1 CHAPTER

INTRODUCTION TO FINANCIAL MANAGEMENT

Q.N.	Questions
1.	**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
2.	**Which of the following activities are performed by CFOs now in addition to those performed by past CFOs**
	(a) Budgeting (b) Forecasting (c) Risk Management (d) Treasury management
3.	**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
4.	**"Shareholders Wealth" in a firm is reflected by**
	(a) the number of people employed in the firm (b) the book value of the firm's assets less the book value of its liabilities (c) the amount of salary paid to its employees (d) the market price per share of the firm
5.	**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
6.	**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

7. Which of the following is the common connection in financing, investing decisions

(a) Investment instruments type should be same as financing instrument type
(b) Investments will definitely grow in line with financing
(c) Debt Equity ratio should be same for investments and financing actions
(d) Risk Return Trade off

8. 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

9. 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

10. 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

11. 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

12. Decision about mergers, takeovers, expansion, liquidiation were covered in financial management under phase of Financial Management

(a) Traditional
(b) Transitional
(c) Modern
(d) None

13. Reserves & Surplus are which form of financing

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

14. Which of following activities will not lead to increase in shareholders wealth?

(a) Investing in projects with high cash flows
(b) Raising funds through sources which have low cost

(c) Regular growth in dividends
(d) Maintaining high levels of cash at bank

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

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

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

Q. N	THEORY QUESTIONS
1.	**For starting business what are the major decisions an entrepreneur has to go through ?**
	The Various Stages are:- Stage 1:- Decide which assets (premises, machinery, equipment etc.) to buy. Stage 2:- Determining what is total investment (since assets cost money) required for buying assets. Stage 3:- Apart from buying assets the entrepreneur would also need to determine how much cash he would need to run the daily operations (payment for raw material, salaries, wages etc.). In other words this is also defined as Working Capital requirement. Stage 4:- The next stage is to decide what all sources, does the entrepreneur need to tap to finance the total investment (assets and working capital). The sources could be Share Capital (Including Entrepreneur's own funds) or Borrowing from Banks or Investment from Financial Institutions etc.
2.	**What is the meaning of Financial Management & What are the three major decisions in Financial Management?**
	Financial management is that managerial activity which is concerned with planning and controlling of the firm's financial resources. In other words it is concerned with acquiring, financing and managing assets to accomplish the overall goal of a business enterprise (mainly to maximise the shareholder's wealth). "Financial Management comprises of forecasting, planning, organizing, directing, co-ordinating and controlling of all activities relating to acquisition and application of the financial resources of an undertaking in keeping with its financial objective. Any business enterprise requiring money and the 3 key questions being enquired into **1.** Where to get the money from? (Financing Decision) **2.** Where to invest the money? (Investment Decision) **3.** How much to distribute amongst shareholders to keep them satisfied? (Dividend Decision)
3.	**What are various sources of raising funds?**
	Some of the sources of funds:- **(a) Equity:** The funds raised by the issue of equity shares are the best from the risk point of view for the firm, since there is no question of repayment of equity capital except when the firm is under liquidation. **(b) Debentures:** Debentures as a source of funds are comparatively cheaper than the shares because of their tax advantage. The interest the company pays on a debenture is free of tax, unlike a dividend payment which is made from the taxed profits.

(c) Funding from Banks: Commercial Banks play an important role in funding of the business enterprises. Apart from supporting businesses in their routine activities (deposits, payments etc.) they play an important role in meeting the long term and short term needs of a business enterprise.
(d) International Funding: Funding today is not limited to domestic market. With liberalization and globalization a business enterprise has options to raise capital from International markets also. Foreign Direct Investment (FDI) and Foreign Institutional Investors (FII) are two major routes for raising funds from foreign sources besides ADR's (American depository receipts) and GDR's (Global depository receipts).

(e) Angel Financing: Angel Financing is a form of an equity-financing where an angel investor is a wealthy individual who provides capital for start-up or expansion, in exchange for an ownership/equity in the company. Angel investors have idle cash available and are looking for a higher rate of return than what is given by traditional investments.

4. What do you mean by effective utilisation of Funds ?

The finance manager is also responsible for effective utilisation of funds. He has to point out situations where the funds are being kept idle or where proper use of funds is not being made. All the funds are procured at a certain cost and after entailing a certain amount of risk. If these funds are not utilised in the manner so that they generate an income higher than the cost of procuring them, there is no point in running the business. Hence, it is crucial to employ the funds properly and profitably. Some of the aspects of funds utilization are:
(a) Utilization for Fixed Assets: The funds are to be invested in the manner so that the company can produce at its optimum level without endangering its financial solvency. For this, the finance manager would be required to possess sound knowledge of techniques of capital budgeting.
(b) Utilization for Working Capital: The finance manager must also keep in view the need for adequate working capital and ensure that while the firms enjoy an optimum level of working capital they do not keep too much funds blocked in inventories, book debts, cash etc

5. Explain evolution of Financial Management or various stages of financial management.

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.

6. Explain Long term and Short term Finance Functions.

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

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

Long term Finance Function Decisions

(a) **Investment decisions (I)**: These decisions relate to the **selection of assets in which funds will be invested by a firm.** Funds procured from different sources have to be invested in various kinds of assets. Long term funds are used in a project for various fixed assets and also for current assets. The investment of funds in a project has to be made after careful assessment of the various projects through capital budgeting.

(b) **Financing decisions (F):** These decisions relate to **acquiring the optimum finance** to meet financial objectives and seeing that fixed and working capital are effectively managed. The financial manager needs to possess a good knowledge of the sources of available funds and their respective costs and needs to ensure that the company has a sound capital structure, i.e. a proper balance between equity capital and debt.

(c) **Dividend decisions (D):** These decisions relate to the **determination as to how much and how frequently cash can be paid out of the profits** of an organisation as income for its owners/shareholders. The owner of any profit-making organization looks for reward for his investment in two ways, the growth of the capital invested and the cash paid out as income; for a sole trader this income would be termed as drawings and for a limited liability company the term is *dividends*.

All three types of decisions are interrelated, the first two pertaining to any kind of organisation while the third relates only to profit-making organisations, thus it can be seen that financial management is of vital importance at every level of business activity, from a sole trader to the largest multinational corporation.

Short-term Finance Decisions/ Function

Working Capital Management (WCM): Generally short term decision are reduced to management of current asset and current liability (i.e., working capital Management)

7. Explain importance of Financial Management

The best way to demonstrate the importance of good financial management is to describe some of the tasks that it involves:-

- Taking care not to over-invest in fixed assets.
- Balancing cash-outflow with cash-inflows
- Ensuring that there is a sufficient level of short-term working capital.
- Setting sales revenue targets that will deliver growth.
- Increasing gross profit by setting the correct pricing for products or services
- Controlling the level of general and administrative expenses by finding more cost-efficient ways of running the day-to-day business operations
- Tax planning that will minimize the taxes a business has to pay.

8.	**What are responsibilities of Finance Executive ?**
	His responsibilities include: **(a) Financial analysis and planning:** Determining the proper amount of funds to employ in the firm, i.e. designating the size of the firm and its rate of growth. **(b) Investment decisions:** The efficient allocation of funds to specific assets. **(c) Financing and capital structure decisions:** Raising funds on favourable terms as possible i.e. determining the composition of liabilities. **(d) Management of financial resources (such as working capital).** **(e) Risk management:** Protecting assets.
9.	**Explain role of Finance executive in today's world**
	Today, the role of Financial Executive, is no longer confined to accounting, financial reporting and risk management. Some of the key activities that highlight the changing role of a Finance Executive are as follows:- • Budgeting • Forecasting • Managing M & As • Profitability analysis relating to customers or products • Pricing Analysis • Decisions about outsourcing • Overseeing the IT function. • Overseeing the HR function. • Strategic planning (sometimes overseeing this function). • Regulatory compliance. • Risk management.
10.	**What is scope of Financial Management**
	Based on financial management guru Ezra Solomon's concept of financial management, following aspects are taken up in detail under the study of financial management: (a) Determination of size of the enterprise and determination of rate of growth. (b) Determining the composition of assets of the enterprise. (c) Determining the mix of enterprise's financing i.e. consideration of level of debt to equity, etc. (d) Analysis, planning and control of financial affairs of the enterprise.
11.	**Explain two objectives of Financial Management**
	The two objectives are (i) profit Maximisation and (ii) Wealth Maximisation Profit Maximisation It has traditionally been argued that the primary objective of a company is to earn profit; hence the objective of financial management is also profit maximisation. This implies that the finance manager has to make his decisions in a manner so that the profits of the concern are maximised. Each alternative, therefore, is to be seen as to whether or not it gives maximum profit. However, profit maximisation cannot be the sole objective of a company. It is at best a limited objective. **If profit is**

given undue importance, a number of problems can arise. Some of these have been discussed below:

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

(ii) **Profit maximisation has to be attempted with a realisation of risks involved.** There is a direct relationship between risk and profit. Many risky propositions yield high profit. Higher the risk, higher is the possibility of profits. If profit maximisation is the only goal, then risk factor is altogether ignored.

