CA INTERMEDIATE

FINANCIAL MANAGEMENT

THEORY CUM MCQ BOOK

By

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This book is dedicated to

'LORD SHIVA'

INDEX

CHAPTER 1 SCOPE & OBJECTIVES OF FINANCIAL MANAGEMENT

Question 1
Explain two basic functions of Financial Management.

Answer
Two Basic Functions of Financial Management
1. 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.

2. 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
Differentiate between Financial Management and Financial Accounting.

Answer
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 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 3

Write short notes on the following:

1. ***Inter relationship between investment, financing and dividend decisions.***
2. ***Finance function***

Answer

1. Inter-relationship between Investment, Financing and Dividend Decisions:

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.

2. Finance Function:

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 4

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

Answer

Funds procured from different sources have different characteristics in terms of risk, cost and control. The cost of funds should be at the minimum level for that a proper balancing of risk and control factors must be carried out. Another key consideration in choosing the source of new business finance is to strike a balance between equity and debt to ensure the funding structure suits the business.

Question 5

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

Answer

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.

Question 6

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

Answer

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

A. The maximisation of firm's profit.

B. 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.
5. 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

"The profit maximization is not an operationally feasible criterion." Comment on it. Or explain the limitations or profit maximization. Or What are disadvantage of Profit Maximization?

Answer

1. The term profit is vague.
2. Profit maximisation has to be attempted with a realisation of risks involved.
3. Profit maximisation as an objective does not take into account the time pattern of returns.
4. Profit maximisation as an objective is too narrow.

Question 8

State advantage of 'Wealth Maximization' goals in Financial Management

Answer

Followings are the advantages of 'wealth Maximization':

(a) Emphasizes the long term gains
(b) Recognises risk or uncertainty
(c) Recognises the timing of returns
(d) Considers shareholders' return.

Question 9

Explain the role of Finance Manager in the changing scenario of financial management in India.

Answer

Role of Finance Manager in the Changing Scenario of Financial Management in India:

In the modern enterprise, the finance manager occupies a key position and his role is becoming more and more pervasive and significant in solving the finance problems. The traditional role of the finance manager was confined just to raising of funds from a number of sources, but the recent development in the socio-economic and political scenario throughout the world has placed him in a central position in the business organisation. He is now responsible for shaping the fortunes of the enterprise, and is involved in the most vital decision of allocation of capital like mergers, acquisitions, etc. He is working in a challenging environment which changes continuously. Emergence of financial service sector and development of internet in the field of information technology has also brought new challenges before the Indian finance managers. Development of new financial tools, techniques, instruments and products and emphasis on public sector undertaking to be self-supporting and their dependence on capital market for fund requirements have all changed the role of a finance manager. His role, especially, assumes significance in the present day context of liberalization, deregulation and globalization.

Question 10

Discuss the functions of a Chief Financial Officer.

Answer

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

1. Estimating requirement of funds
2. Decision regarding capital structure
3. Investment decisions
4. Dividend decision
5. Cash management
6. Evaluating financial performance
7. Financial negotiation
8. Keeping touch with stock exchange quotations & behaviour of share prices.

Question 11

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

Answer

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:

1. Financial analysis and planning: Determining the proper amount of funds to be employed in the firm.

2. Investment decisions: Efficient allocation of funds to specific assets.
3. Financial and capital structure decisions: Raising of funds on favourable terms as possible, i.e., determining the composition of liabilities.
4. Management of financial resources (such as working capital).
5. Risk Management: Protecting assets.

Question 12

Discuss emerging issues affecting the future role of Chief Financial Officer (CFO).

Answer

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

1. ***Regulation***: Regulation requirements are increasing and CFOs have an increasingly personal stake in regulatory adherence.
2. ***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.
3. ***Technology:*** Technology is evolving very quickly, providing the potential for CFOs to reconfigure finance processes and drive business insight through 'big data' and analytics.
4. ***Risk:*** The nature of the risks that organisations face is changing, requiring more effective risk management approaches and increasingly CFOs have a role to play in ensuring an appropriate corporate ethos.
5. ***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.
6. ***Stakeholder Management:*** Stakeholder management and relationships will become important as increasingly CFOs become the face of the corporate brand.
7. ***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.
8. ***Reporting:*** Reporting requirements will broaden and continue to be burdensome for CFOs.
9. ***Talent and Capability:*** A brighter spotlight will shine on talent, capability and behaviours in the top finance role.

MULTIPLE CHOICE QUESTIONS

1. Focus of financial management is mainly concerned with the decision related to:

(a) Financing
(b) Investing
(c) Dividend
(d) All of above.

2. The main objective of financial management is to:

(a) Secure profitability
(b) Maximise shareholder wealth
(c) Enhancing the cost of debt
(d) None of above.

3. The shareholder value maximisation model holds that the primary goal of the firm is to maximise its:

(a) Accounting profit
(b) Liquidity
(c) Market value
(d) Working capital.

4. Wealth maximisation approach is based on the concept of:

(a) Cost benefit analysis
(b) Cash flow approach
(c) Time value of money
(d) All of the above.

5. Management of all matters related to an organisation's finances is called:

(a) Cash inflows and outflows
(b) Allocation of resources
(c) Financial management
(d) Finance.

6. Which of the following is the disadvantage of having shareholders wealth maximisation goals?

(a) Emphasizes the short-term gains.
(b) Ignores the timing of returns.
(c) Requires immediate resources.
(d) Offers no clear relationship between financial decisions and share price.

7. The most important goal of financial management is:

(a) Profit maximisation
(b) Matching income and expenditure
(c) Using business assets effectively
(d) Wealth maximisation.

8. To achieve wealth maximization, the finance manager has to take careful decision in respect of:

(a) Investment
(b) Financing
(c) Dividend
(d) All the above.

9. Early in the history of finance, an important issue was:

(a) Liquidity
(b) Technology
(c) Capital structure
(d) Financing options.

10. Which of the following are microeconomic variables that help define and explain the discipline of finance?

(a) Risk and return
(b) Capital structure
(c) Inflation
(d) All of the above.

11. Financial Management is mainly concerned with the-

(a) Acquiring and developing assets to forfeit its overall benefit.
(b) Acquiring, financing and managing assets to accomplish the overall goal of a business enterprise.
(c) Efficient management of the business.
(d) Sole objective of profit maximisation.

12. Which of the following need not be followed by the finance manager for measuring and maximising shareholders' wealth?

(a) Accounting profit analysis.
(b) Cash Flow approach.
(c) Cost benefit analysis.
(d) Application of time value of money.

ANSWERS

1.	*(d)*	**2.**	*(b)*	**3.**	*(c)*	**4.**	*(d)*	**5.**	*(c)*	**6.**	*(d)*
7.	*(d)*	**8.**	*(d)*	**9.**	*(a)*	**10.**	*(d)*	**11.**	*(b)*	**12.**	*(a)*

CHAPTER 2 TYPES OF FINANCING

Question 1

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

Answer

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

There can be an argument that trade credit is a cost free source of finance. But it is not. It involves implicit cost. The supplier extending trade credit incurs cost in the form of opportunity cost of funds invested in trade receivables. Generally, the supplier passes on these costs to the buyer by increasing the price of the goods or alternatively by not extending cash discount facility.

Question 2

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

Answer

It refers to financing that arises out of regular, day-to-day operations. Spontaneous sources of financing include all those sources that are available upon demand or that arise naturally as a part of doing business. Example: Trade credit, accounts payable etc.

Question 3

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.

Question 4

Explain the term 'Ploughing back of Profits'.

Answer

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

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

Answer

Advantages of Raising Funds by Issue of Equity Shares:

1. 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.
2. Equity capital increases the company's financial base and thus helps further the borrowing powers of the company.
3. 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.
4. The company can make further issue of share capital by making a right issue.

Question 6

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

Answer

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

1. 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.
2. Issue of new equity dilutes existing control pattern while borrowing does not result in dilution of control.
3. In a period of rising prices, borrowing is advantageous. The fixed monetary outgo decreases in real terms as the price level increases.

Question 7

Discuss the advantages of preference share capital as an instrument of raising funds.

Answer

Advantages of Issue of Preference Shares are:

1. No dilution in EPS on enlarged capital base.
2. There is no risk of takeover as the preference shareholders do not have voting rights.
3. There is leveraging advantage as it bears a fixed charge.
4. The preference dividends are fixed and pre-decided. Preference shareholders do not participate in surplus profit as the ordinary shareholders
5. Preference capital can be redeemed after a specified period.

Question 8

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

Answer

A company can make an issue of fully paid-up bonus shares, from:

(a) Free Reserves

(b) Securities Premium Account

(c) Capital Redemption Reserve Account (made from profits for the redemption of redeemable preference shares.)

(d) Balance in Profit and Loss Account

(e) Balance in sinking fund created for the redemption of debentures, after they have been redeemed.

Question 9

What is debt securitisation? Explain the basics of debt securitisation process.

