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- CAPITAL STRUCTURE DECISIONS
- TYPES OF LEVERAGES
- CAPITAL BUDGETING
- WORKING CAPITAL MANAGEMENT
- TYPES OF FINANCES

LET'S HEDGE.....

FORWARD CONTRACT

FUTURES CONTRACT

OPTION CONTRACT

CALL OPTION

PUT OPTION

what is life without little bit of money?

CURRENCY

£ Pound € Euro ₹ Rupee $ Dollar ¥ Yen

CA MAYANK KOTHARI

Module III - Theory Book

CA IPC

FINANCIAL MANAGEMENT

Group I- Paper 3

Mayank M. Kothari
BBA, ACA

Fourth Edition, September2015

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EXAMS MADE EASY

Financial Management
Module III- Theory Book
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- **CA Mayank Kothari**

Words of Acknowledgment

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- Finally and the most important,

Thank you
Mom & Dad
Your everyday support means a lot to me.

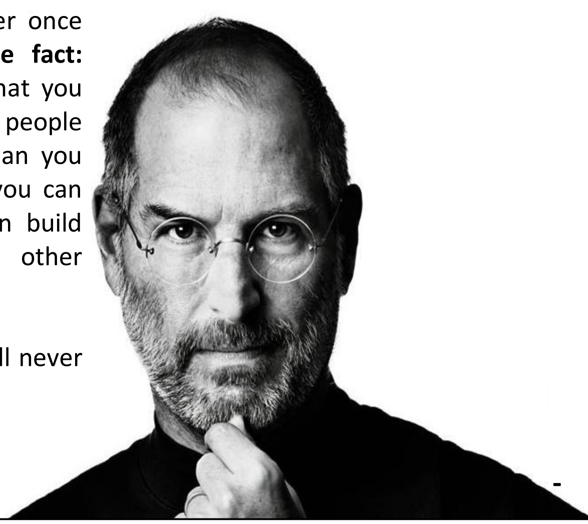
- **CA Mayank Kothari**

Think Different…

"When you grow up you tend to get told the world is the way it is, and your life is just to live it inside the world, try not to bash into the walls too much, try to have a nice family… have fun... save a little money.

That's a very limited life.
Life can be much broader once you discover **one simple fact:** Everything around you that you call life was made up by people that were no smarter than you and you can change it, you can influence it, and you can build your own things that other people can use.

Once you learn that, you'll never be the same again."



- **Steve Jobs**

Words to the wise

CA Exams

Getting practical with the bookish knowledge is very important.
I had to keep that thing in my mind all the time during exam preparation that only 7-8 People are going to pass out of 100.
Writing the correct answer and expecting to get the marks would have been the biggest mistake I could have done.

Because I cannot underestimate other participant in the contest, that's why I assumed that everybody is going to put their efforts for the same exam, and among 100 it's obvious that atleast 30-35 people can give the right answer for any particular question but not all the 30-35 are going to Pass the Exam. Clear enough.

So, writing the correct answer and expecting a spot in top 8 represents that I am still the poor guy who didn't understand the game yet.
And there's absolutely no place for the weak people in exams like CA, hence there's no choice but to be Strong.

Knowing all these things I was bound to put extra efforts, something which majority of the students might not be doing in their preparation.
I researched, I surfed, I asked and then found few things. I did it and frankly it was a blind game because I didn't know whether it's going to work or not. But taking the risk again is only option which may give you return. And on the other side I was happy somewhere because the moment I decided to do something extra was the moment I separated myself from rest of the world. In my eyes I was no more a person picked up from the crowd. First you only have to feel that you are special and then the world will participate in your belief.

- ✓ It's a game, not an exam
- ✓ Your fight is against the rest of the participants not with ICAI or its question paper.
- ✓ You not only have to prepare for what's in there your course, but also you have to prepare more than what the best person sitting in the exam will be.
- ✓ Be a Smart, not a Dolt
- ✓ If you have an option, why not to think big.
- ✓ Have some special reason of your own to get that degree, only then you will put extra efforts.
- ✓ Push your own limits and get out of the comfort zone.
- ✓ Every day break your own records else the world out there will break you to your knees.

Perseverance is what all required.
Keep Going, Keep Trying, Keep Improving... One day everything will be yours.

-CA Mayank Kothari **...**

Types of Financing

Bridge Financing

- ✓ 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.
- ✓ 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.

Case Study

In December 2010, Kohlberg Kravis Roberts (KKR) and partners marketed a bridge loan for its upcoming acquisition of Del Monte Foods. As is common in such cases, KKR planned for the newly private company to borrow money by issuing corporate bonds. To ensure the money would be available, KKR sought $1.6B in bridge loan guarantees, for which it promised to pay 8.75% interest for 60 days and 11.75% thereafter. At KKR's option, these loans could then be replaced with eight-year corporate bonds (in effect, a put) paying 11.75%. In return for the loans and guarantees, KKR was offering roughly 2% in fees.