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

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

Wealth Maximisation/ Value Creation

Wealth = Present value of benefits – Present Value of Costs

We will first like to define what is Wealth Maximization Model. Shareholders wealth are the result of cost benefit analysis adjusted with their timing and risk i.e. time value of money.

So, It is important that benefits measured by the finance manager are in terms of cash flow. Finance manager should emphasis on Cash flow for investment or financing decisions not on Accounting profit.

The shareholder value maximization model holds that the primary goal of the firm is to maximize its market value and implies that business decisions should seek to increase the net present value of the economic profits of the firm. So, for measuring and maximising shareholders wealth finance manager should follow:

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

12. Explain Advantages & Dis-advantages of Profit & Wealth maximisation method

Goal	Objective	Advantages	Disadvantages
Profit Maximization	Large amount of profits	(i) Easy to calculate profits (ii) Easy to determine the link between financial decisions andprofits.	(i) Emphasizes the short term gains (ii) Ignores risk or uncertainty (iii) Ignores the timing of returns Requires immediateresources.
Shareholders Wealth Maximisation	Highest market value of shares.	(i) Emphasizes the long term gains (ii) Recognises risk or uncertainty (iii) Recognises the timing of returns (iv) Considers	(i) Offers no clear relationship between financial decisionsand share price. Can lead to management anxiety and frustration.

		shareholders' return.	

13. Why Wealth Maximisation works ?

To answer this question it is important to first understand and know what other goals a business enterprise may have. Some of the other goals a business enterprise may follow are:-

- ♦ Achieving a higher growth rate
- ♦ Attaining a larger market share
- ♦ Gaining leadership in the market in terms of products and technology
- ♦ Promoting employee welfare
- ♦ Increasing customer satisfaction
- ♦ Improving community life, supporting education and research, solving societal problems, etc.

14. Explain linking of FM with Accounts.

The relationship between financial management and accounting are closely related to the extent that accounting is an important input in financial decision making. In other words, accounting is a necessary input into the financial management function.

Financial accounting generates information relating to operations of the organisation. The outcome of accounting is the financial statements such as balance sheet, income statement, and the statement of changes in financial position. The information contained in these statements and reports helps the financial managers in gauging the past performance and future directions of the organisation.
Though financial management and accounting are closely related, still they differ in the treatment of funds and also with regards to decision making. Some of the differences are:-

Treatment of Funds

In accounting, the measurement of funds is based on the accrual principle i.e. revenue is recognised at the point of sale and not when collected and expenses are recognised when they are incurred rather than when actually paid. The accrual based accounting data do not reflect fully the financial conditions of the organisation.

Decision–making

The purpose of accounting is to collect and present financial data of the past, present and future operations of the organization. The financial manager uses these data for financial decision making. It is not that the financial managers cannot collect data or accountants cannot make decisions, but 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 accounting ends.

15. How to address agency problem?

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

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

♦ Managerial compensation is linked to profit of the company to some extent and also with the long term objectives of the company.

♦ Employee is also designed to address the issue with the underlying assumption that maximisation of the stock price is the objective of the investors.

♦ Effecting monitoring can be done.

2 CHAPTER TYPES OF FINANCING

Q.N	QUESTIONS
1.	**_____ bonds give the investor an option back to the company before maturity.**
	(a) Callable (b) Puttable (c) Both (d) Foreign
2.	**Marketable securities are primarily**
	(a) short-term debt instruments (b) short-term equity securities (c) long-term debt instruments (d) long-term equity securities
3.	**Equity Share**
	(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
4.	**Debt capital refers to:**
	(a) Money raised through the sale of shares. (b) Funds raised by borrowing & must be repaid (c) Factoring accounts receivable (d) Inventory loans
5.	**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
6.	**External sources of finance do not include**
	(a) Debentures (b) Retained earnings (c) Overdrafts (d) Leasing
7.	**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
8.	**The most popular source of short-term funding is**
	(a) Factoring (b) Trade credit (c) Family and friends (d) Commercial banks

9.	**Reserves & Surplus are which form of financing**	
	(a) Security Financing	(b) Internal Financing
	(c) Loans Financing	(d) International Financing
10.	**Commercial paper is a issued by ___ interest rate of which is linked to _____**	
	(a) Debenture, Corporates, 1 Year Gov Securities Yield	
	(b) Promissory Note, Corporates, 1 Year Gov Securities Yield	
	(c) Promissory Note, Banks, 1 Year Gov Securities Yield	
	(d) Promissory Note, Banks, RBI Repo rate	
11.	**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
12.	**A company has an existing EPS of Rs. 7.5; it makes an FPO of 15000 shares issued at a price of Rs. 25 per share. The funds thus raised are expected to earn a post-tax return of 28%. What will be the expected impact on EPS?**	
	(a) EPS will remain 7.5	(b) EPS will be greater than 7.5
	(c) EPS will be below 7.5	(d) Information not sufficient for calculation
13.	**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
14.	**A debenture**	
	(a) Is a long-term loan	(b) Does not require security
	(c) Is a short-term loan	(d) Receives dividend payments
15.	**Internal sources of finance do not include**	
	(a) Better management of working capital	(b) Ordinary shares
	(c) Retained earnings	(d) Reserve and Surplus
16.	**The venture capital financing is a financing of new high risky venture promoted by skilled entrepreneurs who lack and funds but have**	
	(a) Society	(b) Government
	(c) Competitors	(d) Technology

1.	(b)	**2.**	(a)	**3.**	(a)	**4.**	(a)	**5.**	(b)

6.	(b)	**7.**	(c)	**8.**	(b)	**9.**	(b)	**10.**	(b)
11.	(b)	**12.**	(c)	**13.**	(c)	**14.**	(a)	**15.**	(b)
16.	(b)								

Q.N	QUESTIONS
1.	**What are various types of Financing Needs?**

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

(i) Long-term financial needs: Such needs generally refer to those requirements of funds which are for a period exceeding 5-10 years. All investments in plant, machinery, land, buildings, etc., are considered as long-term financial needs. Funds required to finance permanent or hardcore working capital should also be procured from long term sources.

(ii) Medium-term financial needs: Such requirements refer to those funds which are required for a period exceeding one year but not exceeding 5 years. This might be needed for stores and spares, critical spares, tools, dies, moulds.

(iii) Short-term financial needs: Such type of financial needs arise to finance current assets such as stock, debtors, cash etc. Investment in these assets are known as meeting of working capital requirements of the concern. The main characteristic of short-term financial needs is that they arise for a short period of time not exceeding the accounting period. i.e., one year.

2. What is general rule for Financing of Assets?

General rule for financing of different assets would take place. These rules can be changed depending on the nature of borrower i.e. depending on the borrower' level of operation Besides, the stage of development of the business and nature of business would also decide the type of borrowing. Generally, it can be as follows:

Stage	Nature of Business	Sources of Fund
Early stage	High Uncertainty	Equity; mainly Angel fund
	High to moderate Uncertainty	Equity; Venture capital; Debt
Growth Stage	Moderate to Low Uncertainty	Debt; Venture Capital; Private Equity
Stable stage	Low Uncertainty	Debt

3. What are various long term sources of Finance??

There are different sources of funds available to meet long term financial needs of the business. These sources may be broadly classified into:

- **Share capital** (both equity and preference) &
- **Debt** (including debentures, long term borrowings or other debt instruments).

4. Explain Equity Shares, its advantages and disadvantages ??

A public limited company may raise funds from promoters or from the investing public by way of owner's capital or equity capital by issuing ordinary equity shares. Some of the characteristics of Owners/Equity Share Capital are:

- It is a source of permanent capital. The holders of such share capital in the company are called equity shareholders or ordinary shareholders.
- Equity shareholders are practically owners of the company as they undertake the highest risk.