Answer

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

Process of Debt Securitisation:

1. 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.

2. 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.

3. 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 10

Discuss advantages of debt securitisation.

Answer

Advantages of Debt Securitisation

(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.

Question 11

What is Venture Capital Financing?

Answer

Venture Capital Financing: The term venture capital refers to capital investment made in a business or industrial enterprise, which carries elements of risks and insecurity and the probability of business hazards. Capital investment may assume the form of either equity or debt or both as a derivative instrument. The risk associated with the enterprise could be so high as to entail total loss or be so insignificant as to lead to high gains.

The European Venture Capital Association describes venture capital as risk finance for entrepreneurial
growth oriented companies. It is an investment for the medium or long term seeking to maximise the return.

Venture Capital, thus, implies an investment in the form of equity for high-risk projects with the expectation of higher profits. The investments are made through private placement with the expectation of risk of total loss or huge returns. High technology industry is more attractive to venture capital financing due to the high profit potential. The main object of investing equity is to get high capital profit at saturation stage.

In broad sense under venture capital financing venture capitalist makes investment to purchase debt or equity from inexperienced entrepreneurs who undertake highly risky ventures with potential of success.

Question 12

Discuss methods of Venture Capital Financing.

Answer

Methods of Venture Capital Financing: The venture capital financing refers to financing and funding of the small scale enterprises, high technology and risky ventures. Some common methods of venture capital financing are as follows:

1. Equity financing:

The venture capital undertakings generally requires 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.

2. 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 Financers charge royalty ranging between 2 to 15 per cent; actual rate depends on other factors of the venture such as gestation period, cash flow patterns, riskiness and other factors of the enterprise. Some Venture Capital financers 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.

3. 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 Venture Capital Fund provides funding equal to 80-87.5% of the project's cost for commercial application of indigenous technology or adopting imported technology to domestic applications.

4. Participating Debenture:

Such security carries charges in three phases- in the startup phase, no interest is charged, next stage a low rate of interest is charged upto a particular level of operations, after that, a high rate of interest is required to be paid.

Question 13

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

Answer

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

1. 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.
2. The technical ability of the team is also vital. They should be able to develop and produce a new product / service.
3. Technical feasibility of the new product / service should be considered.
4. 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.
5. A research must be carried out to ensure that there is a market for the new product.
6. The venture capitalist himself should have the capacity to bear risk or loss, if the project fails.
7. The venture capitalist should try to establish a number of exist routes.
8. 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 14

Discuss Seed Capital Assistance.

Answer

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 ₹2 crores and the maximum assistance under the project will be restricted to 50% of the required promoters contribution or ₹15 lacs whichever is lower.

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

Question 15
Discuss Global Depository Receipts (GDRs).

Answer
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.
By issue of GDRs Indian companies are able to tap global equity market to raise foreign currency funds by way of equity. It has distinct advantage over debt as there is no repayment of the principal and service costs are lower.

Question 16
Discuss American Depository Receipts (ADRs).

Answer
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 17
Discuss Indian Depository Receipts (IDRs).

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

Question 18
What is Bridge finance?

Answer
Bridge Finance: Bridge finance refers, normally, to loans taken by the business, usually from commercial banks for a short period, pending disbursement of term loans by financial institutions, normally it takes time for the financial institution to finalise procedures of creation of security, tie-up participation with other institutions etc. even though a positive appraisal of the project has been made. However, once the loans are approved in principle, firms in order not to lose further time in starting their projects arrange for bridge finance. Such temporary loan is normally repaid out of the proceeds of the principal term loans. It is secured by hypothecation of moveable assets, personal guarantees and demand promissory notes. Generally rate of interest on bridge finance is higher as compared with that on term loans.

Question 19
Discuss Packing Credit.

Answer
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.

Normally, banks insist upon their customers to lodge the irrevocable letters of credit opened in favour of the customer by the overseas buyers. The letter of credit and firms' sale contracts not only serve as evidence of a definite arrangement for realisation of the export proceeds but also indicate the amount of finance required by the exporter. Packing Credit, in the case of customers of long standing may also be granted against firm contracts entered into by them with overseas buyers.

Question 20
State the different types of Packing Credit.

Answer
Different Types of Packing Credit:

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.

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.

Forward exchange contract: Another requirement of packing credit facility is that if the export bill is to be drawn in a foreign currency, the exporter should enter into a forward exchange contact with the bank, thereby avoiding risk involved in a possible change in the rate of exchange.

Question 21
Discuss features of Secured Premium Notes.

Answer
Secured premium notes are issued along with detachable warrants and are redeemable after a notified period of say 4 to 7 years. This is a kind of NCD attached with warrant. It was first introduced by TISCO, which issued the SPNs to existing shareholders on right basis. Subsequently the SPNs will be repaid in some number of equal instalments. The warrant attached to SPNs gives the holder the right to apply for and get allotment of equity shares as per the conditions within the time period notified by the company.

Question 22
Explain in brief the features of Commercial Paper.

Answer
Features of Commercial Paper (CP): A commercial paper is an unsecured money market instrument issued in the form of a promissory note. Since the CP represents an unsecured borrowing in the money market, the regulation of CP comes under the purview of the Reserve Bank of India which issued guidelines in 1990 on the basis of the recommendations of the Vaghul Working Group. These guidelines were aimed at:

1. Enabling the highly rated corporate borrowers to diversify their sources of short term borrowings, and
2. To provide an additional instrument to the short term investors.

It can be issued for maturities between 7 days and a maximum upto one year from the date of issue. These can be issued in denominations of ₹5 lakh or multiples therefore. All eligible issuers are required to get the credit rating from credit rating agencies.

Question 23
Discuss the eligibility criteria for issue of commercial paper.

Answer
Eligibility criteria for issuer of commercial paper:

1. The tangible net worth of the company is ₹5 crores or more as per audited balance sheet of the company.
2. The fund base working capital limit is not less than ₹5 crores.
3. The company is required to obtain the necessary credit rating from the rating agencies such as CRISIL, ICRA etc.
4. The issuers should ensure that the credit rating at the time of applying to RBI should not be more than two months old.
5. The minimum current ratio should be 1.33:1 based on classification of current assets and liabilities.
6. 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.
7. All issue expenses shall be borne by the company issuing commercial paper.

Question 24
Discuss Deep Discount Bonds.

Answer
Deep Discount 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 lockin period.

IDBI was first to issue a Deep Discount Bonds (DDBs) 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.

Question 25
Discuss Zero Coupon Bonds.

Answer
Zero Coupon Bonds: 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.

Question 26
Discuss MASALA Bonds.

Answer
MASALA Bonds: 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 de-nominated in Indian Rupees. NTPC raised ₹2,000 crore via masala bonds for its capital expenditure in the year 2016.

Question 27

Write the main features of Bulldog Bond.

Answer

(a) A bulldog bond is a type of foreign bond issued by non-British corporations seeking to raise capital in pound-sterling from British investors.

(b) Bulldog bond is a bond, traded in the United Kingdom, which is purchased by buyers interested in earning a revenue stream from the British pound.

(c) These foreign, pound denominated, bonds are referred to as bulldog bonds given that the British bulldog is a national icon of England.

Question 28

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

Answer

This bond is called as Yankee Bond. Following are the other features of this bond:

(a) These bonds are denominated in dollars

(b) Bonds issued by non-US banks and non-US corporations

(c) Bonds are issued in USA

(d) Bonds are to be registered in SEC (Securities and Exchange Commission)

(e) Bonds are issued in tranches

(f) Time taken can be up to 14 weeks

(g) Interest rate is dollar LIBOR (London Interbank Offered Rate)

Question 29

Write short notes on Euro Convertible Bond.

Answer

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:

1. Import of capital goods
2. Retiring foreign currency debts
3. Capitalising Indian joint venture abroad
4. 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.

Question 30

Discuss Floating Rate Bonds.

Answer

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 31

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

Answer

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

1. International banks
2. Capital markets
3. Multilateral financial institutions like IFC, ADB, IBRD etc.
4. Export Credit Agencies
5. Foreign collaborators
6. 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 32

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

Answer

Financial Instruments in the International Market: Some of the various financial instruments dealt with in the international market are:

1. Euro Bonds
2. Foreign Bonds
3. Fully Hedged Bonds

4. Medium Term Notes
5. Floating Rate Notes
6. External Commercial Borrowings
7. Foreign Currency Futures
8. Foreign Currency Option
9. Euro Commercial Papers.

Question 33

Explain the concept of closed and open- ended lease.

Answer

In the close-ended lease, the assets gets transferred to the lessor at the end of lease, the risk of obsolescence, residual values etc. remain with the lessor being the legal owner of the assets.

In the open-ended lease, the lessee has the option of purchasing the assets at the end of lease period.

Question 34

Distinguish between Operating lease and financial lease.