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 a potential of success.
- ✓ Some of the characteristics of Venture Capital Funding are:-
  - (i) It is basically a equity finance in new companies.
  - (ii) It can be viewed as a long term investment in growth-oriented small/medium firms.
  - (iii) 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.

Factors that a venture capitalist should consider before financing any risky project are as follows:

(i) Level of expertise of company's management: Most of venture capitalist believes that the success of a new project is highly dependent on the quality of its management team. They expect that entrepreneur should have a skilled team of managers. Managements also be required to show a high level of commitments to the project.

(ii) Level of expertise in production: Venture capital should ensure that entrepreneur and his team should have necessary technical ability to be able to develop and produce new product / service.

(iii) Nature of new product / service: The venture capitalist should consider whether the development and production of new product / service should be technically feasible. They should employ experts in their respective fields to examine idea proposed by the entrepreneur.

(iv) Future Prospects: Since the degree of risk involved in investing in the company is quite fairly high, venture capitalists should seek to ensure that the prospects for future profits compensate for the risk. Therefore, they should see a detailed business plan setting out the future business strategy.

(v) Competition: The venture capitalist should seek assurance that there is actually a market for a new product. Further venture capitalists should see the research carried on by the entrepreneur.
(vi) Risk borne by entrepreneur: The venture capitalist is expected to see that the entrepreneur bears a high degree of risk. This will assure them that the entrepreneur have the sufficient level of the commitments to project as they themselves will have a lot of loss, should the project fail.
(vii) Exit Route: The venture capitalist should try to establish a number of exist routes. These may include a sale of shares to the public, sale of shares to another business, or sale of shares to original owners.
(viii) Board membership: In case of companies, to ensure proper protection of their investment, venture capitalist should require a place on the Board of Directors. This will enable them to have their say on all significant matters affecting the business.

Debt Securitisation

'Banks will have to unload bad loans to Asset Reconstruction Companies by FY2007' read a leading business newspaper headline sometime back.

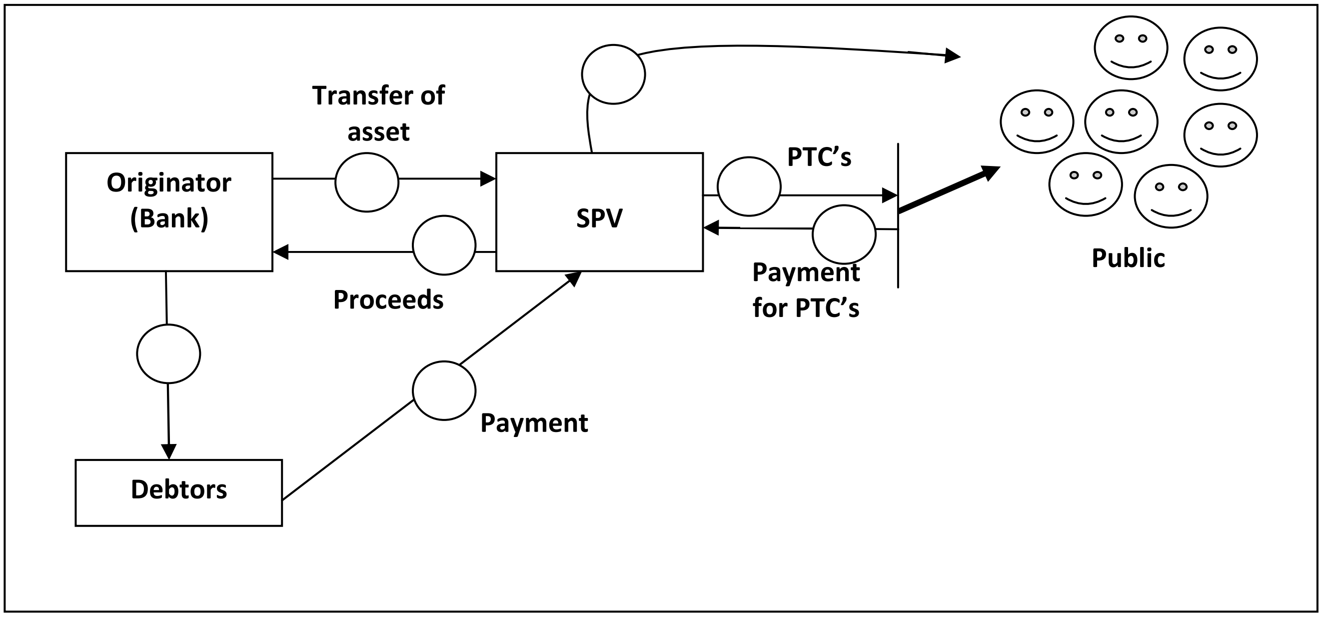
A bank selling its bad loans! This might sound strange, but it has been made possible by securitisation.