Advantages of raising funds by issue of equity shares are:

(i) It is a permanent source of finance. Since such shares are not redeemable, the company has no liability for cash outflows associated with its redemption. In other words, once the company has issued equity shares, they are tradable i.e. they can be purchased and sold. So, a company is in no way responsible for any cash outflows of investors by which they become the shareholders of the company by purchasing the shares of existing shareholders.

(ii) Equity capital increases the company's financial base and thus helps to further the borrowing powers of the company. In other words, by issuing equity shares, a company manage to raise some money for its capital expenditures and this helps it to raise more funds with the help of debt. This is because; debt will enable the company to increase its earnings per share and consequently, its share prices.

(iii) A company is not obliged legally to pay dividends. Hence in times of uncertainties or when the company is not performing well, dividend payments can be reduced or even suspended.

(iv) A company can make further increase its share capital by initiating a right issue.

Disadvantages of raising funds by issue of equity shares are:

Apart from the above mentioned advantages, raising of funds through equity share capital has some disadvantages in comparison to other sources of finance. These are as follows:

(i) Investors find ordinary shares riskier because of uncertain dividend payments and capital gains.

(ii) The issue of new equity shares reduces the earning per share of the existing shareholders until and unless the profits are proportionately increased.

(iii) The issue of new equity shares can also reduce the ownership and control of the existing shareholders.

5. Explain Preference Share Capital, its advantages and disadvantages??

These are special kind of shares; the holders of such shares enjoy priority, both as regard to the payment of a fixed amount of dividend and also towards repayment of capital on winding up of the company. Some of the characteristics of Preference Share Capital are as follows:

♦ Long-term funds from preference shares can be raised through a public issue of shares.

♦ Such shares are normally cumulative, *i.e.*, the dividend payable in a year of loss gets carried over to the next year till there are adequate profits to pay the cumulative dividends.

Advantages of raising funds by issue of preference shares are:

(i) No dilution in EPS on enlarged capital base – On the other hand if equity shares are issued it reduces EPS, thus affecting the market perception about the company.

(ii) There is also the advantage of leverage as it bears a fixed charge (because companies are required to pay a fixed rate of dividend in case of a issue of preference shares). Non-payment of preference dividends does not force a company into liquidity.

(iii) There is no risk of takeover as the preference shareholders do not have voting rights except where dividend payment are in arrears.

Disadvantages of raising funds by issue of preference shares are:

(i) One of the major disadvantages of preference shares is that preference dividend is not tax deductible and so does not provide a tax shield to the company. Hence preference shares are costlier to the company than debt e.g. debenture.
(ii) Preference dividends are cumulative in nature. This means that if in a particular year preference dividends are not paid they shall be accumulated and paid later. Also, if these dividends are not paid, no dividend can be paid to ordinary shareholders. The non-payment of dividend to ordinary shareholders could seriously impair the reputation of the concerned company.

6. Explain Debentures, its advantages and disadvantages??

Loans can be raised from public by issuing debentures or bonds by public limited companies. Some of the characteristics of debentures are:

♦ Debentures are normally issued in different denominations ranging from Rs100 to Rs1,000 and carry different rates of interest.

♦ Normally, debentures are issued on the basis of a debenture trust deed which lists the terms and conditions on which the debentures are floated.

♦ Debentures are basically instruments for raising long-term debt capital.

♦ The period of maturity normally varies from 3 to 10 years and may also increase for projects having high gestation period.

Debentures can be divided into the following three categories based on their convertibility:
(i) Non-convertible debentures – These types of debentures do not have any feature of conversion and are repayable on maturity.
(ii) Fully convertible debentures – Such debentures are converted into equity shares as per the terms of issue in relation to price and the time of conversion. Interest rates on such debentures are generally less than the non-convertible debentures because they carry an attractive feature of getting themselves converted into shares at a later time.
(iii) Partly convertible debentures – These debentures carry features of both convertible and non-convertible debentures. The investor has the advantage of having both the features in one debenture.

Advantages of raising finance by issue of debentures are:
(i) The cost of debentures is much lower than the cost of preference or equity capital as the interest is tax-deductible. Also, investors consider debenture investment safer than equity or preferred investment and, hence, may require a lower return on debenture investment.
(ii) Debenture financing does not result in dilution of control.
(iii) In a period of rising prices, debenture issue is advantageous. The fixed monetary outgo decreases in real terms as the price level increases. In other words, the company has to pay a fixed rate of interest.

Disadvantages of debenture financing are:
(i) Debenture interest and the repayment of its principal amount is an obligatory payment.
(ii) The protective covenants associated with a debenture issue may be restrictive.
(iii) Debenture financing enhances the financial risk associated with the firm because of the reasons given in point (i).
(iv) Since debentures need to be paid at the time of maturity, a large amount of cash outflow is needed at that time.

7.	**Explain Bridge Finance??**

Bridge Finance: Bridge finance refers to loans taken by a company normally from commercial banks for a **short period because of pending disbursement of loans sanctioned by financial institutions**. Though it is of short-term nature but since it is an important step in the facilitation of long-term loan, therefore it is being discussed along with the long term sources of funds.

Normally, it takes time for financial institutions to disburse loans to companies. However, once the loans are approved by the term lending institutions, companies, in order not to lose further time in starting their projects, arrange short term loans from commercial banks. The bridge loans are repaid/ adjusted out of the term loans as and when disbursed by the concerned institutions. Bridge loans are normally secured by hypothecating movable assets, personal guarantees and demand promissory notes. Generally, the rate of interest on bridge finance is higher as compared with that on term loans.

8.	**Explain Venture Capital Financing & its characteristics??**

The venture capital financing refers to **financing of new high risky venture promoted by qualified entrepreneurs** who lack experience and funds to give shape to their ideas. In broad sense, under venture capital financing, venture capitalist make investment to purchase equity or debt securities from inexperienced entrepreneurs who undertake highly risky ventures with potential to succeed in future.

Characteristics

Some of the characteristics of Venture Capital financing are:

- ♦ It is basically an equity finance in new companies.
- ♦ It can be viewed as a long-term investment in growth-oriented small/medium firms.
- ♦ Apart from providing funds, the investor also provides support in form of sales strategy, business networking and management expertise, enabling the growth of the entrepreneur.

9.	**Explain methods of Venture Financing.**

Some common methods of venture capital financing are as follows:

(i) Equity financing: The venture capital undertakings generally require funds for a longer period but may not be able to provide returns to the investors during the initial stages. Therefore, the venture capital finance is generally provided by way of equity share capital. The equity contribution of venture capital firm does not exceed 49% of the total equity capital of venture capital undertakings so that the effective control and ownership remains with the entrepreneur.

(ii) Conditional loan: A conditional loan is repayable in the form of a royalty after the venture is able to generate sales. No interest is paid on such loans. In India venture capital financiers charge royalty ranging between 2 and 15 per cent; actual rate depends on other factors of the venture such as gestation period, cash flow patterns, risk and other factors of the enterprise.

Some Venture capital financiers give a choice to the enterprise of paying a high rate of interest (which could be well above 20 per cent) instead of royalty on sales once it becomes commercially sound.

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

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

10. Explain Debt Securitisation?

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

Example:- A finance company has given a large number of car loans. It needs more money so that it is in a position to give more loans. One way to achieve this is to sell all the existing loans. But, in the absence of a liquid secondary market for individual car loans, this is not feasible.

So, this process of debt securitization helps the finance company to raise funds and get the loans off its Balance Sheet. These funds also help the company disburse further loans. Similarly, the process is beneficial to the investors also as it creates a liquid investment in a diversified pool of car loans, which may be an attractive option to other fixed income instruments. The whole process is carried out in such a way that the original debtors i.e. the car loan borrowers may not be aware of the transaction. They might have continued making payments the way they are already doing. However, these payments shall now be made to the new investors who have emerged out of this securitization process.

11. Explain difference between Financial & Operating Lease.

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

5.	The lease is usually full payout, that is, the single lease repays the cost of the asset together with the interest.	The lease is usually non-payout, since the lessor expects to lease the same asset over and over again to several users.

12. Explain various types of Leases.

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

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

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

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

13. Explain various short term sources of Finance.

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

(i) Trade Credit: It represents credit granted by suppliers of goods, etc., as an incident of sale. The usual duration of such credit is 15 to 90 days. It generates automatically in the course of business and is common to almost all business operations. It can be in the form of an 'open account' or 'bills payable'.

(ii) Accrued Expenses and Deferred (Unearned) Income: Accrued expenses represent liabilities which a company has to pay for the services which it has already received like wages, taxes, interest and dividends. Such expenses arise out of the day-to-day activities of the company and hence represent a spontaneous source of finance.

