shares. GDRs are created when the local currency shares of an Indian company are delivered to Depository's local custodian Bank against which the Depository bank issues depository receipts in US dollars. The GDRs may be traded freely in the overseas market like any other dollar-expressed security either on a foreign stock exchange or in the over-the-counter market or among qualified institutional buyers.

American Depository Receipts (ADRs): American Depository Receipts (ADRs) are securities offered by non-US companies who want to list on any of the US exchanges. It is a derivative instrument. It represents a certain number of company's shares. These are used by depository bank against a fee income. ADRs allow US investors to buy shares of these companies without the cost of investing directly in a foreign stock exchange. ADRs are listed on either NYSE or NASDAQ. It facilitates integration of global capital markets. The company can use the ADR route either to get international listing or to raise money in international capital market.

Question 44**(May 22 – 2 Marks)**

Distinguish between American Depository Receipts and Global Depository Receipts.

Solution

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

Alternatively:

American Depository Receipts (ADRs): These are securities offered by non-US companies who want to list on any of the US exchange. Each ADR represents a certain number of a company's regular shares. ADRs allow US investors to buy shares of these companies without the costs of investing directly in a foreign stock exchange.

Global Depository Receipts (GDRs): These are negotiable certificates held in the bank of one country representing a specific number of shares of a stock traded on the exchange of another country. These financial instruments are used by companies to raise capital in either dollars or Euros. These are mainly traded in European countries and particularly in London.

Question 45**(MTP 2 May 24 – 2 Marks)**

Explain the concept of Indian depository receipts.

Solution

Indian Depository Receipts: The concept of the depository receipt mechanism which is used to raise funds in foreign currency has been applied in the Indian capital market through the issue of Indian Depository Receipts (IDRs). 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.

➤ Other Sources of Finance**Question 46**

Explain the features of crowd funding.

1. Raise From.
2. Medium.
3. Consideration.
4. Parties.
5. Charge

(May 24 – 2 Marks)**Solution**

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.

Question 47

Briefly DESCRIBE bridge finance.

Investment
Loan

Solution

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**

Question 48

(MTP 2 Nov 22 – 2 Marks)

Write a short note on seed capital assistance.

Solution

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

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

Question 49

(Nov 19 – 4 Marks)

Briefly describe any four sources of short-term finance.

Solution

Sources of Short Term Finance: 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. Such

expenses arise out of the day-to-day activities of the company and hence represent a spontaneous source of finance.

Deferred Income: These are the amounts received by a company in lieu of goods and services to be provided in the future. Since these receipts increase a company's liquidity, they are also considered to be an important source of short-term finance.

- (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. 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.
- (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. Lending results in gross revenues out of which costs, such as interest on deposits, administrative costs, etc., are met and a reasonable profit is made. A bank's lending policy is not merely profit motivated but has to also keep in mind the socio-economic development of the country. Some of the facilities provided by banks are Short Term Loans, Overdraft, Cash Credits, Advances against goods, Bills Purchased/Discounted.
- (viii) **Financing of Export Trade by Banks:** Exports play an important role in accelerating the economic growth of developing countries like India. Of the several factors influencing export growth, credit is a very important factor which enables exporters in efficiently executing their export orders. The commercial banks provide short-term export finance mainly by way of pre and post-shipment credit. Export finance is granted in Rupees as well as in foreign currency.
- (ix) **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 time period.
- (x) **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.
- (xi) **Public Deposits:** Public deposits are very important source of short-term and medium term finances particularly due to credit squeeze by the Reserve Bank of India. A company can accept public deposits subject to the stipulations of Reserve Bank of India from time to time maximum up to 35 per cent of its paid up capital and reserves, from the public and shareholders. These deposits may be accepted for a period of six months to three years. Public deposits are unsecured loans; they should not be used for acquiring fixed assets since they are to be repaid within a period of 3 years. These are mainly used to finance working capital requirements.

**Question 50****(May 18 – 4 Marks)**

What are the sources of short term financial requirement of the company?

Solution

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 51**(May 24 – 4 Marks)**

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.

Solution

Some of the forms of bank credit are:

- (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 52**(MTP 2 May 22 – 4 Marks)**

DISCUSS in briefly any two long term sources of finance for a partnership firm.

Solution

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

Loans from Commercial Banks: Commercial banks provide long term loans for the purpose of expansion or setting up of new units. Their repayment is usually scheduled over a long period of time. The liquidity of such loans is said to depend on the anticipated income of the borrowers.

As part of the long term funding for a partnership firm, the banks also fund the long term working capital requirement (it is also called WCTL i.e. working capital term loan).

Lease financing: Leasing is a general contract between the owner and user of the asset over a specified period of time. The asset is purchased initially by the lessor (leasing company) and thereafter leased to the user (lessee firm) which pays a specified rent at periodical intervals. Thus, leasing is an alternative to the purchase of an asset out of own or borrowed funds. Moreover, lease finance can be arranged much faster as compared to term loans from financial institutions.