The concept

Securitisation is the process of conversion of existing assets or future cash flows into marketable securities. In other words, securitisation deals with the conversion of assets which are not marketable into marketable ones.

The originator, entity owning the assets out of an agreement identifies a pool of homogeneous assets, which it desires to securitize.

1. Originator makes sales to customers in the normal course of business.
2. Originator transfers the assets to a different entity who has trust agreement with trustee, Guarentee agreement with guarentee and is top rated by rating agency, commonly known as special purpose vehicle (SPV)
3. SPV will convert such assets into certificates known as Pay through or Pass through certificates and sell those certificates to public.
4. Public subscribes to such certificates and pay to the SPV
5. SPV after deducting his charges transfers the proceeds to Originator.
6. The debtors will due amount.
7. As and when SPV collects money from debtors, it will be immediately distributed to public (In case of pass through certificates) or will accumulate upto a point of time say a year and then distribute to public (In case of pay through certificates).



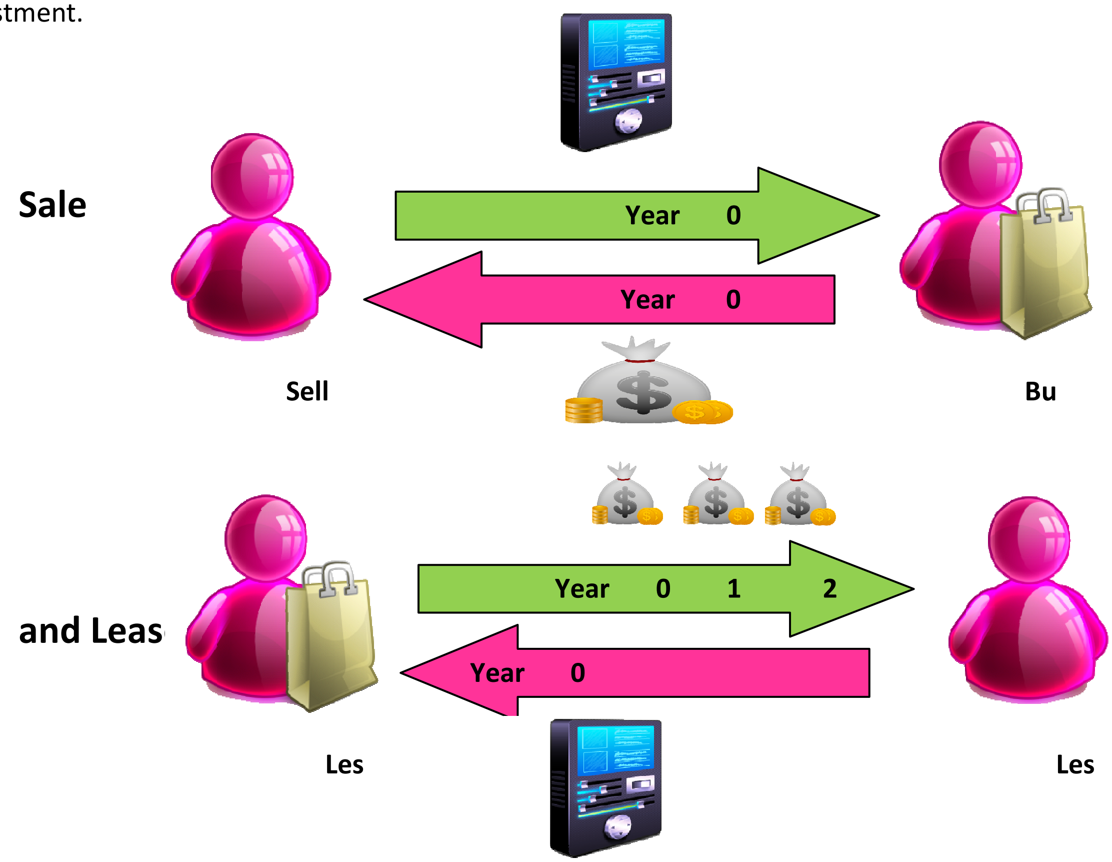
Lease Financing

Distinguish between Financial and Operating lease

Basis	Financial Lease	Operating Lease
Lease term	Covers the economic life of the equipment	Covers significantly less than the economic life of the equipment
Cancellation	Financial lease cannot be cancelled during the primary lease period.	Operating lease can be cancelled by the lessee prior to its expiration.
Amortization	The lease rentals are more or less fully amortized during the primary lease period.	The lease rentals are not sufficient enough to amortize the cost of the asset.
Risk of obsolescence	The lessee is required to take the risk of obsolescence.	The lessee is protected against the risk of obsolescence.
Costs of maintenance, taxes, insurance etc.	Incurred by the lessee unless the contract provides otherwise.	Incurred by the lessor.