Answer

Difference between Operating lease and Financial lease

S.N	Financial Lease	Operating Lease
1	The risk and reward incident to ownership are passed on the lessee. The lessor only remains the legal owner of the asset.	The lessee is only provided the use of the asset for a certain time. Risk incident to ownership belongs only to the lessor.
2	The lessee bears the risk of obsolescence.	The lessor bears the risk of obsolescence.
3	The lease is non-cancellable by either party under it.	The lease is kept cancellable by the lessor.
4	The lessor does not bear the cost of repairs, maintenance or operations.	Usually, the lessor bears the cost of repairs, maintenance or operations.
5	The lease is usually full payout	The lease is usually non-payout.

Question 35

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.

Question 36

Discuss classification of Finance Lease.

Answer

(1) Tax-oriented Lease: In financial lease, we have pointed out that risk and reward of ownership are substantially transferred to lessee in economic sense. Nevertheless in a financial lease if the lessor is considered as the owner of the asset for claiming tax benefit of depreciation, then the financial lease is considered as 'tax -oriented lease'. Deduction of depreciation from lease rental reduces profit of lessor which is then subjected to tax. In other words, depreciation reduces the tax burden. Depreciation is a non-cash expenditure that results in 'tax saving'. Putting differently we can say there is a cash inflow arising out of tax saving due to depreciation. This is a genuine benefit that arises from depreciation being a tax deductible non-cash expenditure. The lesser can pass on a part of depreciation benefit to the lessee making the arrangement attractive for the lessee. This enhances the competitive advantage of the lessor. If in place of lessor, lessee is entitled to claim depreciation for tax purpose then it is not a 'tax oriented lease'. In that case, the tax treatment will be same as that of owning an asset through borrowing. Depreciation benefit of tax is of paramount importance in lease versus buy decision in determining cash flow implication to the lessor and lessee and the subsequent value of the lease to the respective parties.

(2) Leveraged Lease: A leveraged lease is tax oriented lease where the lessor borrows substantial amount from the lender to purchase the asset he leases. But an arrangement is made in such a way through tripartite agreement between the lender (financier of the leased asset), lessor and the lessee , so that, in case of default of payment of lease rental by the lessee , the lessor is not liable to make loan repayment to the lender. Instead of lessor, the lender has to take appropriate steps to recover the loan instalments due on loan to purchase the leased asset from the lessee. Leveraged lease is a complicated arrangement and normally entered in case of very high value transactions.

(3) Sale and Lease Back: It is arrangement under which an entity sells the asset to another party and simultaneously takes it back from the other party under a lease arrangement.

Question 37

Differentiate between Factoring and Bills discounting.

Answer

Differentiation between Factoring and Bills Discounting

S.N	Factoring	Bills Discounting
1	Factoring is called as "Invoice Factoring".	Whereas Bills discounting is known as "Invoice discounting."
2	In Factoring, the parties are known as the client, factor and debtor.	In Bills discounting, they are known as drawer, drawee and payee.
3	Factoring is a sort of management of book debts.	Bills discounting is a sort of borrowing from commercial banks.
4	For factoring there is no specific Act	In the case of bills discounting, the Negotiable Instruments Act is applicable.

MULTIPLE CHOICE QUESTIONS

1. Equity shares:

(a) Have an unlimited life, and voting rights and receive dividends
(b) Have a limited life, with no voting rights but receive dividends
(c) Have a limited life, and voting rights and receive dividends
(d) Have an unlimited life, and voting rights but receive no dividends

2. External sources of finance do not include:

(a) Debentures
(b) Retained earnings
(c) Overdrafts
(d) Leasing

3. Internal sources of finance do not include:

(a) Better management of working capital
(b) Ordinary shares
(c) Retained earnings
(d) Reserve and Surplus

4. In preference shares:

(a) Dividends are not available
(b) Limited voting rights are available
(c) Are not part of a company's share capital
(d) Interest can be received

5. A debenture:

(a) Is a long-term loan
(b) Does not require security
(c) Is a short-term loan
(d) Receives dividend payments

6. Debt capital refers to:

(a) Money raised through the sale of shares.
(b) Funds raised by borrowing that must be repaid.
(c) Factoring accounts receivable.
(d) Inventory loans.

7. The most popular source of short-term funding is:

(a) Factoring.
(b) Trade credit.
(c) Family and friends.
(d) Commercial banks.

8. Marketable securities are primarily:

(a) Short-term debt instruments.
(b) Short-term equity securities.
(c) Long-term debt instruments.
(d) Long-term equity securities.

9. Which of the following marketable securities is the obligation of a commercial bank?

(a) Commercial paper
(b) Negotiable certificate of deposit
(c) Repurchase agreement
(d) T-bills

10. Reserves & Surplus are which form of financing?

(a) Security Financing
(b) Internal Financing
(c) Loans Financing
(d) International Financing

11. With reference to `IFC Masala Bonds', which of the statements given below is/are correct?

1. The International Finance Corporation, which offered these bonds, is an arm of the World Bank.
2. They are rupee-denominated bonds and are a source of debt financing for the public and private sector.

(a) 1 only
(b) 2 only
(c) Both 1 and 2
(d) Neither 1 nor 2

12. External Commercial Borrowings can be accessed through ....

(a) only automatic route
(b) only approval route
(c) both automatic and approval route
(d) neither automatic nor approval route

ANSWERS

1.	(a)	**2.**	(b)	**3.**	(b)	**4.**	(b)	**5.**	(a)	**6.**	(b)
7.	(b)	**8.**	(a)	**9.**	(b)	**10.**	(b)	**11.**	(c)	**12.**	(c)

CHAPTER 3 RATIO ANALYSIS

Question 1
Discuss any three ratios computed for investment analysis.

Answer
Three ratios computed for investment analysis are as follows:

1. Earnings per share	=	Net Profit avail. to equity shareholders ÷ No. of eq. shares
2. Dividend yield ratio	=	(Equity dividend per share ÷ Market price per share) × 100
3. Return on capital employed*	=	(Earnings before interest and tax ÷ Capital employed) × 100

* It can be pretax or post tax

Question 2
Discuss the financial ratios for evaluating company performance on operating efficiency and liquidity position aspects.

Answer
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 and Gearing ratio?

Answer

Stock Turnover Ratio and Gearing Ratio:

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:

$$\text{Gearing Ratio} = \frac{\text{Long term Debt} + \text{Preference share capital}}{\text{Net Assets or Shareholders' funds}}$$

Question 4

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

Answer

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.

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

   Net profit margin = Net Income ÷ Revenue

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

   Asset Turnover = Revenue ÷ Assets

3. ***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:

   Equity Multiplier = Assets ÷ Shareholders' Equity.

Calculation of Return on Equity:

$$\text{Return on Equity} = (\text{Net Profit Margin}) \times (\text{Asset Turnover}) \times (\text{Equity Multiplier}) \text{ or}$$

$$\text{Return on Equity} = \frac{\text{Net Profit}}{\text{Revenue}} \times \frac{\text{Revunue}}{\text{Assets}} \times \frac{\text{Assets}}{\text{Shareholder's Equity}}$$

Question 5

Explain briefly the limitations of Financial ratios.

Answer

Limitations of Financial Ratios:

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.

Question 6

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

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

Answer

Important Ratios used in different situations:

1. ***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.

2. ***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.

3. ***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.

4. ***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.

MULTIPLE CHOICE QUESTIONS

1. Ratio of Net sales to Net working capital is a:

(a) Profitability ratio
(b) Liquidity ratio
(c) Current ratio
(d) Working capital turnover ratio

2. Long-term solvency is indicated by:

(a) Debt/equity ratio
(b) Current Ratio
(c) Operating ratio
(d) Net profit ratio

3. Ratio of net profit before interest and tax to sales is:

(a) Gross profit ratio
(b) Net profit ratio
(c) Operating profit ratio
(d) Interest coverage ratio.

4. Observing changes in the financial variables across the years is:

(a) Vertical analysis
(b) Horizontal Analysis
(c) Peer-firm Analysis
(d) Industry Analysis.

5. The Receivable-Turnover ratio helps management to:

(a) Managing resources
(b) Managing inventory
(c) Managing customer relationship
(d) Managing working capital

6. Which of the following is a liquidity ratio?

(a) Equity ratio
(b) Proprietary ratio
(c) Net Working Capital
(d) Capital Gearing ratio

7. Which of the following is not a part of Quick Assets?

(a) Disposable investments
(b) Receivables
(c) Cash and Cash equivalents
(d) Prepaid expenses

8. Capital Gearing ratio is the fraction of:

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

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

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

(a) 15 times
(b) 16 times
(c) 17 times
(d) 18 times

10. Equity multiplier allows the investor to see:

(a) What portion of interest on debt can be covered from earnings available to equity shareholders?
(b) How many times preference share interest be paid from earnings available to equity shareholders?
(c) What portion of return on equity is the result of debt?
(d) How many times equity is multiplied to get the value of debt?