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

(iv) Commercial Paper: A Commercial Paper is an unsecured money market instrument issued in the form of a promissory note. The Reserve Bank of India introduced the commercial paper scheme in the

year 1989 with a view to enabling highly rated corporate borrowers to diversify their sources of short-term borrowings and to provide an additional instrument to investors.

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

(vi) Certificates of Deposit (CD): A certificate of deposit (CD) is basically a savings certificate with a fixed maturity date of not less than 15 days up to a maximum of one year.

(vii) Financing of Export Trade by Banks: Exports play an important role in accelerating the economic growth of developing countries like India. Out of the several factors influencing export growth, credit is a very important factor which enables exporters in efficiently executing their export orders.

(viii) Inter Corporate Deposits: The companies can borrow funds for a short period, say 6 months, from other companies which have surplus liquidity. The rate of interest on inter corporate deposits varies depending upon the amount involved and the time period.

(ix) Certificate of Deposit (CD): The certificate of deposit is a document of title similar to a time deposit receipt issued by a bank except that there is no prescribed interest rate on such funds.

The main advantage of CD is that banker is not required to encash the deposit before maturity period and the investor is assured of liquidity because he can sell the CD in secondary market.

(x) Public Deposits: Public deposits are very important source of short-term and medium term finances particularly due to credit squeeze by the Reserve Bank of India. A company can accept public deposits subject to the stipulations of Reserve Bank of India from time to time upto a maximum amount of 35 per cent of its paid up capital and reserves..

14. Explain various facilities available to exporter.

Other facilities extended to the exporters are as follows:

(i) On behalf of approved exporters, banks establish letters of credit on their overseas or up country suppliers.

(ii) Guarantees for waiver of excise duty, etc. due performance of contracts, bond in lieu of cash security deposit, guarantees for advance payments etc., are also issued by banks to approved clients.

(iii) To approved clients undertaking exports on deferred payment terms, banks also provide finance.

(iv) Banks also endeavour to secure for their exporter-customers status reports of their buyers and trade information on various commodities through their correspondents.

(v) Economic intelligence on various countries is also provided by banks to their exporter clients.

15. Name some facilities given by banks.

Some of the facilities provided by banks are:

(a) 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.

(b) 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.

(c) Clean Overdrafts: Request for clean advances are entertained only from parties which are financially sound and having reputation for their integrity. The bank has to rely upon the personal security of the borrowers. Therefore, while entertaining proposals for clean advances; banks exercise a good deal of restraint since they have no backing of any tangible security.

(d) Cash Credits: Cash Credit is an arrangement under which a customer is allowed an advance up to certain limit against credit granted by bank. Under this arrangement, a customer need not borrow the entire amount of advance at one time; he can only draw to the extent of his requirements and deposit his surplus funds in his account. Interest is not charged on the full amount of the advance but on the amount actually availed by him.

(e) Advances against goods: Advances against goods occupy an important place in total bank credit. They provide a reliable source of repayment.

(f) Bills Purchased/ Discounted: Under this head, banks give advances against the security of bills which may be clean or documentary. Bills are sometimes purchased from approved customers in whose favour limits are sanctioned.

16. What are various other sources of Financing??

(i) Seed Capital Assistance: The Seed Capital Assistance scheme is designed by IDBI for professionally or technically qualified entrepreneurs and/or persons possessing relevant experience, skills and entrepreneurial traits but lack adequate financial resources. All the projects eligible for financial assistance from IDBI, directly or indirectly through refinance are eligible under the scheme.

(ii) Internal Cash Accruals: Existing profit-making companies which undertake an expansion diversification programme may be permitted to invest a part of their accumulated reserves or cash profits for creation of capital assets. In such cases, past performance of the company permits the capital expenditure from within the company by way of disinvestment of working/invested funds. In other words, the surplus generated from operations, after meeting all the contractual, statutory and working requirement of funds, is available for further capital expenditure.

(iii) Unsecured Loans: Unsecured loans are typically provided by promoters to meet the promoters' contribution norm. These loans are subordinate to institutional loans. The rate of interest chargeable on these loans should be less than or equal to the rate of interest on institutional loans and interest can be paid only after payment of institutional dues. These loans cannot be repaid without the prior approval of financial institutions. Unsecured loans are considered as part of the equity for the purpose of calculating debt equity ratio.

(iv) Deferred Payment Guarantee: Many a time suppliers of machinery provide deferred credit facility under which payment for the purchase of machinery can be made over a period of time. The entire cost of the machinery is financed and the company is not required to contribute any amount initially towards acquisition of the machinery. Normally, the supplier of machinery insists that bank guarantee should be furnished by the buyer. Such a facility does not have a moratorium period for repayment. Hence, it is advisable only for an existing profit-making company.

(v) Capital Incentives: The backward area development incentives available often determine the location of a new industrial unit. These incentives usually consist of a lump sum subsidy and exemption from or deferment of sales tax and octroi duty. The quantum of incentives is determined by the degree of backwardness of the location.

17. Explain Sources of External Financing.

The sources of external financing include:

(i) Commercial Banks: Like domestic loans, commercial banks all over the world extend Foreign Currency (FC) loans also for international operations. These banks also provide to overdraw over and above the loan amount.

(ii) Development Banks: Development banks offer long & medium term loans including FC loans. Many agencies at the national level offer a number of concessions to foreign companies to invest within their country and to finance exports from their countries e.g. EXIM Bank of USA.

(iii) Discounting of Trade Bills: This is used as a short-term financing method. It is used widely in Europe and Asian countries to finance both domestic and international business.

(iv) International Agencies: A number of international agencies have emerged over the years to finance international trade & business. The more notable among them include The International Finance Corporation (IFC), The International Bank for Reconstruction and Development (IBRD), The Asian Development Bank (ADB), The International Monetary Fund (IMF), etc.

(v) International Capital Markets: Today, modern organisations including MNC's depend upon sizeable borrowings in Rupees as well as Foreign Currency (FC). In order to cater to the needs of such organisations, international capital markets have sprung all over the globe such as in London.

18. Explain ADR, GDR, IDR

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

The Indian companies have preferred the GDRs to ADRs because the US market exposes them to a higher level of responsibility than a European listing in the areas of disclosure, costs, liabilities and timing. The regulations are somewhat more stringent and onerous, even for companies already listed and held by retail investors in their home country. The most onerous aspect of a US listing for the companies is to provide full, half yearly and quarterly accounts in accordance with, or at least reconciled with US GAAPs.

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

ADRs/GDRs and the Indian Scenario: Indian companies are shedding their reluctance to tap the US markets. Infosys Technologies was the first Indian company to be listed on Nasdaq in 1999. However, the first Indian firm to issue sponsored GDR or ADR was Reliance industries Limited. Beside these two companies there are several other Indian firms which are also listed in the overseas bourses. These are Wipro, MTNL, State Bank of India, Tata Motors, Dr. Reddy's Lab, etc.

(c) Indian Depository Receipts (IDRs): 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). IDRs are similar to ADRs/GDRs in the sense that foreign companies can issue IDRs to raise funds from the Indian Capital Market in 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.

19. What are contemporary sources of crowd funding.

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

(ii) Equity funding: Equity crowdfunding is a mechanism where investor invests money in an organisation and receive securities of that organisation in return. Every investor would be entitled to a stake in the organisation depending on their investment. The digital nature of crowdfunding targets large number of investors with small contributions. This type of funding is mostly adopted by startups. Some of the platforms offering equity crowdfunding are StartEngine, EquityNet, SeedInvest, etc.

(iii) Peer-to-Peer (P2P) lending: It is that category of crowdfunding where lenders match with the borrowers in order to provide unsecured loans through online platform. The fund raised are paid back by the borrowers with interest, though this kind of lending involves certain risk of defaults.

(iv) Start-up funding: A start-up company being newly formed needs fund before starting any project. However, as a start-up, it is difficult to manage loans from bank, leaving crowdfunding as one of the sources of finance. Through crowdfunding, a start-up company can raise money from large group of people. The crowdfunding may be in the form of equity funding,
P2P lending or both.

(v) Donation-based Crowdfunding: It is a source of finance where large group of people donate money as a charity for some cause with no expectation of any ownership or debt. Some of the platforms that are used for donation based crowdfunding are GoFundMe (used for donations against medical needs, education, etc.), Ketto (used for donation against medical needs), FuelADream (used for donation against charity projects, new ideas), etc.

20. Different types of Packaging Credit.

(a) **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.