Other Types of Lease

1. **Sale and lease back leasing**
   Leaseback, short for 'sale-and-leaseback,' is a financial transaction, where one sells an asset and leases it back for the long-term; therefore, one continues to be able to use the asset but no longer owns it. After purchasing an asset, the owner enters a long-term agreement by which the property is leased back to the seller, at an agreed rate. One reason for a leaseback is for the seller to raise money by offloading a valuable asset to a buyer who is presumably interested in making a long-term secured investment.



2. **Sale aid lease**
   When the leasing company (lessor) enters into an agreement with the manufacturer of the equipment, to market the latter's product through its own leasing operations, it is called "sales-aid-lease". Leasing company gets a commission from the manufacturer on such sales.

3. **Leveraged Lease**
   Under this lease, a third party is involved beside lessor and 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.

"Let's go invent tomorrow rather than worrying about what happened yesterday."

Write Short Notes on

<table>
<tr><td>Deep Discount Bonds</td><td>Deep Discount Bonds is a 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 the first to issue a deep discount bond in India in January, 1992. The bond of a face value of ₹1 lakh was sold for ₹2,700 with a maturity period of 25 years. The investor could hold the bond for 25 years or seek redemption at the end of every five years with a specified maturity value as shown below.
<table>
<tr><td>Holding Period (years)</td><td>5</td><td>10</td><td>15</td><td>20</td><td>25</td></tr>
<tr><td>Maturity Value</td><td>5,700</td><td>12,000</td><td>25,000</td><td>50,000</td><td>1,00,000</td></tr>
<tr><td>Annual rate of interest</td><td>16.12</td><td>16.09</td><td>15.99</td><td>15.71</td><td>15.54</td></tr>
</table>
The investor can sell the bonds in stock market and realise the difference between face value (₹2,700) and market price as capital gain.
Note that Deep Discount Bond may have interest rates which can be lower than the usual rate.</td></tr>
<tr><td>Zero Coupon Bonds</td><td>A zero-coupon bond (also discount bond or deep discount bond) is a bond bought at a price lower than its face value, with the face value repaid at the time of maturity.
It does not make periodic interest payments, or have so-called "coupons", hence the term zero-coupon bond.
When the bond reaches maturity, its investor receives its par (or face) value.
Some zero coupon bonds are inflation indexed, so the amount of money that will be paid to the bond holder is calculated to have a set amount of purchasing power rather than a set amount of money, but the majority of zero coupon bonds pay a set amount of money known as the face value of the bond.
Zero coupon bonds may be long or short term investments. Long-term zero coupon maturity dates typically start at ten to fifteen years. The bonds can be held until maturity or sold on secondary bond markets. Short-term zero coupon bonds generally have maturities of less than one year and are called bills. The U.S. Treasury bill market is the most active and liquid debt market in the world.</td></tr>
<tr><td>Seed Capital Assistance</td><td>The Seed capital assistance scheme is designed by IDBI for professionally or technically qualified entrepreneurs and/or persons possessing relevant experience, skills and entrepreneurial traits.
All the projects eligible for financial assistance from IDBI, directly or indirectly through refinance are eligible under the scheme.
The Seed Capital Assistance is interest free but carries a service charge of one per cent per annum for the first five years and at increasing rate thereafter.
However, IDBI will have the option to charge interest at such rate as may be determined by IDBI on the loan if the financial position and profitability of the company so permits during the currency of the loan.
The repayment schedule is fixed depending upon the repaying capacity of the unit with an initial moratorium upto five years.
The project cost should not exceed ₹2 crores and the maximum assistance under the project will be restricted to 50 percent of the required promoter's contribution or</td></tr>
</table>