11. A company has average accounts receivable of ₹10,00,000 and annual credit sales of ₹60,00,000. Its average collection period would be:

(a) 60.83 days
(b) 6.00 days
(c) 1.67 days
(d) 0.67 days

12. A company has net profit margin of 5%, total assets of ₹90,00,000 and return on assets of 9%. Its total asset turnover ratio would be:

(a) 1.6
(b) 1.7
(c) 1.8
(d) 1.9

13. What does Q ratio measures?

(a) Relationship between market value and book value per equity share.
(b) Proportion of profit available per equity share.
(c) Overall earnings on average total assets.
(d) Market value of equity as well as debt in comparison to all assets at their replacement cost.

14. Calculate operating expenses from the information given below:

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

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

15. Which of the following is not a profitability ratio?

(a) P/E ratio
(b) Return on capital employed (ROCE)
(c) Q Ratio
(d) Preference Dividend Coverage Ratio

ANSWERS

1.	(d)	**2.**	(a)	**3.**	(c)	**4.**	(b)	**5.**	(d)	**6.**	(c)
7.	(d)	**8.**	(a)	**9.**	(b)	**10.**	(c)	**11.**	(a)	**12.**	(c)
13.	(d)	**14.**	(c)	**15.**	(d)						

CHAPTER 4 COST OF CAPITAL

Question 1

What is meant by weighted average cost of capital? Illustrate with an example.

Answer

Meaning of Weighted Average Cost of Capital (WACC) and an Example:

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:

1. Calculating the cost of specific source of fund e.g. cost of debt, equity etc;
2. Multiplying the cost of each source by its proportion in capital structure; and
3. Adding the weighted component cost to get the firm's WACC represented by K_0.

$$K_0 = K_eW_e + K_r W_r + K_dW_d + K_pW_p$$

Question 2

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

Answer

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:

$$K_e = \frac{D_1}{P_0} \times 100$$

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.

MULTIPLE CHOICE QUESTIONS

1. Which of the following is not an assumption of the capital asset pricing model (CAPM)?

- *(a)* The capital market is efficient.
- *(b)* Investors lend or borrow at a risk-free rate of return.
- *(c)* Investors do not have the same expectations about the risk and return.
- *(d)* Investor's decisions are based on a single-time period.

2. Given: risk-free rate of return = 5 %; market return = 10%; cost of equity = 15%; value of beta (β) is:

- *(a)* 1.9
- *(b)* 1.8
- *(c)* 2.0
- *(d)* 2.2

3. …………… may be defined as the cost of raising an additional rupee of capital:

- *(a)* Marginal cost of capital
- *(b)* Weighted Average cost of capital
- *(c)* Simple Average cost of capital
- *(d)* Liquid cost of capital

4. Which of the following cost of capital requires to adjust taxes?

- *(a)* Cost of Equity Share
- *(b)* Cost of Preference Shares,
- *(c)* Cost of Debentures
- *(d)* Cost of Retained Earnings

5. Marginal Cost of capital is the cost of:

- *(a)* Additional Revenue
- *(b)* Additional Funds
- *(c)* Additional Interests
- *(d)* None of the above

6. In order to calculate Weighted Average Cost of Capital, weights may be based on:

- *(a)* Market Values
- *(b)* Target Values
- *(c)* Book Values
- *(d)* Anyone of the above

7. Firm's Cost of Capital is the average cost of:

- *(a)* All sources of finance
- *(b)* All Borrowings
- *(c)* All share capital
- *(d)* All Bonds & Debentures

8. A company has a financial structure where equity is 70% of its total debt plus equity. Its cost of equity is 10% and gross loan interest is 5%. Corporation tax is paid at 30%. What is the company's weighted average cost of capital (WACC)?

(a) 7.55%
(b) 7.80%
(c) 8.70%
(d) 8.05%

9. The cost of equity capital is all of the following except:

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

10. What is the overall (weighted average) cost of capital when the firm has ₹20 crores in long-term debt, ₹4 crores in preferred stock, and ₹16 crores in equity shares? The before-tax cost for debt, preferred stock, and equity capital are 8%, 9%, and 15%, respectively. Assume a 50% tax rate.

(a) 7.60%
(b) 6.90%
(c) 7.30%
(d) 8.90%

ANSWERS

1.	(c)	**2.**	(c)	**3.**	(a)	**4.**	(c)	**5.**	(b)	**6.**	(d)
7.	(a)	**8.**	(d)	**9.**	(d)	**10.**	(d)				

CHAPTER 5 FINANCING DECISIONS – CAPITAL STRUCTURE

Question 1

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

Answer

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:

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

Question 2

Discuss financial break-even.

Answer

Financial Break-even: 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.

Question 3

Discuss the major considerations in capital structure planning, or List the fundamental principles governing capital structure.

Answer

Fundamental Principles Governing Capital Structure:

1. ***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).

2. ***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.

3. ***Control Principle:***

   While designing a capital structure, the finance manager may also keep in mind that existing management control and ownership remains undisturbed.

4. ***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.

5. ***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 4

What is optimum capital structure? Explain.

Answer

Optimum Capital Structure:

Optimum capital structure deals with the issue of right mix of debt and equity in the long-term capital structure of a firm. According to this, if a company takes on debt, the value of the firm increases upto a certain point. Beyond that value of the firm will start to decrease. If the company is unable to pay the debt within the specified period then it will affect the goodwill of the company in the market. Therefore, company should select its appropriate capital structure with due consideration of all factors.

Question 5

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

Answer

Over-capitalization and its Causes and Consequences 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:

1. Raising more money through issue of shares or debentures than company can employ profitably.
2. Borrowing huge amount at higher rate than rate at which company can earn.
3. Excessive payment for the acquisition of fictitious assets such as goodwill etc.
4. Improper provision for depreciation, replacement of assets and distribution of dividends at a higher rate.
5. Wrong estimation of earnings and capitalization.

Consequences of Over-Capitalisation

1. Considerable reduction in the rate of dividend and interest payments.
2. Reduction in the market price of shares.

3. Resorting to "window dressing".
4. Some companies may opt for reorganization. However, sometimes the matter gets worse and the company may go into liquidation.

Question 6

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

Answer

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

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

Question 7

Explain, briefly, Modigliani and Miller approach (without tax) on Cost of Capital.

Answer

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:

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

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

1. 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.

$$\text{Value of levered firm } (V_L) = \text{Value of unlevered firm } (V_{UL})$$

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

2. 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. The cost of equity in a levered firm is determined as under:

$$Ke = K_o + (K_o - K_d) \times \text{Debt/Equity} \quad \text{or}$$

$$Ke = \text{Earning for equity/Equity}$$

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

Question 8

Explain Trade off Theory in Capital Structure.

Answer

The Trade-off Theory: The trade-off theory of capital structure refers to the idea that a company chooses how much debt finance and how much equity finance to use by balancing the costs and benefits. Tradeoff theory of capital structure basically entails offsetting the costs of debt against the benefits of debt.

Trade-off theory of capital structure primarily deals with the two concepts - cost of financial distress and agency costs. An important purpose of the trade-off theory of capital structure is to explain the fact that corporations usually are financed partly with debt and partly with equity.

It states that ***there is an advantage to financing with debt***, the tax benefits of debt and there is a cost of financing with debt, the costs of financial distress including bankruptcy costs of debt and non-bankruptcy costs (e.g. staff leaving, suppliers demanding disadvantageous payment terms, bondholder/stockholder infighting, etc). The marginal benefit of further increases in debt declines as debt increases, while the marginal cost increases, so that a firm that is optimizing its overall value will focus on this trade-off when choosing how much debt and equity to use for financing. Modigliani and Miller in 1963 introduced the tax benefit of debt. Later work led to an optimal capital structure which is given by the trade-off theory. According to Modigliani and Miller, the attractiveness of debt decreases with the personal tax on the interest income. A firm experiences financial distress when the firm is unable to cope with the debt holders' obligations. If the firm continues to fail in making payments to the debt holders, the firm can even be insolvent.

The first element of Trade-off theory of capital structure, considered as the cost of debt is usually the ***financial distress costs or bankruptcy costs of debt.*** The direct cost of financial distress refers to the cost of insolvency of a company. Once the proceedings of insolvency start, the assets of the firm may be needed to be sold at distress price, which is generally much lower than the current values of the assets. A huge amount of administrative and legal costs is also associated with the insolvency. Even if the company is not insolvent, the financial distress of the company may include a number of indirect costs like - cost of employees, cost of customers, cost of suppliers, cost of investors, cost of managers and cost of shareholders. The firms may often experience a dispute of interests among the management of the firm, debt holders and shareholders. These disputes generally give birth to agency problems that in turn give rise to the agency costs.

The ***agency costs*** may affect the capital structure of a firm. There may be two types of conflicts - shareholders-managers conflict and shareholders-debtholders conflict. The introduction of a dynamic Trade- off theory of capital structure makes the predictions of this theory a lot more accurate and reflective of that in practice.

Question 9

Explain Pecking Order Theory in Capital Structure.