(b) **Packing credit against hypothecation of goods:** Export finance is made available on certain terms and conditions where the exporter has pledge able interest and the goods are hypothecated to the bank as security with stipulated margin.

(c) **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.

(d) **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.

(e) **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.

21. Different Types of post Shipment Finance.

It takes the following forms:

(a) **Purchase/discounting of documentary export bills**: Finance is provided to exporters by purchasing export bills drawn payable at sight or by discounting usance export bills covering confirmed sales and backed by documents including documents of the title of goods such as bill of lading, post parcel receipts, or air consignment notes.

(b) **E.C.G.C. Guarantee:** Post-shipment finance, given to an exporter by a bank through purchase negotiation or discount of an export bill against an order, qualifies for post-shipment export credit guarantee.

(c) **Advance against export bills sent for collection:** Finance is provided by banks to exporters by way of advance against export bills forwarded through them for collection, taking into account the creditworthiness of the party, nature of goods exported, usance, standing of drawee etc.

(d) **Advance against duty draw backs, cash subsidy, etc.:** To finance export losses sustained by exporters, bank advance against duty draw-back, cash subsidy etc., receivable by them against export performance. Such advances are of clean nature; hence necessary precaution should be exercised.

3 CHAPTER RATIO ANALYSIS

Q.N	QUESTIONS
1.	**Gross Profit= ₹60,000, GP Ratio=20%, Stock Velocity=6 times then find out what is average stock ?**
	(a) 40,000 (b) 300,000 (c) 240,000 (d) 37,500
2.	**Observing changes in the financial variables across the years is**
	(a) Vertical analysis (b) Horizontal Analysis (c) Peer-firm Analysis (d) Industry Analysis
3.	**Total sales=3000000, Cash sales 25% of credit sales, Debtors Turnover is 8times then what are the average debtors?**
	(a) 2400000 (b) 300000 (c) 600000 (d) 900000
4.	**The_____ is useful in evaluating credit and collection policies.**
	(a) Average payment period (b) Current ratio (c) Average collection period (d) Inventory turnover ratio
5.	**Which of the following is not true about ratio analysis**
	(a) It is affected by price level changes (b) It is difficult to evolve a standard ratio (c) It can give false and misleading results (d) It is not useful in inter-firm & intra firm comparison
6.	**Inventory ratio is a relationship between _____.**
	(a) Cost of goods purchased and cost of average inventory (b) Cost of goods sold & cost of average inventory, cost of goods purchased & cost of average inventory (c) Cost of goods sold and cost of average inventory (d) None of the options is correct
7.	**If Working capital of company is ₹1,35,000, Current ratio=2.5, Liquid ratio=1.5, reserve & surplus is=₹90,000 then what are the Quick assets of the company?**
	(a) 90,000 (b) 1,35,000 (c) 1,45,000 (d) 60,000
8.	**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
9.	**If Gross Profit=54000, GP Ratio=20%, Average collection period is 18 days (360 Days year), then find out Average Debtors considering that credit sales are 20% of total sales?**
	(a) 13500 (b) 10800 (c) 12000 (d) 14000
10.	**Long-term solvency is indicated by**
	(a) Debt/equity ratio (b) Current Ratio (c) Operating ratio (d) Net profit ratio
11.	**Current Ratio is 2.5:1 and Liquid Ratio is 1.5:1. If inventory is ₹ 9,60,000, then the amount of current assets will be:**
	(a) ₹ 9.6 Lakh (b) ₹ 14.40 Lakh (c) ₹ 24 Lakh (d) ₹ 38.40 Lakh
12.	**Which of the following is not true about ratio analysis?**
	(a) It is affected by price level changes. (b) It is difficult to evolve a standard ratio. (c) It can give false and misleading results. (d) It is not useful in inter-firm and intra firm comparison
13.	**Which of the following is not a part of Quick Assets**
	(a) Disposable investments (b) Receivables (c) Cash and Cash equivalents (d) Prepaid expenses
14.	**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
15.	**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

16.	**The Receivable-Turnover ratio helps management to**	
	(a) Managing resources	(b) Managing inventory
	(c) Managing customer relationship	(d) Managing working capital
17.	**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	
18.	**Which ratio not include fictitious assets and losses**	
	(a) Cost of goods purchased and cost of average inventory	
	(b) Cost of goods sold & cost of average inventory, cost of goods purchased & cost of average inventor	
	(c) Cost of goods sold and cost of average inventory	
	(d) None of the options is correct	
19.	**A company has average accounts receivable of ₹10,00,000 & 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
20.	Which of the following is a liquidity ratio	
	(a) Equity ratio	(b) Proprietary ratio
	(c) Net Working Capital	(d) Capital Gearing ratio

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

Q.N	THEORY QUESTIONS
1.	**What sources of information for financial statement analysis are:**
	The sources of information for financial statement analysis are: **i.** Annual Reports **ii.** Interim financial statements **iii.** Notes to Accounts **iv.** Statement of cash flows **v.** Business periodicals. **vi.** Credit and investment advisory services
2.	**Explain Return on Equity using the Du Pont Model.**
	There are various 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. The components are as follows: **(i) Profitability/Net Profit Margin:** The net profit margin is simply the after-tax profit a company generates for each rupee of revenue. Net profit margin varies across industries, making it important to compare a potential investment against its competitors. **Profitability or Net Profit margin** = (Profit or Net Income) / (Sales or Revenue) **(ii) Investment Turnover/ Asset Turnover/ Capital Turnover:** The asset turnover ratio is a measure of how effectively a company converts its assets into sales. It is calculated as follows: **Investment / Asset / Capital Turnover** = (Sales or Revenue) /Investment or Assets or Capital **(iii) 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** = (Investment or Assets or Capital) / Shareholders' Equity
3.	**What is Financial Analysis**
	It may be of two types: - Horizontal and vertical. **Horizontal Analysis:** When financial statement of one year are analysed and interpreted after comparing with another year or years, it is known as horizontal analysis. It can be based on the ratios derived from the financial information over the same time span. **Vertical Analysis:** When financial statement of single year is analyzed then it is called vertical analysis. This analysis is useful in inter firm comparison. Every item of Profit

and loss account is expressed as a percentage of gross sales, while every item on a balance sheet is expressed as a percentage of total assets held by the firm.

4. Explain Limitations of Financial Ratios

The limitations of financial ratios are listed below:

(i) Diversified product lines: Many businesses operate a large number of divisions in quite different industries. In such cases ratios calculated on the basis of aggregate data cannot be used for inter-firm comparisons.

(ii) Financial data are badly distorted by inflation: Historical cost values may be substantially different from true values. Such distortions of financial data are also carried in the financial ratios.

(iii) Seasonal factors: It may also influence financial data.

(iv) To give a good shape to the popularly used financial ratios (like current ratio, debt-equity ratios etc.): The business may make some year-end adjustments. Such window dressing can change the character of financial ratios which would be different had there been no such change.

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

(vi) 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.

Financial ratios provide clues but not conclusions. These are tools only in the hands of experts because there is no standard ready-made interpretation of financial ratios.

5. What are different Financial Ratios for evaluating performance ?

(a) 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 obligations when they become due. This ability is reflected in the liquidity ratios of a firm. The liquidity ratios are particularly useful in credit analysis by banks and other suppliers of short- term loans.

(b) Long-term Solvency: Ratio analysis is equally useful for assessing the long- term financial viability of a firm. This aspect of the financial position of a borrower is of concern to the long term creditors, security analysts and the present and potential owners of a business.

(c) Operating Efficiency: Ratio analysis throws light on the degree of efficiency in the management and utilisation of its assets. The various activity ratios measure this kind of operational efficiency. In fact, the solvency of a firm is, in the ultimate analysis, dependent upon the sales revenues generated by the use of its assets – total as well as its components.

(d) Overall Profitability: Unlike the outside parties which are interested in one aspect of the financial position of a firm, the management is constantly concerned about the overall profitability of the enterprise. That is, they are concerned about the ability of the firm to meet its short-term as well as long-term obligations to its creditors, to ensure a reasonable return to its owners and secure optimum utilisation of the assets of the firm. This is possible if an integrated view is taken and all the ratios are considered together.

(e) Inter-firm Comparison: Ratio analysis not only throws light on the financial position of a firm but also serves as a stepping stone to remedial measures. This is made possible due to inter-firm comparison/comparison with industry averages.

(f) Financial Ratios for Budgeting: In this field ratios are able to provide a great deal of assistance. Budget is only an estimate of future activity based on past experience, in the making of which the relationship between different spheres of activities are invaluable.