	₹15 lacs, whichever is lower.
Certificate of Deposit (CD)	A certificate of deposit is a promissory note issued by a bank. It is a time deposit that restricts holders from withdrawing funds on demand. Although it is still possible to withdraw the money, this action will often incur a penalty. CDs can be issued by (i) scheduled commercial banks {excluding Regional Rural Banks and Local Area Banks}; and (ii) select All-India Financial Institutions (FIs) that have been permitted by RBI to raise short-term resources within the umbrella limit (prescribed in paragraph 3.2 below) fixed by RBI. Minimum amount of a CD should be Rs.1 lakh, i.e., the minimum deposit that could be accepted from a single subscriber should not be less than Rs.1 lakh, and in multiples of Rs. 1 lakh thereafter. The maturity period of CDs issued by banks should not be less than 7 days and not more than one year, from the date of issue. CDs in physical form are freely transferable by endorsement and delivery.
Commercial Paper	**1. What is Commercial Paper (CP)?** Commercial Paper (CP) is an unsecured money market instrument issued in the form of a promissory note. **2. When it was introduced?** It was introduced in India in 1990. **3. Who can issue CP?** Corporates, primary dealers (PDs) and the All-India Financial Institutions (FIs) are eligible to issue CP. **4. What is the minimum and maximum period of maturity prescribed for CP?** CP can be issued for maturities between a minimum of 7 days and a maximum of up to one year from the date of issue.However, the maturity date of the CP should not go beyond the date up to which the credit rating of the issuer is valid. **5. In what denominations a CP that can be issued?** CP can be issued in denominations of Rs.5 lakh or multiples thereof. **6. Who can invest in CP?** Individuals, banking companies, other corporate bodies (registered or incorporated in India) and unincorporated bodies, Non-Resident Indians (NRIs) and Foreign Institutional Investors (FIIs) etc. can invest in CPs. However, investment by FIIs would be within the limits set for them by Securities and Exchange Board of India (SEBI) from time-to-time. **7. Whether CP can be held in dematerilaised form?** Yes. **8. Whether CPs are traded in the secondary market?** Yes. CPs are actively traded in the OTC [over the counter] market. Such transactions, however, are to be reported on the reporting platform within 15 minutes of the trade for dissemination of trade information to market participation thereby ensuring market transparency.

 "Your work is going to fill a large part of your life, and the only way to be truly satisfied is to do what you believe is great work. And the only way to do great work is to love what you do. If you haven't found it yet, keep looking. Don't settle. As with all matters of the heart, you'll know when you find it."

Other Sources of Finance

American Depositary Receipts	✓ Shares of many non-US companies trade on US stock exchanges through ADRs. ✓ ADRs are denominated and pay dividends in US dollars and may be traded like regular shares of stock. ✓ This is an excellent way for the public in US to buy shares in a non US company while realizing any dividends and capital gains in U.S. dollars. ✓ One ADR may represent a portion of a foreign share, one share or a bundle of shares of a foreign corporation. ✓ If the ADR's are "sponsored," the corporation provides financial information and other assistance to the bank and may subsidize the administration of the ADR. ✓ "Unsponsored" ADRs do not receive such assistance. ✓ Fees associated with the creating or releasing of ADRs from ordinary shares, charged by the commercial banks with correspondent banks in the international sites.
Global Depositary Receipts	✓ A bank certificate issued in more than one country for shares in a foreign company. ✓ The shares are held by a foreign branch of an international bank. ✓ The shares trade as domestic shares, but are offered for sale globally through the various bank branches. ✓ Several international banks issue GDRs, such as JPMorgan Chase, Citigroup, Deutsche Bank, The Bank of New York Mellon. ✓ GDRs are often listed in the Frankfurt Stock Exchange, Luxembourg Stock Exchange and in the London Stock Exchange, where they are traded on the International Order Book (IOB).
Indian Depositary Receipts	✓ An Indian Depository Receipt (IDR) is a financial instrument denominated in Indian Rupees in the form of a depository receipt created by a Domestic Depository against the underlying equity of issuing company to enable foreign companies to raise funds from the Indian securities Markets. ✓ The foreign company IDRs will deposit shares to an Indian depository. ✓ The depository would issue receipts to investors in India against these shares. ✓ The benefit of the underlying shares (like bonus, dividends etc.) would accrue to the depository receipt holders in India.
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.
Packing Credit	✓ Packing credit is an advance made available by banks to an exporter. ✓ Any exporter, having at hand a firm export order placed with him by his foreign buyer on an irrevocable letter of credit opened in his favour, can approach a bank for availing of packing credit. ✓ An advance so taken by an exporter is required to be liquidated within 180 days from the date of its commencement by negotiation of export bills or receipt of export proceeds in an approved manner. ✓ Thus Packing Credit is essentially a short-term advance.

Angle of Incidence	✓ This angle is formed by the intersection of sales line and total cost line at the break- even point. ✓ This angle shows the rate at which profits are being earned once the break-even point has been reached. ✓ The wider the angle the greater is the rate of earning profits. ✓ A large angle of incidence with a high margin of safety indicates extremely favourable position.
Cost Volume Profit (CVP) Analysis:- Assumptions	✓ Changes in the levels of revenues and costs arise only because of changes in the number of products (or service) units produced and sold. ✓ Total cost can be separated into two components: Fixed and variable ✓ Graphically, the behaviour of total revenues and total cost are linear in relation to output level within a relevant range. ✓ Selling price, variable cost per unit and total fixed costs are known and constant. ✓ (All revenues and costs can be added, sub traded and compared without taking into account the time value of money.