Answer

Pecking order theory: This theory is based on Asymmetric information, which refers to a situation in which different parties have different information. In a firm, managers will have better information than investors. This theory states that firms prefer to issue debt when they are positive about future earnings. Equity is issued when they are doubtful and internal finance is insufficient. The pecking order theory argues that the capital structure decision is affected by manager's choice of a source of capital that gives higher priority to sources that reveal the least amount of information. ***Myres*** has given the name 'PECKING ORDER' theory as here is no well-defined debt- equity target and there are two kind of equity internal and external. Now Debt is cheaper than both internal and external equity because of interest. Further internal equity is less than external equity particularly because of no transaction/issue cost, no tax etc.

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

MULTIPLE CHOICE QUESTIONS

1. The assumptions of MM hypothesis of capital structure do not include the following:

(a) Capital markets are imperfect
(b) Investors have homogeneous expectations
(c) All firms can be classified into homogeneous risk classes
(d) The dividend-payout ratio is cent percent, and there is no corporate tax

2. Which of the following is irrelevant for optimal capital structure?

(a) Flexibility
(b) Solvency
(c) Liquidity
(d) Control

3. Financial Structure refers to:

(a) All financial resources
(b) Short-term funds
(c) Long-term funds
(d) None of these

4. An EBIT-EPS indifference analysis chart is used for:

(a) Evaluating the effects of business risk on EPS
(b) Examining EPS results for alternative financial plans at varying EBIT levels
(c) Determining the impact of a change in sales on EBIT
(d) Showing the changes in EPS quality over time

5. The term "capital structure" means:

(a) Long-term debt, preferred stock, and equity shares
(b) Current assets and current liabilities
(c) Net working capital
(d) Shareholder's equity

6. The cost of monitoring management is considered to be a (an):

(a) Bankruptcy cost
(b) Transaction cost
(c) Agency cost
(d) Institutional cost

7. The traditional approach towards the valuation of a firm assumes:

(a) That the overall capitalization rate changes in financial leverage.
(b) That there is an optimum capital structure.
(c) That the total risk is not changed with the changes in the capital structure.
(d) That the markets are perfect.

8. Market values are often used in computing the weighted average cost of capital because:

(a) This is the simplest way to do the calculation.
(b) This is consistent with the goal of maximizing shareholder value.
(c) This is required by SEBI.
(d) This is a very common mistake.

9. A firm's optimal capital structure:

(a) Is the debt-equity ratio that results in the minimum possible weighted average cost of capital
(b) 40 percent debt and 60 percent equity
(c) When the debt-equity ratio is 0.50
(d) When Cost of equity is minimum

10. Capital structure of a firm influences the:

(a) Risk
(b) Return
(c) Both Risk and Return
(d) Return but not Risk

11. Consider the below mentioned statements:

1. A company is considered to be over-capitalised when its actual capitalisation is lower than the proper capitalisation as warranted by the earning capacity.
2. Both over-capitalisation and under-capitalisation are detrimental to the interests of the society.

State True or False:

(a) 1-True, 2-True
(b) 1-False, 2-True
(c) 1-False, 2-False
(d) 1-True, 2-False

12. A critical assumption of the Net Operating Income (NOI) approach to valuation is:

(a) That debt and equity levels remain unchanged.
(b) That dividends increase at a constant rate.
(c) That k_o remains constant regardless of changes in leverage.
(d) That interest expense and taxes are included in the calculation.

13. Which of the following steps may be adopted to avoid the negative consequences of over-capitalisation?

(a) The shares of the company should be split up. This will reduce dividend per share, though EPS shall remain unchanged.
(b) Issue of Bonus Shares.
(c) Revising upward the par value of shares in exchange of the existing shares held by them.
(d) Reduction in claims of debenture-holders and creditors.

1.	(a)	**2.**	(b)	**3.**	(a)	**4.**	(b)	**5.**	(a)	**6.**	(c)
7.	(b)	**8.**	(b)	**9.**	(a)	**10.**	(c)	**11.**	(b)	**12.**	(c)
13.	(d)										

CHAPTER 6 FINANCING DECISIONS – LEVERAGES

Question 1

Explain the principles of "Trading on equity".

Answer

Financial leverage indicates the use of funds with fixed cost like long term debts and preference share capital along with equity share capital which is known as trading on equity. The basic aim of financial leverage is to increase the earnings available to equity shareholders using fixed cost fund. A firm is known to have a positive/favourable leverage when its earnings are more than the cost of debt. If earnings are equal to or less than cost of debt, it will be 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 2

Differentiate between Business risk and Financial risk.

Answer

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

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

MULTIPLE CHOICE QUESTIONS

1. Given

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

The operating leverage is:

(a) 2.00
(b) 2.50
(c) 2.67
(d) 2.47

2. If EBIT is ₹15,00,000, interest is ₹2,50,000, corporate tax is 40%, degree of financial leverage is;

(a) 1.11
(b) 1.20
(c) 1.31
(d) 1.41

3. If DOL is 1.24 and DFL is 1.99, DCL would be:

(a) 2.14
(b) 2.18
(c) 2.31
(d) 2.47

4. Operating Leverage is calculated as:

(a) Contribution ÷ EBIT
(b) EBIT ÷ PBT
(c) EBIT ÷ Interest
(d) EBIT ÷ Tax

5. Financial Leverage is calculated as:

(a) EBIT ÷ Contribution
(b) EBIT ÷ PBT
(c) EBIT ÷ Sales
(d) EBIT ÷ Variables Cost

6. Which of the following is correct?

(a) CL = OL + FL
(b) CL = OL – FL
(c) CL = OL x FL
(d) OL = OL ÷ FL

7. Which of the following indicates business risk?

(a) Operating leverage

(b) Financial leverage
(c) Combined leverage
(d) Total leverage

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

9. From the following information, calculate combined leverage:

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

(a) 10 times
(b) 6 times
(c) 1.667 times
(d) 0.10 times

10. Operating leverage is a function of which of the following factors?
(a) Amount of variable cost.
(b) Variable contribution margin.
(c) Volume of purchases.
(d) Amount of semi-variable cost.

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

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

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

14. When EBIT is much higher than Financial break-even point, then degree of financial leverage will be slightly:

(a) Less than 1
(b) Equals to 1
(c) More than 1
(d) Equals to 0

15. Firm with high operating leverage will have:

(a) Higher breakeven point
(b) Lower business risk
(c) Higher margin of safety
(d) All of above

16. When sales are at breakeven point, the degree of operating leverage will be:

(a) Zero
(b) Infinite
(c) One
(d) None of above

17. If degree of combined leverage is 3 and margin of safety is 0.50, then degree of financial leverage is:

(a) 6.00
(b) 3.00
(c) 0.50
(d) 1.50

ANSWERS

1.	(a)	**2.**	(b)	**3.**	(d)	**4.**	(a)	**5.**	(b)	**6.**	(c)
7.	(a)	**8.**	(b)	**9.**	(a)	**10.**	(b)	**11.**	(c)	**12.**	(b)
13.	(d)	**14.**	(c)	**15.**	(a)	**16.**	(b)	**17.**	(d)		

CHAPTER 7 INVESTMENT DECISIONS OR CAPITAL BUDGETING

Question 1
Write a short note on "Cut - off Rate".

Answer
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 2
What do you understand by desirability factor/profitability index?

Answer
Desirability Factor/Profitability Index: 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:

Sum of Discounted Cash inflows ÷ Initial Cash outlay or Total Discounted Cash outflow

Question 3
Explain the concept of discounted payback period.

Answer
Concept of Discounted Payback Period: 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 4
Write a short note on internal rate of return.

Answer
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 5
Identify the limitations of Internal Rate of Return.

Answer
Followings are the limitations of IRR:

(a) 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.

(b) The IRR approach creates a peculiar situation if we compare two projects with different inflow/outflow patterns.

(c) 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.

(d) If mutually exclusive projects are considered as investment options which have considerably different cash outlays. A project with a larger fund commitment but lower IRR contributes more in terms of absolute NPV and increases the shareholders' wealth. In such situation decisions based only on IRR criterion may not be correct.

Question 6
Define Modified Internal Rate of Return method.

Answer
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 in flow to the zeroth year outflow is called the MIRR.

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

Answer

In the most of the situations the Net Present Value Method (NPV) and Profitability Index (PI) yield same accept or reject decision. In general items, under PI method a project is acceptable if profitability index value is greater than 1 and rejected if it less than 1. Under NPV method a project is acceptable if Net present value of a project is positive and rejected if it is negative.

Clearly a project offering a profitability index greater than 1 must also offer a net present value which is positive. But a conflict may arise between two methods if a choice between mutually exclusive projects has to be made. Consider the following example:

	Project A	***Project B***
PV of Cash inflows	2,00,000	1,00,000
Initial cash outflows	1,00,000	40,000
Net present value	1,00,000	60,000
P.I	2 times	2.5 times

According to NPV method, project A would be preferred, whereas according to profitability index method project B would be preferred. This is because Net present value gives ranking on the basis of absolute value of rupees, whereas, profitability index gives ranking on the basis of ratio. Although PI method is based on NPV, it is a better evaluation technique than NPV in a situation of capital rationing.