6. Different users of Ratio Analysis and their objectives.

	Users	Objectives	Ratios Used
1.	Shareholders	Being owners of the organisation they are interested to know about profitability and growth of the organization	Mainly Profitability Ratios [In particular Earning per share (EPS), Dividend per share (DPS), Price Earnings (P/E), Dividend Payout ratio (DP)]
2.	Investors	They are interested to know overall financial health of the organisation particularly future perspective of the organisations.	• Profitability Ratios • Capital structure Ratios • Solvency Ratios • Turnover Ratios
3.	Lenders	They will keep an eye on the safety perspective of their money lent to the organisation	• Coverage Ratios • Solvency Ratios • Turnover Ratios • Profitability Ratio
4.	Creditors	They are interested to know liability position of the organisation particularly in short term. Creditors would like to know whether the organisation will be able to pay the amount on due date.	• Liquidity Ratios • Short term solvency Ratios/ Liquidity Ratios
5.	Employees	They will be interested to know the overall financial wealth of the organization and compare it with competitor company.	• Liquidity Ratios • Long terms solvency Ratios • Profitability Ratios • Return on investment
6.	Government	They will analyse the financial statements to determine taxations and other details payable to the government.	• Profitability Ratios
7.	Production Manager	They are interested to know about data regarding input output, production quantities etc.	• Input output Ratio • Raw material consumption ratio.
8.	Sales Manager	Data related to units sold for various years, other associated figures and predicted future sales figure will be an area of interest for them	• Turnover ratios (basically receivable turnover ratio) • Expenses Ratios

9.	Finance Manager	They are interested to know various ratios for their future predictions of financial requirement.	• Profitability Ratios (particularly related to Return on investment) • Turnover ratios • Capital Structure Ratios
10.	CEO/ General Manager	They will try to assess the complete perspective of the company, starting from Sales, Finance, Inventory, Human resources, Production etc.	• All Ratios
11.	Telecom	Finance Manager/ Analyst will calculate ratios of their company and compare it with Industry norms.	• Ratio related to 'call' • Revenue and expenses per customer
12.	Bank	Finance Manager/ Analyst will calculate ratios of their company and compare it with Industry norms.	• Loan to deposit Ratios • Operating expenses and income ratios
13.	Hotel	Finance Manager/ Analyst will calculate ratios of their company and compare it with Industry norms.	• Room occupancy ratio • Bed occupancy Ratios
14.	Transport	Finance Manager/ Analyst will calculate ratios of their company and compare it with Industry norms.	• Passenger-kilometre • Operating cost-per passenger kilometre

4 CHAPTER COST OF CAPITAL

Q.N	QUESTIONS	
1.	**Cost of Capital refers to**	
	(a) Floatation Costs	(b) Dividend
	(c) Minimum Required Rate of Return	(d) Opportunity cost
2.	**While issuing new equity shares, the cost of issue is known as**	
	(a) WACC	(b) Cost of Equity
	(c) Cost of Debt	(d) Floatation Cost
3.	**An organization can affect its WACC through changing**	
	(a) Capital Structure	(b) Dividend Policy
	(c) Investment Policy	(d) All of these
4.	**Interest on government bonds is also known as**	
	(a) Beta of the security	(b) Market Rate of Return
	(c) Market Price of the Security	(d) Risk Free Rate of Return
5.	**Cost of capital is lowest in case of debt because of**	
	(a) Tax Deductibility	(b) Lower Stated rate
	(c) Time Value of Money	(d) All of the above
6.	**In order to find cost of equity under CAPM, which of these is not required**	
	(a) Risk free rate	(b) Beta
	(c) Market Price of the Security	(d) Market Rate of Return
7.	**Cost of capital is that minimum __which a firm must and is expected to earn on its_ so as to maintain the market value of its shares**	
	(a) investments, rate of return	(b) rate of return, investments
	(c) expenditure, rate of return	(d) rate of return, expenditure
8.	**Increase in which of the following would not increase cost of equity calculated on CAPM model?**	
	(a) Market Risk premium	(b) Expected market rate of interest
	(c) Beta	(d) Effective tax rate
9.	**A company recently issued 9% preferred shares. The preferred shares sold for Rs. 40 a share with a par of Rs. 20. The cost of issuing the stock was Rs. 5 a share. What is the company's cost of preferred share**	
	(a) 9%	(b) 4.5%
	(c) 5.1%	(d) 10.3%

10.	**Capital Structure weights can be based on**	
	(a) Market Values of Debt & Equity	(b) Market Value of Equity & Face value of Debt
	(c) Initial Issue Price of Debt & Equity	(d) Book Value of Assets
11.	**Equity financing may be considered better than debt financing because of the fact that**	
	(a) Issuance cost of equity is lesser than that of debt (b) It is more attractive for investors because of potential for higher returns (c) Dividend is tax deductible (d) It is less expensive than debt	
12.	**A company's equity share is currently selling for 50 per share. Current year's dividend was Rs. 2 per share and the earnings of the company is expected to increase by 5%. What is the firm's cost of existing equity**	
	(a) 9.2%	(b) 4.2%
	(c) 14%	(d) 9%
13.	**Which of the following has an implicit cost of capital**	
	(a) Equity Shares	(b) Preference Shares
	(c) Retained Earnings	(d) Debentures
14.	**Cost of capital is highest in case of**	
	(a) Debt (b) Equity (c) Loans (d) Bonds	
15.	**A company is considering a project with an initial cost of Rs.1 million. The project is expected to generate cash flows of Rs.500,000 per year for 5 years. The company's cost of capital is 12%. What is the project's net present value?**	
	(a) 7,99,610.00 (b) 10,24,323.00 (c) 10,93,515.00 (d) 11,68,916.00	
16.	**Which of the following statement is false**	
	(a) Retained earnings do not involve any cost (b) Weightage average cost of capital is sum total of cost of debt and equity (c) Cost of equity is impacted by tax effects (d) All of the above	
17.	**A company's debt equity ratio is 3:5. Pretax cost of debt and equity are 7% and 10% respectively. What is the weighted average cost of capital if the tax rate is 30%?**	
	(a) 12.21%	(b) 17%
	(c) 14.9%	(d) 8.09%
18.	**With retention ratio of 60% and return on equity of 15.5%, the growth rate shall be**	

(a) 14. 90%	(b) 9.30%
(c) 25.84%	(d) 16.10%

19. **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

1.	(c)	**2.**	(d)	**3.**	(d)	**4.**	(d)	**5.**	(a)
6.	(c)	**7.**	(b)	**8.**	(d)	**9.**	(c)	**10.**	(a)
11.	(b)	**12.**	(a)	**13.**	(c)	**14.**	(b)	**15.**	(a)
16.	(d)	**17.**	(d)	**18.**	(b)	**19.**	(d)		

Q.N	THEORY QUESTIONS
1.	**What is Cost of Capital**
	Cost of capital is the return expected by the providers of capital (i.e. shareholders, lenders and the debt-holders) to the business as a compensation for their contribution to the total capital. When an entity (corporate or others) procured finances from either source as listed above, it has to pay some additional amount of money besides the principal amount. The additional money paid to these financiers may be either one off payment or regular payment at specified intervals. This additional money paid is said to be the cost of using the capital and it is called the cost of capital. This cost of capital expressed in rate is used to discount/ compound the cash flow or stream of cash flows. Cost of capital is also known as 'cut-off' rate, 'hurdle rate', 'minimum rate of return' etc. It is used as a benchmark for: • Framing debt policy of a firm. • Taking Capital budgeting decisions.
2.	**Significance of Cost of Capital**
	(i) Evaluation of investment options: The estimated benefits (future cash flows) from available investment opportunities (business or project) are converted into the present value of benefits by discounting them with the relevant cost of capital. **(ii) Financing Decision:** When a finance manager has to choose one of the two sources of finance, he can simply compare their cost and choose the source which has lower cost. Besides cost, he also considers financial risk and control. **(iii) Designing of optimum credit policy:** While appraising the credit period to be allowed to the customers, the cost of allowing credit period is compared against the benefit/ profit earned by providing credit to customer of segment of customers.
3.	**Features of Bonds or Debentures**
	(i) Face Value: Debentures or bonds are denominated with some value, this denominated value is called face value of the debenture. Interest is calculated on the face value of the debenture. **(ii) Interest (Coupon) Rate:** Each debenture bears a fixed interest (coupon) rate (except Zero coupon bond and Deep discount bond). Interest (coupon) rate is applied to face value of debenture to calculate interest, which is payable to the holders of debentures periodically (annually, semi-annually, etc.). **(iii) Maturity period:** Debentures or Bonds has a fixed maturity period for redemption. However, in case of irredeemable debentures maturity period is not defined and it is taken as infinite. **(iv) Redemption Value:** Redeemable debentures or bonds are redeemed on its specified maturity date. Based on the debt covenants, the redemption value is determined. Redemption value may vary from the face value of the debenture. **(v) Benefit of tax shield:** The payment of interest to the debenture holders are allowed as expenses for the purpose of corporate tax determination. Hence, interest paid to the debenture holders save the tax liability of the company.