Theory Questions from Different Chapters

Q1 Explain the Inter-relationship between Investment, Financing and Dividend Decisions

Answer:

The finance functions are divided into three major decisions, viz., investment, financing and dividend decisions. 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 has an influence on the profitability of the company and ultimately on its wealth.

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

Q2 Differentiate between Inflation Bonds and Floating Rate Bonds

Answer: Inflation Bonds are the bonds in which interest rate is adjusted for inflation. Thus, the investor gets interest which is free from the effects of inflation. For example, if the interest rate is 11 per cent and the inflation is 5 per cent, the investor will earn 16 per cent meaning thereby that the investor is protected against inflation.

Floating Rate Bonds, as the name suggests, are the bonds where the interest rate is not fixed and is allowed to float depending upon the market conditions. This is an ideal instrument which can be resorted to by the issuer to hedge themselves against the volatility in the interest rates. This has become more popular as a money market instrument and has been successfully issued by financial institutions like IDBI, ICICI etc.

Q3 Differential between Business Risk and Financial Risk:

Answer:

Business risk refers to the risk associated with the firm's operations.

- ✓ It is the uncertainty about the future operating income (EBIT), i.e. how well can the operating income be predicted?
- ✓ Business risk can be measured by the standard deviation of the Basic Earning Power ratio.

Financial risk refers to the additional risk placed on the firm's shareholders as a result of debt use i.e. the additional risk a shareholder bears when a company uses debt in addition to equity financing.

- ✓ Companies that issue more debt instruments would have higher financial risk than companies financed mostly or entirely by equity.
- ✓ Financial risk can be measured by ratios such as the firm's financial leverage multiplier, total debt to assets ratio or degree of financial leverage.
- ✓ A company's risk is composed of financial risk, which is linked to debt, and risk, which is often linked to economic climate.
- ✓ If a company is entirely financed by equity, it would pose almost no financial risk, but, it would be susceptible to business risk or changes in the overall economic climate.

Q4 Discuss the risk-return considerations in financing of current assets.

Answer:

- ✓ The financing of current assets involves a trade off between risk and return. A firm can choose from short or long term sources of finance. Short term financing is less expensive than long term financing but at the same time, short term financing involves greater risk than long term financing.
- ✓ Depending on the mix of short term and long term financing, the approach followed by a company may be referred as matching approach, conservative approach and aggressive approach.
- ✓ In matching approach, long-term finance is used to finance fixed assets and permanent current assets and short term financing to finance temporary or variable current assets. Under the conservative plan, the firm finances its permanent assets and also a part of temporary current assets with long term financing and hence less risk of facing the problem of shortage of funds.
- ✓ An aggressive policy is said to be followed by the firm when it uses more short term financing than warranted by the matching plan and finances a part of its permanent current assets with short term financing.

Q5 The overall cost of capital can be reduced by increasing the debt portion in the capital structure. Discuss.

Answer: In a zero-tax environment, MM Hypothesis has proved that the overall cost of capital is independent of the amount of leverage in the capital structure. However, when companies are subject to tax, the overall cost of capital will be reduced due to the tax shield provided by debt.

Q6 "Liquidity ratios are particularly useful in credit analysis by banks and other suppliers of short-term loans." Comment.

Answer: The given statement is true because with the help of these ratios the stakeholders 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.

Q7 Discuss Profitability Index (PI) as a tool of capital budgeting and give an illustration.

Answer: In capital budgeting, there are cases when we have to compare or rank a number of proposals each involving different amount of cash flows. One of the methods of comparing/ranking such proposal is to work out what is known as profitability index (PI). It is also called benefit-cost ratio. It may be calculated as follows:

PI = Present value of net cash inflows/Initial cash outlay

Suppose, for example a company is considering two projects viz., A and B. The present value of net cash flows and initial outlay are as follows:

	Project A	Project B
Present Value of Net Cash Inflows	36,000	34,000
Initial Cash Outlay	30,000	29,000

In the case of the example, Project A has profitability index of 1.20 whereas Project B's ratio is 1.17 calculated as under:

A= 36,000/30,000=1.20
B=34,000/29,000=1.17

It may be noted that as long as the profitability index is equal to or greater than 1.00, the project is acceptable.
Alternatively, profitability index may also be calculated as under:
PI = Sum of discounted cash inflows/Sum of discounted cash outlfows

Q8 "Financial Leverage is a double edged sword" Comment.

Answer: On one hand when cost of 'fixed cost fund' is less than the return on investment financial leverage will help to increase return on equity and EPS. The firm will also benefit from the saving of tax on interest on debts etc. However, when cost of debt will be more than the return it will affect return of equity and EPS unfavourably and as a result firm can be under financial distress. This is why financial leverage is known as "double edged sword".