Question 8
Distinguish between Net Present Value and Internal Rate of Return.

Answer
NPV versus IRR: 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.

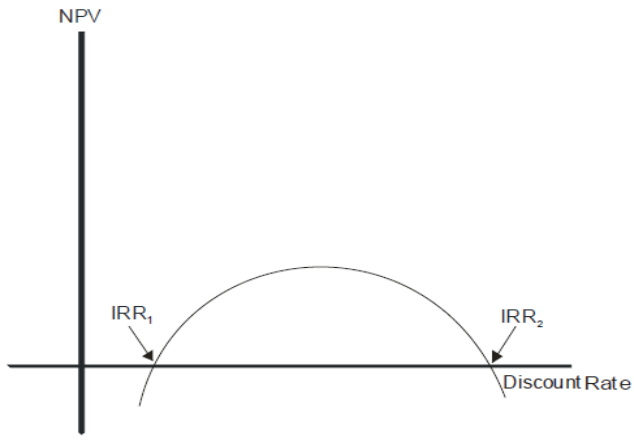
The net present value is expressed in financial values whereas internal rate of return (IRR) is expressed in percentage terms.

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 9
Explain the concept of Multiple Internal Rate of Return.

Answer
Multiple Internal Rate of Return (MIRR):

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 IRR1 and IRR2. To understand the concept of multiple IRRs it is necessary to understand the implicit re-investment assumption in both NPV and IRR techniques.

MULTIPLE CHOICE QUESTIONS

1. A capital budgeting technique which does not require the computation of cost of capital for decision making purposes is:

(a) Net Present Value method
(b) Internal Rate of Return method
(c) Modified Internal Rate of Return method
(d) Payback Period method

2. If two alternative proposals are such that the acceptance of one shall exclude the possibility of the acceptance of another then such decision making will lead to:

(a) Mutually exclusive decisions
(b) Accept reject decisions
(c) Contingent decisions
(d) None of the above

3. In case a company considers a discounting factor higher than the cost of capital for arriving at present values, the present values of cash inflows will be:

(a) Less than those computed on the basis of cost of capital
(b) More than those computed on the basis of cost of capital
(c) Equal to those computed on the basis of the cost of capital
(d) None of the above

4. If the cut off rate of a project is greater than IRR, we may:

(a) Accept the proposal
(b) Reject the proposal
(c) Be neutral about it
(d) Wait for the IRR to increase and match the cut off rate

5. While evaluating capital investment proposals, time value of money is used in which of the following techniques:

(a) Payback Period method
(b) Accounting rate of return
(c) Net present value
(d) None of the above

6. IRR would favour project proposals which have:

(a) Heavy cash inflows in the early stages of the project.
(b) Evenly distributed cash inflows throughout the project.
(c) Heavy cash inflows at the later stages of the project.
(d) None of the above.

7. The re-investment assumption in the case of the IRR technique assumes that:

(a) Cash flows can be re-invested at the projects IRR.

(b) Cash flows can be re-invested at the weighted cost of capital.
(c) Cash flows can be re-invested at the marginal cost of capital.
(d) None of the above

8. Multiple IRRs are obtained when:
(a) Cash flows in the early stages of the project exceed cash flows during the later stages.
(b) Cash flows reverse their signs during the project.
(c) Cash flows are uneven.
(d) None of the above.

9. Depreciation is included as a cost in which of the following techniques:
(a) Accounting rate of return
(b) Net present value
(c) Internal rate of return
(d) None of the above

10. Management is considering a ₹1,00,000 investment in a project with a 5 year life and no residual value. If the total income from the project is expected to be ₹60,000 and recognition is given to the effect of straight line depreciation on the investment, the average rate of return is:
(a) 12%
(b) 24%
(c) 60%
(d) 75%

11. Assume cash outflow equals ₹1,20,000 followed by cash inflows of ₹25,000 per year for 8 years and a cost of capital of 11%. What is the Net present value?
(a) (₹38,214)
(b) ₹9,653
(c) ₹8,653
(d) ₹38,214

12. What is the Internal rate of return for a project having cash flows of ₹40,000 per year for 10 years and a cost of ₹2,26,009?
(a) 8%
(b) 9%
(c) 10%
(d) 12%

13. While evaluating investments, the release of working capital at the end of the project's life should be considered as:
(a) Cash inflow
(b) Cash outflow
(c) Having no effect upon the capital budgeting decision
(d) None of the above

14. Capital rationing refers to a situation where:

(a) Funds are restricted and the management has to choose from amongst available alternative investments.

(b) Funds are unlimited and the management has to decide how to allocate them to suitable projects.

(c) Very few feasible investment proposals are available with the management.

(d) None of the above.

15. Capital budgeting is done for:

(a) Evaluating short term investment decisions.

(b) Evaluating medium term investment decisions.

(c) Evaluating long term investment decisions.

(d) None of the above.

ANSWERS

1.	(d)	**2.**	(a)	**3.**	(a)	**4.**	(b)	**5.**	(c)	**6.**	(a)
7.	(a)	**8.**	(b)	**9.**	(a)	**10.**	(b)	**11.**	(c)	**12.**	(d)
13.	(a)	**14.**	(a)	**15.**	(c)						

CHAPTER 8 DIVIDEND DECISIONS

Question 1
Discuss Modigliani and Miller (M.M) Hypothesis of Dividend Decisions.

Answer
Modigliani – Miller theory was proposed by Franco Modigliani and Merton Miller in 1961. MM approach is in support of the irrelevance of dividends i.e. firm's dividend policy has no effect on its value of assets.

Assumptions of M.M Hypothesis:
1. Perfect capital markets: The firm operates in a market in which all investors are rational and information is freely available to all.
2. No taxes or no tax discrimination between dividend income and capital appreciation (capital gain): This assumption is necessary for the universal applicability of the theory, since, the tax rates or provisions to tax income may be different in different countries.
3. Fixed investment policy: It is necessary to assume that all investment should be financed through equity only, since, implication after using debt as a source of finance may be difficult to understand. Further, the impact will be different in different cases.
4. No floatation or transaction cost: Similarly, these costs may differ country to country or market to market.
5. Risk of uncertainty does not exist. Investors are able to forecast future prices and dividend with certainty and one discount rate is appropriate for all securities and all time periods.

According to MM hypothesis:
Market value of equity shares of its firm depends solely on its earning power and is not influence by the manner in which its earnings are split between dividends and retained earnings.

Market value of equity shares is not affected by dividend size. MM hypothesis is primarily based on the arbitrage argument.

Advantages of MM Hypothesis:
1. This model is logically consistent.
2. It provides a satisfactory framework on dividend policy with the concept of Arbitrage process.

Limitations of MM Hypothesis
1. Validity of various assumptions is questionable.
2. This model may not be valid under uncertainty.

$$\text{Value of firm } (nP_0) = \frac{(n+\triangle n)P1-I+E}{1+Ke}$$

Question 2
Discuss Walter Model.

Answer

Assumptions of Walter Model:

1. All investments proposals of the firm are to be financed through retained earnings only.
2. 'r' rate of return & 'Ke' cost of capital are constant.
3. Perfect capital markets: The firm operates in a market in which all investors are rational and information is freely available to all.
4. No taxes or no tax discrimination between dividend income and capital appreciation (capital gain): This assumption is necessary for the universal applicability of the theory, since, the tax rates or provisions to tax income may be different in different countries.
5. No floatation or transaction cost: Similarly, these costs may differ country to country or market to market.
6. The firm has perpetual life.

The relationship between dividend and share price based on Walter's formula is shown below:

$$\text{Market Price (P)} = \frac{D+(E-D)r/Ke}{Ke}$$

Market price is dependent upon two factors; firstly, the quantum of dividend and secondly, profitable opportunities available to the company in investing the earnings retained.

Growth Company (r is higher than Ke): In this condition company is able to invest/utilize the fund in a better manner. In this case shareholder, can accept low dividend because their value of share would be higher. Optimum payout is NIL

Constant Company (r = Ke): In this condition each and every payout is optimum payout.

Decline Company(r is lower than Ke): In this case company is not in a position to cover the cost of capital, in such case shareholders would prefer a higher dividend so that they can utilize their funds elsewhere in more profitable opportunities. Optimum payout is 100%

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.

Limitations of Walter Model:

1. The formula does not consider all the factors affecting dividend policy and share prices. Moreover, determination of market capitalisation rate is difficult.
2. Further, the formula ignores such factors as taxation, various legal and contractual obligations, management policy and attitude towards dividend policy and so on.

Question 3

Discuss Gordon Model.

Answer

Gordon Model (Dividend Discount Model) It is financial model that values shares at the discounted value of the future dividend payments. Under this model, the price a share will be traded is calculated by the NPV of all expected future dividend payment discounted by an appropriate risk- adjusted rate. The dividend discount model price is the intrinsic value of the stock i.e.