4.	**A security is exposed to two risks, what are they?**
	The risk to which a security is exposed, can be classified into two groups: **(i) Unsystematic Risk:** This is also called company specific risk as the risk is related with the company's performance. This type of risk can be reduced or eliminated by diversification of the securities portfolio. This is also known as diversifiable risk. **(ii) Systematic Risk:** It is the macro-economic or market specific risk under which a company operates. This type of risk cannot be eliminated by the diversification hence, it is non-diversifiable. The examples are inflation, Government policy, interest rate etc. As diversifiable risk can be eliminated by an investor through diversification, the non-diversifiable risk is the risk which cannot be eliminated; therefore, a business should be concerned as per CAPM method, solely with non-diversifiable risk.
5.	**Explain CAPM Method & its drawback**
	• The idea behind CAPM is that the investors need to be compensated in two ways- (i) Time value of money and (ii) Risk. • The time value of money is represented by the risk-free rate in the formula and compensates the investors for placing money in any investment over a period of time. • The other half of the formula represents risk and calculates the amount of compensation the investor needs for taking on additional risk. This is calculated by taking a risk measure (beta) which compares the returns of the asset to the market over a period of time and compares it with the market premium. The CAPM says that the expected return of a security or a portfolio equals the rate on a risk-free security plus risk premium. If this expected return does not meet or beat the required return, then the investment should not be undertaken. The shortcomings of this approach are: (a) Estimation of beta with historical data is unrealistic; and (b) Market imperfections may lead investors to unsystematic risk. Despite these shortcomings, the CAPM is useful in calculating cost of equity, even when the firm is suffering losses.
6.	**DISCUSS the meaning of weighted average cost of capital. ILLUSTRATE with an example.**
	WACC is also known as the overall cost of capital which includes the cost of different sources of capital as explained above. WACC of a company depends on the capital structure of a company. It weighs the cost of capital of a particular source of capital with its proportion to the total capital. Thus, weighted average cost of capital is the weighted average after-tax costs of the individual components of firm's capital structure. That is, the after-tax cost of each debt and equity is calculated separately and added together to a single overall cost of capital To show the example, just make any example and show how to calculate WACC.

7.	**DISCUSS the dividend price approach, and earnings price approach to estimate cost of equity capital.**

This is also known as Dividend Valuation Model. This model makes an assumption that the dividend per share is expected to remain constant forever. Here, cost of equity capital is computed by dividing the expected dividend by market price per share as follows:

Cost of Equity = D / P0
Ke= Cost of equity
D = Expected dividend (also written as D1)
P0 = Market price of equity (ex- dividend)

The advocates of this approach co-relate the earnings of the company with the market price of its share. Accordingly, the cost of equity share capital would be based upon the expected rate of earnings of a company. The argument is that each investor expects a certain amount of earnings, whether distributed or not from the company in whose shares he invests. Thus, if an investor expects that the company in which he is going to subscribe for shares should have at least a 20% rate of earning, the cost of equity share capital can be construed on this basis.
Cost of Equity = EPS / MPS

8.	**What is the DIFFERENCE between Book Value and Market Value weights?**

Book Value (BV): Book value weight is operationally easy and convenient. While using BV, reserves such as share premium and retained profits are included in the BV of equity, in addition to the nominal value of share capital. Here, the value of equity will generally not reflect historic asset values, as well as the future prospects of an organisation.

Market Value (MV): Market value weight is more correct and represent a firm's capital structure. It is preferable to use MV weights for the equity . While using MV, reserves such as share premium and retained profits are ignored as they are in effect incorporated into the value of equity. It represents existing conditions and also take into consideration the impacts of changing market conditions and the current prices of various security. Similarly, in case of debt, MV is better to be used rather than the BV of the debt, though the difference may not be very significant.

There is no separate market value for retained earnings. Market value of equity shares represents both paid up equity capital and retained earnings. But cost of equity is not same as cost of retained earnings. Hence to give market value weights, market value of equity shares should be apportioned in the ratio of book value of paid up equity capital and book value of retained earnings.

9.	**DISCUSS Marginal Cost of Capital.**

The marginal cost of capital may be defined as the cost of raising an additional rupee of capital. Since the capital is raised in substantial amount in practice, marginal cost is referred to as the cost incurred in raising new funds. Marginal cost of capital is derived, when the average cost of capital is calculated using the marginal weights.

The marginal weights represent the proportion of funds the firm intends to employ. Thus, the problem of choosing between the book value weights and the market value weights does not arise in the case of marginal cost of capital computation.

To calculate the marginal cost of capital, the intended financing proportion should be applied as weights to marginal component costs. The marginal cost of capital should, therefore, be calculated in the composite sense. When a firm raises funds in proportional manner and the component's cost remains unchanged, there will be no difference between average cost of capital (of the total funds) and the marginal cost of capital. The component costs may remain constant upto certain level of funds raised and then start increasing with amount of funds raised.

10. EXPLAIN YTM approach of calculating Cost of Debt.

The cost of redeemable debt (Kd) is also calculated by discounting the relevant cash flows using Internal rate of return (IRR). Here, YTM is the annual return of an investment from the current date till maturity date. So, YTM is the internal rate of return at which current price of a debt equals to the present value of all cash-flows.

The relevant cash flows are as follows:

Year	**Cash flows**
0	**Net proceeds in case of new issue/ Current market price in case of existing debt (NP or P0)**
1 to n	**Interest net of tax[I(1-t)]**
n	**Redemption value (RV)**

Steps to calculate relevant cash flows:
Step-1: Identify the cash flows.
Step-2: Calculate NPVs of cash flows as identified above using two discount rates (guessing).
Step-3: Calculate IRR.

5 CHAPTER

CAPITAL STRUCTURE

Q.N	QUESTIONS
1.	**Assertion(A):- Risk principle of capital structure is one that minimize cost of capital structure.** **Reason(R):- According to this principle ,reliance is placed more on equity for financial purpose.**
	(a)Both A & R are true and R is correct explanation of A (b) Both A & R are true but R is not correct explanation of A (c) A is true but R is false (d) A is false, but R is true
2.	**Financial Structure refers to**
	(a) All financial resources (b) Short-term funds (c) Long-term funds (d) None of these
3.	**To have optimal capital structure the firm must have fulfill the following condition –**
	(a) Return on investment should be greater than cost of investment. (b) There should be minimum financial risk. (c) Cost of investment should be greater than return of investment. (d) All the above.
4.	**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
5.	**The cost of monitoring management is considered to be a (an)**
	(a) Bankruptcy cost (b) Transaction cost (c) Agency cost (d) Institutional cost
6.	**Which of the following statements regarding Modigliani and Miller's propositions (assuming perfect capital markets and homogenous expectations) is most accurate?**
	(a) Firm value is maximized with a capital structure consisting of 100% equity. (b) The cost of equity increases as the firm increases its financial leverage