When	Effect	Result
ROI > Interest	Favourable	Advantage
ROI< Interest	Unfavourable	Disadvantage
ROI = Interest	Nuetral	Neither Advantage nor Disadvantage

Q9 Explain briefly the limitations of Financial ratios

Answer: The limitations of financial ratios are listed below:

1. **Diversified product lines:** Many businesses operate a large number of divisions in quite different industries. In such cases, ratios calculated on the basis of aggregate data cannot be used for inter-firm comparisons.
2. Financial data are badly distorted by inflation: Historical cost values may be substantially different from true values. Such distortions of financial data are also carried in the financial ratios.
3. Seasonal factors may also influence financial data.
4. To give a good shape to the popularly used financial ratios (like current ratio, debt equity ratios, etc.): The business may make some year-end adjustments. Such window dressing can change the character of financial ratios which would be different had there been no such change.
5. Differences in accounting policies and accounting period: It can make the accounting data of two firms non-comparable as also the accounting ratios.
6. There is no standard set of ratios against which a firm's ratios can be compared: Sometimes a firm's ratios are compared with the industry average. But if a firm desires to be above the average, then industry average becomes a low standard.
   On the other hand, for a below average firm, industry averages become too high a standard to achieve.
7. It is very difficult to generalise whether a particular ratio is good or bad: For example, a low current ratio may be said 'bad' from the point of view of low liquidity, but a high current ratio may not be 'good' as this may result from inefficient working capital management.
8. 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.
   (Write any four)

Q10 Differentiate between Factoring and Bills discounting.

Answer: The differences between Factoring and Bills discounting are:

(a) Factoring is called as "Invoice Factoring' whereas Bills discounting is known as 'Invoice discounting."

(b) In Factoring, the parties are known as the client, factor and debtor whereas in Bills discounting, they are known as drawer, drawee and payee.

(c) Factoring is a sort of management of book debts whereas bills discounting is a sort of borrowing from commercial banks.

(d) For factoring there is no specific Act, whereas in the case of bills discounting, the Negotiable Instruments Act is applicable

Q11 Explain "Ploughing back of profits"

Answer:

- ✓ Long term funds may also be provided by accumulating the profits of the company and by 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.

 "A lot of companies have chosen to downsize, and maybe that was the right thing for them. We chose a different path. Our belief was that if we kept putting great products in front of customers, they would continue to open their wallets."

Q12 Meaning of Capital Structure and its Differentiation from Financial Structure

Answer:

- ✓ 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.

Q13 Explain briefly the accounts receivable systems.

Answer: 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.

Q14 Concept of Seed Capital Assistance

Answer: It is a scheme designed by IDBI for professionally or technically qualified entrepreneurs and/or persons possessing relevant experience, skills and entrepreneurial traits. All the projects eligible for financial assistance from IDBI, directly or indirectly through refinance, are eligible under the scheme. The assistance is interest-free but carries a service charge of one percent per annum for the first five years and at an increasing rate thereafter. The project cost should not exceed Rs. 2 crores and the maximum assistance under the project will be restricted to 50 percent of the required promoter's contribution or Rs.15 lacs whichever is lower.

Q15 Forms of Bank Credit

Answer: The various forms of bank credit in financing the working capital of a business organisation are:

(a) Cash credit;
(b) Bank overdraft;
(c) Bills discounting;
(d) Bill acceptance;
(e) Line of credit;
(f) Letter of credit; and
(g) Bank guarantees.

Q16 Concentration Banking:

Answer: 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.

Q17 Lock Box System:

Answer: Another means to accelerate the flow of funds is a lock box system. 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.

Q18 Financial Instruments in the International Market

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

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

(Note: Students may answer any four of the above financial instruments)

Q19 Discuss factors that a venture capitalist should consider before financing any risky project.

Answer:

(a) 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.
(b) The technical ability of the team is also vital. They should be able to develop and produce a new product / service.
(c) Technical feasibility of the new product / service should be considered.
(d) 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.
(e) A research must be carried out to ensure that there is a market for the new product.
(f) The venture capitalist himself should have the capacity to bear risk or loss, if the project fails.
(g) The venture capitalist should try to establish a number of exist routes.
(h) 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.
(Note: Students may answer any four of the above factors)

Q20 Net Operating Income (NOI) Theory of Capital Structure

Answer: According to this approach, there is no relationship between the cost of capital and value of the firm. The value of the firm is independent of the capital structure of the firm.