Intrinsic value = Sum of PV of Future cash flows Intrinsic value

Assumptions of Gordon Model:

1. Firm is an all equity firm i.e. no debt.
2. IRR will remain constant, because change of IRR will change the growth rate and consequently the value will be affected. Hence this assumption is necessary.
3. Ke will remains constant, because change in discount rate will affect the present value.
4. Retention ratio (b), once decide upon, is constant i.e. constant dividend payout ratio will be followed.
5. 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.
6. Ke > g, this assumption is necessary and based on the principles of series of sum of geometric progression for 'n' number of years.
7. All investment proposals of the firm are to be financed through retained earnings only.

Advantages of Gordon Model:

1. The dividend discount model is a useful heuristic model that relates the present stock price to the present value of its future cash flows.
2. This Model is easy to understand.

Limitations of Gordon Model:

1. The dividend discount model, depends on projections about company growth rate and future capitalization rates of the remaining cash flows, which may be difficult to calculate accurately.
2. The true intrinsic value of a stock is unknowable

Formulae:

P_0 (with zero growth) = D/K_e

P_0 (with constant growth) = $\frac{D1}{Ke-g}$

P_0 (with variable growth) = $\frac{D1}{1+Ke} + \frac{D2}{(1+Ke)^2} + \frac{D3}{(1+Ke)^3} + ...+ \frac{Pn}{(1+Ke)^{n+1}}$

Question 4

Discuss Traditional Model (Graham & Dodd Model).

Answer

According to the traditional position expounded by Graham & Dodd, the stock market places considerably more weight on dividends than on retained earnings. Their view is expressed quantitatively in the following valuation model:

$$P = m\,(D + E/3)$$

Where, P = Market price per share, D = Dividend per share, E = Earnings per share, m = a multiplier

Question 5
Discuss Linter Model.

Answer
Linter model has two parameters:

1. The target payout ratio,
2. The spread at which current dividends adjust to the target.

John Linter based his model on a series of interviews which he conducted with corporate managers in the mid 1950's.While developing the model, he considers the following ***assumptions:***

1. Firm have a long term dividend payout ratio. They maintain a fixed dividend payout over a long term. Mature companies with stable earnings may have high payouts and growth companies usually have low payouts.
2. Managers are more concerned with changes in dividends than the absolute amounts of dividends.
3. Dividend changes follow changes in long run sustainable earnings.
4. Managers are reluctant to affect dividend changes that may have to be reversed.

$$D_1 = D_0 + [(EPS \times \text{Target payout}) - D_0] \times Af$$

Where D_1 = Dividend in year 1, D_0 = Dividend in year 0 (last year dividend), EPS = Earnings per share
Af = Adjustment factor

Question 6
Discuss Stock Splits.

Answer
Stock split means splitting one share into many. Stock splits is a tool used by the companies to regulate the prices of shares i.e. if a share price increases beyond a limit, it may become less tradable, for e.g. suppose a company's share price increases from ₹50 to ₹1000 over the years, it is possible that it might goes out of range of many investors.

Advantages of Stock Splits:
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.

Limitations of Stock Splits:
1. Additional expenditure need to be incurred on the process of stock split.
2. Low share price may attract speculators or short term investors, which are generally not preferred by any company.

MULTIPLE CHOICE QUESTIONS

1. Which one of the following is the assumption of Gordon's Model:

(a) $K_e > g$

(b) Retention ratio, (b), once decide upon, is constant

(c) Firm is an all equity firm

(d) All of the above

2. What should be the optimum Dividend pay-out ratio, when r = 15% & Ke = 12%:

(a) 100%

(b) 50%

(c) Zero

(d) None of the above.

3. Which of the following is the irrelevance theory?

(a) Walter model

(b) Gordon model

(c) M.M. hypothesis

(d) Linter's model

4. If the company's D/P ratio is 60% & ROI is 16%, what should be the growth rate?

(a) 5%

(b) 7%

(c) 6.4%

(d) 9.6%

5. If the shareholders prefer regular income, how does this affect the dividend decision?

(a) It will lead to payment of dividend

(b) It is the indicator to retain more earnings

(c) It has no impact on dividend decision

(d) Can't say

6. Mature companies having few investment opportunities will show high pay-out ratios, this statement is:

(a) False

(b) True

(c) Partial true

(d) None of these

7. Which of the following is the limitation of Linter's model?

(a) This model does not offer a market price for the shares.

(b) The adjustment factor is an arbitrary number and not based on any scientific criterion or methods.

(c) Both (a) & (b)

(d) None of the above.

8. What are the different options other than cash used for distributing profits to shareholders?

(a) Bonus shares
(b) Stock split
(c) Both (a) and (b)
(d) None of the above

9. Which of the following statement is correct with respect to Gordon's model?

(a) When IRR is greater than cost of capital, the price per share increases and dividend pay-out decreases.
(b) When IRR is greater than cost of capital, the price per share decreases and dividend pay-out increases.
(c) When IRR is equal to cost of capital, the price per share increases and dividend pay-out decreases.
(d) When IRR is lower than cost of capital, the price per share increases and dividend pay-out decreases.

10. Compute EPS according to Graham & Dodd approach from the given information:

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

(a) ₹30
(b) ₹56
(c) ₹28
(d) ₹84

11. Which among the following is not an assumption of Walter's Model?

(a) Rate of return and cost of capital are constant
(b) Information is freely available to all
(c) There is discrimination in taxes
(d) The firm has perpetual life

ANSWERS

1.	(d)	**2.**	(c)	**3.**	(c)	**4.**	(c)	**5.**	(a)	**6.**	(b)
7.	(c)	**8.**	(a)	**9.**	(a)	**10.**	(a)	**11.**	(c)		

CHAPTER 9 MANAGEMENT OF WORKING CAPITAL

Question 1
Elucidate the fundamental tasks or functions of treasury department of firm.

Answer
Fundamental tasks of treasury department of firm are:

(1) ***Cash Management:*** It involves efficient cash collection process and managing payment of cash both inside the organisation and to third parties.

(2) ***Currency Management:*** The treasury department manages the foreign currency risk exposure of the company.

(3) ***Fund Management:*** Treasury department is responsible for planning and sourcing the company's short, medium and long-term cash needs. They also facilitate temporary investment of surplus funds by mapping the time gap between funds inflow and outflow.

(4) ***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. Short-term finance can come in the form of bank loans or through the sale of commercial paper in the money market.

(5) ***Corporate Finance:*** Treasury department is involved with both acquisition and divestment activities within the group. In addition, it will often have responsibility for investor relations.

Question 2
Discuss Miller-Orr Cash Management model.

Answer
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. The formula for calculation of the spread between the control limits is:

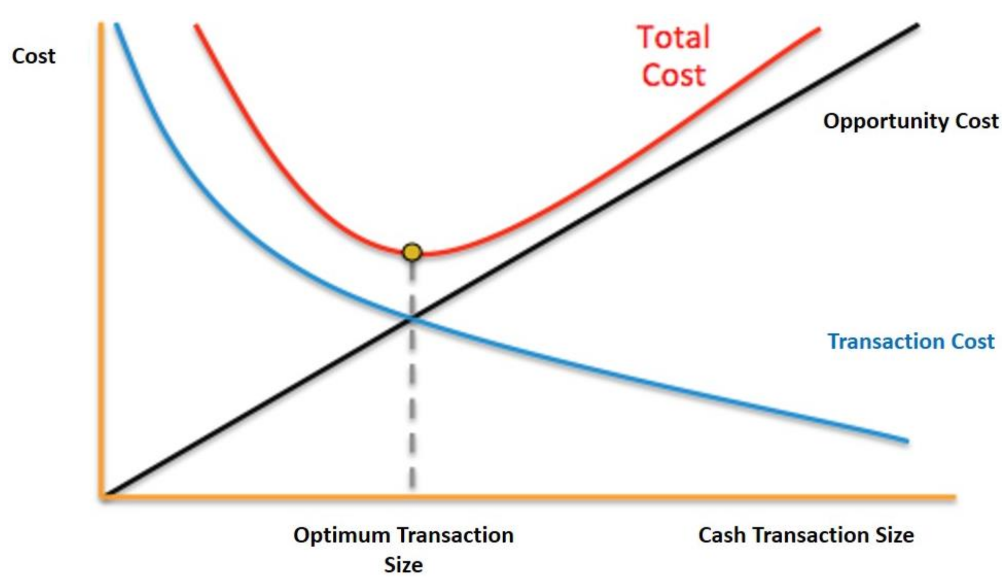
Question 3

Explain Baumol's Model of Cash Management.

Answer

William J. Baumol developed a model for optimum cash balance which is normally used in inventory management. The optimum cash balance is the trade-off between cost of holding cash (opportunity cost of cash held) and the transaction cost (i.e. cost of converting marketable securities in to cash). Optimum cash balance is reached at a point where the two opposing costs are equal and where the total cost is minimum.