Assumptions of NOI Approach

(a) There are no taxes.
(b) The market capitalizes the value of the firm as a 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 i.e. increase in cost of equity (Ke). The increase in cost of equity is such as completely offset the benefits of using cheaper debt.
(d) The overall cost of capital remains same for all degrees of debt equity mix.

Q21 Define 'Present Value' and 'Perpetuity'.

Answer:

Present Value: Present Value" is the current value of a "Future Amount". It can also be defined as the amount to be invested today (Present Value) at a given rate over specified period to equal the "Future Amount".

Perpetuity: Perpetuity is an annuity in which the periodic payments or receipts begin on a fixed date and continue indefinitely or perpetually. Fixed coupon payments on permanently invested (irredeemable) sums of money are prime examples of perpetuities.

Q22 Debt Securitisation and its Advantages
Answer: Debt securitisation is a method of recycling of funds and is especially beneficial to financial intermediaries to support lending volumes. Under debt securitisation a group of illiquid assets say a mortgage or any asset that yields stable and regular cash flows like bank loans, consumer finance, and credit card payment are pooled together and sold to intermediary. The intermediary then issues debt securities.
The advantages of debt securitisation to the originator are the following:

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

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

Q23 Operating risk is associated with cost structure, whereas financial risk is associated with capital structure of a business concern." Critically examine this statement.
Answer: Operating risk refers to the risk associated with the firm's operations. It is represented by the variability of earnings before interest and tax (EBIT). The variability in turn is influenced by revenues and expenses, which are affected by demand of firm's products, variations in prices and proportion of fixed cost in total cost. If there is no fixed cost, there would be no operating risk. Whereas financial risk refers to the additional risk placed on firm's shareholders as a result of debt and preference shares used in the capital structure of the concern. Companies that issue more debt instruments would have higher financial risk than companies financed mostly by equity.

Q24 State the advantage of Electronic Cash Management System.
Answer:
(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.
(Note: Students may answer any four of the above advantages).

Q25 What is Virtual Banking? State its advantages.
Answer: 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.

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

Q26 What is Over capitalisation? State its causes and consequences.

Answer: 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:

- ✓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.
- ✓Excessive payment for the acquisition of fictitious assets such as goodwill etc.
- ✓Improper provision for depreciation, replacement of assets and distribution of dividends at a higher rate.
- ✓Wrong estimation of earnings and capitalization.

(Note: Students may answer any two of the above reasons)

Consequences of Over-Capitalisation

Over-capitalisation results in the following consequences:

- ✓ 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.

(Note: Students may answer any two of the above consequences)

Q27 Management of marketable securities is an integral part of investment of cash.' Comment.

Answer: 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.

Q28 State the main elements of leveraged lease.

Answer: Under this lease, a third party is involved beside lessor and lessee. The lessor borrows a part of the purchase cost (say 80%) of the asset from the third party i.e., lender. The 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.

Q29 Explain four kinds of float with reference to management of cash.
Answer:
The four kinds of float are:

- ✓ Billing Float: 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.
- ✓ 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.
- ✓ Bank processing float: This is the time from the deposit of the cheque to the crediting of funds in the seller's account.

Q30 State the different types of Packing Credit.
Answer: Packing credit may be of the following types:

1. **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.

2. **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.

3. **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.

4. **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.

5. **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.

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

Q31 Discuss the estimation of working capital need based on operating cycle process.

Answer: 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:

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.

Q32 Discuss financial break-even and EBIT-EPS indifference analysis.

Answer: 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.

Q33 "Financing a business through borrowing is cheaper than using equity." Briefly explain.

Answer:

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

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

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

About the Author

CA Mayank Kothari is an Associate Member of the Institute of Chartered Accountants of India.
He has completed his graduation (BBA) from Nagpur University in 2010.

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Achievements

1. Qualified the Chartered Accountancy exam in May 2012 held by ICAI.
2. Secured All India 47th Rank in CA Final and was topper in Nagpur division of ICAI.
3. Also, he received Gold Medal for securing highest, 88 Marks in Indirect Tax paper in Nagpur division.
4. He was felicitated with the Best Student Award from the hands of Vice Chancellor of Nagpur University.
5. He has an experience of working with Big4 firm.
6. He is teaching CA Final SFM and CA IPCC FM to the students in Nagpur division.
7. He is a visiting faculty of Wegan and Leigh College of India, Delhi.

"It's very important for me to love what I do. It was important for me to find a career that I truly enjoy. You can find something that sort of excites you, that's half the battle of life."

"My Job is to not be easy on people; My Job is to make them better."

"Deciding what not to do is as important as deciding what to do."

"The ones who are crazy enough to think that they can change the world are the ones who do."

"If we kept putting great products in front of customers, they would continue to open their wallets."

"Being the richest man on the cemetery doesn't matter to me... Going to bed saying we've done something wonderful... That's what matters to me."