This can be explained with the following diagram:



The optimum cash balance can also be computed algebraically.

$$\text{Optimum Cash Balance} = \sqrt{\frac{2AT}{H}}$$

Where,

A	=	Annual Cash disbursements
T	=	Transaction cost (Fixed cost) per transaction
H	=	Opportunity cost one rupee per annum (Holding cost)

The model is based on the following assumptions:
1. Cash needs of the firm are known with certainty.
2. The cash is used uniformly over a period of time and it is also known with certainty.
3. The holding cost is known and it is constant.
4. The transaction cost also remains constant.

Question 4

State the advantage of Electronic Cash Management System.

Answer

Advantages of Electronic Cash Management System:

1. Significant saving in time.
2. Decrease in interest costs.
3. Less paper work.
4. Greater accounting accuracy.
5. More control over time and funds.
6. Supports electronic payments.
7. Faster transfer of funds from one location to another, where required.
8. Speedy conversion of various instruments into cash.
9. Making available funds wherever required, whenever required.
10. Reduction in the amount of 'idle float' to the maximum possible extent.
11. Ensures no idle funds are placed at any place in the organization.
12. It makes inter-bank balancing of funds much easier.
13. It is a true form of centralised 'Cash Management'.
14. Produces faster electronic reconciliation.
15. Allows for detection of book-keeping errors.
16. Reduces the number of cheques issued.
17. Earns interest income or reduce interest expense.

Question 5

What is Virtual Banking? State its advantages.

Answer

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:

1. Lower cost of handling a transaction.
2. The increased speed of response to customer requirements.

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

Question 6

Write short note on Different kinds of float with reference to management of cash.

Answer

Different Kinds of Float with Reference to Management of Cash: The term float is used to refer to the periods that affect cash as it moves through the different stages of the collection process. Four kinds of float can be identified:

1. ***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.

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

3. ***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.

4. ***Bank processing float:*** This is the time from the deposit of the cheque to the crediting of funds in the seller's account.

Question 7

'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" 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 8

Describe the three principles relating to selection of marketable securities.

Answer

Three Principles Relating to Selection of Marketable Securities:

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

2. ***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, riskier.

3. ***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 9

Explain briefly the accounts receivable systems.

Answer

Accounts Receivable Systems: 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 10

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

Answer

Ageing Schedule: An important means to get an insight into 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 11

Enumerate the various forms of bank credit in financing the working capital of a business organization

Answer

Some of the forms of bank credit are:

1. ***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.

2. ***Overdraft:*** Under this facility, customers are allowed to withdraw in excess of credit balance standing in their Current Account. A fixed limit is therefore granted to the borrower within which the borrower is allowed to overdraw his account.

3. ***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.

4. ***Cash Credits***: Cash Credit is an arrangement under which a customer is allowed an advance up to certain limit against credit granted by bank. Interest is not charged on the full amount of the advance but on the amount actually availed of by him.

5. ***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.

6. ***Bills Purchased/Discounted:*** These advances are allowed against the security of bills which may be clean or documentary. 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.

7. ***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.

8. ***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 12

Discuss the factors to be taken into consideration while determining the requirement of working capital.

Answer

Factors to be taken into consideration while determining the requirement of working capital:

(i) Production Policies ***(ii)*** Nature of the business ***(iii)*** Credit policy ***(iv)*** Inventory policy ***(v)*** Abnormal factors ***(vi)*** Market conditions ***(vii)*** Conditions of supply ***(viii)*** Business cycle ***(ix)*** Growth and expansion ***(x)*** Level of taxes ***(xi)*** Dividend policy ***(xii)*** Price level changes ***(xiii)*** Operating efficiency.

Question 13

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

Answer

Liquidity versus Profitability Issue in Management of Working Capital: 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 14

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

Answer

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.

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

Question 15

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:

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

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.

MULTIPLE CHOICE QUESTIONS

1. The credit terms may be expressed as "3/15 net 60". This means that a 3% discount will be granted if the customer pays within 15 days, if he does not avail the offer, he must make payment within 60 days.

(a) I agree with the statement
(b) I do not agree with the statement
(c) I cannot say.

2. The term 'net 50' implies that the customer will make payment:

(a) Exactly on 50^{th} day
(b) Before 50^{th} day
(c) Not later than 50^{th} day
(d) None of the above.

3. Trade credit is a source of:

(a) Long-term finance
(b) Medium term finance
(c) Spontaneous source of finance
(d) None of the above.

4. The term float is used in:

(a) Inventory Management
(b) Receivable Management
(c) Cash Management
(d) Marketable securities.

5. William J Baumol's model of Cash Management determines optimum cash level where the carrying cost and transaction cost are:

(a) Maximum
(b) Minimum
(c) Medium
(d) None of the above.

6. In Miller – ORR Model of Cash Management:

(a) The lower, upper limit, and return point of Cash Balances are set out
(b) Only upper limit and return point are decided
(c) Only lower limit and return point are decided
(d) None of the above are decided.

7. Working Capital is defined as:

(a) Excess of current assets over current liabilities
(b) Excess of current liabilities over current assets
(c) Excess of Fixed Assets over long-term liabilities
(d) None of the above.

8. Working Capital is also known as "Circulating Capital, fluctuating Capital and revolving capital". The aforesaid statement is;

(a) Correct
(b) Incorrect
(c) Cannot say.

9. The basic objectives of Working Capital Management are:

(a) Optimum utilization of resources for profitability
(b) To meet day-to-day current obligations
(c) Ensuring marginal return on current assets is always more than cost of capital
(d) Select any one of the above statements.

10. The term Gross Working Capital is known as:

(a) The investment in current liabilities
(b) The investment in long-term liability
(c) The investment in current assets
(d) None of the above.

11. The term net working capital refers to the difference between the current assets minus current liabilities.

(a) The statement is correct
(b) The statement is incorrect
(c) I cannot say.

12. The term "Core current assets' was coined by:

(a) Chore Committee
(b) Tandon Committee
(c) Jilani Committee
(d) None of the above.

13. The concept operating cycle refers to the average time which elapses between the acquisition of raw materials and the final cash realization. This statement is:

(a) Correct
(b) Incorrect
(c) Partially True
(d) I cannot say.

14. As a matter of self-imposed financial discipline can there be a situation of zero working capital now-a-days in some of the professionally managed organizations.

(a) Yes
(b) No
(c) Impossible
(d) Cannot say.

15. Over trading arises when a business expands beyond the level of funds available. The statement is:

(a) Incorrect
(b) Correct
(c) Partially correct
(d) I cannot say.

16. A Conservative Working Capital strategy calls for high levels of current assets in relation to sales.

(a) I agree
(b) Do not agree
(c) I cannot say.

17. The term Working Capital leverage refer to the impact of level of working capital on company's profitability. This measures the responsiveness of ROCE for changes in current assets.

(a) I agree
(b) Do not agree
(c) The statement is partially true.

18. The term spontaneous source of finance refers to the finance which naturally arise in the course of business operations. The statement is:

(a) Correct
(b) Incorrect
(c) Partially Correct
(d) I cannot say.

19. Under hedging approach to financing of working capital requirements of a firm, each asset in the balance sheet assets side would be offset with a financing instrument of the same approximate maturity. This statement is:

(a) Incorrect
(b) Correct
(c) Partially correct
(d) I cannot say.

20. Trade credit is a:

(a) Negotiated source of finance
(b) Hybrid source of finance
(c) Spontaneous source of finance
(d) None of the above.

21. Factoring is a method of financing whereby a firm sells its trade debts at a discount to a financial institution. The statement is:

(a) Correct
(b) Incorrect
(c) Partially correct
(d) I cannot say.

22. A factoring arrangement can be both with recourse as well as without recourse:

(a) True
(b) False
(c) Partially correct
(d) Cannot say.

23. The Bank financing of working capital will generally be in the following form. Cash Credit, Overdraft, bills discounting, bills acceptance, line of credit; Letter of credit and bank guarantee.

(a) I agree
(b) I do not agree
(c) I cannot say.

24. When the items of inventory are classified according to value of usage, the technique is known as:

(a) XYZ Analysis
(b) ABC Analysis
(c) DEF Analysis
(d) None of the above.

25. When a firm advises its customers to mail their payments to special Post Office collection centers, the system is known as.

(a) Concentration banking
(b) Lock Box system
(c) Playing the float
(d) None of the above.

ANSWERS

1.	(a)	**2.**	(c)	**3.**	(c)	**4.**	(c)	**5.**	(b)	**6.**	(a)
7.	(a)	**8.**	(a)	**9.**	(b)	**10.**	(c)	**11.**	(a)	**12.**	(b)
13.	(a)	**14.**	(a)	**15.**	(b)	**16.**	(a)	**17.**	(a)	**18.**	(a)
19.	(b)	**20.**	(c)	**21.**	(a)	**22.**	(a)	**23.**	(a)	**24.**	(b)
25.	(b)										