	(c) The use of debt financing increases the firm's weighted average cost of capital (d) None of the above
7.	**Which of the following is irrelevant for optimal capital structure**
	(a) Flexibility (b) Solvency (c) Liquidity (d) Control
8.	**Statement 1: If our corporate tax rate increases from 25% to 30%, our weighted average cost of capital is likely to decline.** **Statement 2: What is happening in the stock or bond markets is irrelevant to our decisions for how to raise capital. We should always seek to raise capital in the exact proportions called for by our optimal capital structure Which of the Statements 1 and 2, correct or incorrect?**
	(a) Correct, Correct (b) Incorrect, correct (c) Incorrect, Incorrect (d) Correct, Incorrect
9.	**Ram Verse Ltd is an all equity financed company. It is considering replacing Rs. 275 lakhs equity shares with 15% debentures of the same amount. Current Market value of the company is 1750 lakhs with cost of capital at 20%. Future EBITs are going to be constant and entire earnings are going to be distributed. Corporate Tax Rate can be assumed to be 30%. What will be the new market value of the firm?**
	(a) Rs.1832.5 lakhs (b) Rs.82.50 lakhs (c) Rs.1750 lakhs (d) Rs.1732.50 lakhs
10.	**The number of indifference points possible between 5 financial plans are**
	(a) 5 (b) 8 (c) 3 (d) 10
11.	**Mr. Dashan recently came back from a conference titled Capital Structure Theory and was extremely excited about what he learned concerning Modigliani and Miller's capital structure propositions. He has been trying to choose between three potential capital structures for his firm, Dashmart Corporation, and believes that Modigliani and Miller's work may guide him in the right direction. The capital structures Munn is considering are:** **CSI: 100% equity. CS II: 50% equity and 50% debt. CS III: 100% debt.** **If he uses Modigliani and Miller's propositions and includes all of their assumptions including the assumption of no taxes, which capital structure is he most likely to choose?** **Which capital struture would be choosen in case of tax regime?**
	(a) CS I and CS II (b) CS I and CS III (c) CS II and CS III (d) Any CS and CS III

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 ko remains constant regardless of changes in leverage (d) That interest expense and taxes are included in the calculation
13.	**Consider the below mentioned statements:-** **(i) A company is considered to be over-capitalised when its actual capitalisation is lower than the proper capitalisation as warranted by the earning capacity.** **(ii) 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
14.	**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
15.	**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
16.	**If the debt component in the capital structure is predominant**
	(a) The fixed interest cost of the firm will be minimum thereby decreasing its risk. (b) Earning per share (EPS)will be very low. (c) Dividend expectation of the equity shareholders are also & PE ratio may decrease. (d) The fixed interest cost of the firm increases thereby increasing its risk.
17.	**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
18.	**Which one of the following approaches of the capital structure pleads that debt financing initially increases the value of the firm;however excess debt financing beyond a particular point reduces the value of the firm?**

(a) Net income approach
(b) Net operating income approach
(c) Traditional approach
(d) M&M Approach

19. 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

1.	(d)	**2.**	(a)	**3.**	(d)	**4.**	(d)	**5.**	(c)
6.	(b)	**7.**	(b)	**8.**	(d)	**9.**	(a)	**10.**	(d)
11.	(a)	**12.**	(d)	**13.**	(d)	**14.**	(a)	**15.**	(c)
16.	(d)	**17.**	(a)	**18.**	(c)	**19.**	(a)		

Q.N	THEORY QUESTIONS
1.	**What is Capital structure?**
	Capital structure is the combination of capitals from different sources of finance. The capital of a company consists of equity share holders' fund, preference share capital and long term external debts. The source and quantum of capital is decided keeping in mind the following factors: **i. Control:** Capital structure should be designed in such a manner that existing shareholders continue to hold majority stake. **ii. Risk:** Capital structure should be designed in such a manner that financial risk of a company does not increase beyond tolerable limit. **iii. Cost:** Overall cost of capital remains minimum.
2.	**Financial Structure refers to**
	The following approaches explain the relationship between cost of capital, capital structure and value of the firm: (a) Net Income (NI) approach (b) Traditional approach. (c) Net Operating Income (NOI) approach (d) Modigliani-Miller (MM) approach
3.	**What assumptions are made to understand this relationship between Cost of Capital, Capital Structure & Value of Firm**
	Following assumptions are made to understand this relationship: • There are only two kinds of funds used by a firm i.e. debt and equity. • The total assets of the firm are given. The degree of leverage can be changed by selling debt to purchase shares or selling shares to retire debt. • Taxes are not considered. • The dividend payout ratio is 100%. • The firm's total financing remains constant. • Business risk is constant over time. • The firm has perpetual life.
4.	**Explain net Income Approach**
	According to this approach, capital structure decision is relevant to the value of the firm. An increase in financial leverage will lead to decline in the weighted average cost of capital (WACC), while the value of the firm as well as market price of ordinary share will increase. Conversely, a decrease in the leverage will cause an increase in the overall cost of capital and a consequent decline in the value as well as market price of equity shares. Where, Ke is Cost of Equity, Kw is Weighted Average Cost of Capital and Kd is Cost of Debt. As debt increases, it causes weighted average cost of capital (WACC) to decrease. The value of the firm on the basis of Net Income (NI) Approach can be ascertained as follows:

V= S + D

Where,
V = Value of the firm
S = Market value of equity
D = Market value of debt

Market Value of Equity = NI / Ke

Where,
NI = Earnings available for equity shareholders
Ke = Equity Capitalisation rate

Under NI approach, the value of the firm will be maximum at a point where weighted average cost of capital (WACC) is minimum. Thus, the theory suggests total or maximum possible debt financing for minimising the cost of capital. The overall cost of capital under this approach is:

Overall Cost of Capital = EBIT / Value of firm

5. Explain Traditional Approach

This approach favours that as a result of financial leverage up to some point, cost of capital comes down and value of firm increases. However, beyond that point, reverse trends emerges. The principle implication of this approach is that the cost of capital is dependent on the capital structure and there is an optimal capital structure which minimises cost of capital.
Under this approach:
i. The rate of interest on debt remains constant for a certain period and thereafter with an increase in leverage, it increases.

ii. The expected rate by equity shareholders remains constant or increase gradually. After that, the equity shareholders starts perceiving a financial risk and then from the optimal point, the expected rate increases speedily.

iii. As a result of the activity of rate of interest and expected rate of return, the WACC first decreases and then increases. The lowest point on the curve is optimal capital structure.

Optimum capital structure occurs at the point where value of the firm is highest and the cost of capital is the lowest. According to net operating income approach, capital structure decisions are totally irrelevant. Modigliani-Miller supports the net operating income approach but provides behavioural justification. The traditional approach strikes a balance between these extremes.

Main Highlight of Traditional Approach
The firm should strive to reach the optimal capital structure and its total valuation through a judicious use of both the debt and equity in capital structure. At the optimal capital structure, the overall cost of capital will be minimum and the value of the firm will be maximum.

6. Explain NOI Approach

NOI means Earnings before interest and tax (EBIT). According to this approach, capital structure decisions of the firm are irrelevant.
Any change in the leverage will not lead to any change in the total value of the firm and the market price of shares, as the overall cost of capital is independent of the degree of leverage. As a result, the division between debt and equity is irrelevant.

As per this approach, an increase in the use of debt which is apparently cheaper is offset by an increase in the equity capitalisation rate. This happens because equity investors seek higher compensation as they are opposed to greater risk due to the existence of fixed return securities in the capital structure.

7. Explain MM without tax approach

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

The **shortcoming** of this approach is that the suggested arbitrage process will fail to work because of imperfections in capital market, existence of transaction cost and presence of corporate income taxes.

8. Explain Tradeoff 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. Trade-off 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 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 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.

9. What is 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.

Myers 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.

10. What are the factors that affect Capital Structure?

While choosing a suitable financing pattern, certain fundamental principles should be kept in mind, to design capital structure, which are discussed below:

(1) Financial leverage or Trading on Equity: The use of long-term fixed interest bearing debt and preference share capital along with equity share capital is called financial leverage or trading on equity. The use of long-term debt increases the earnings per share if the firm yields a return higher than the cost of debt.

(2) Growth and stability of sales: The capital structure of a firm is highly influenced by the growth and stability of its sales. If the sales of a firm are expected to remain fairly stable, it can raise a higher level of debt. Stability of sales ensures that the firm will not face any difficulty in meeting its fixed commitments of interest repayments of debt.

(3) Cost Principle: According to this principle, an ideal pattern or capital structure is one that minimizes cost of capital structure and maximizes earnings per share (EPS). For e.g. 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.

(4) 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 unfavorable business situation. With increase in amount of Debt, financial risk increase and vice versa.

(5) Control Principle: While designing a capital structure, the finance manager may also keep in mind that existing management control and ownership remains undisturbed. Issue of new equity will dilute existing control pattern and it also involves higher cost.

(6) Flexibility Principle: By flexibility, 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. While debt could be interchanged (If the company is loaded with a debt of 18% and funds are available at 15%, it can return old debt with new debt, at a lesser interest rate), but the same option may not be available in case of equity investment.

(7) Other Considerations: Besides above principles, other factors such as nature of industry, timing of issue and competition in the industry should also be considered. Industries facing severe competition also resort to more equity than debt.

11. What are different analysis to choose Optimum Capital Structure?

Objective of financial management is to maximize wealth. Therefore, one should choose a capital structure which maximizes wealth. For this purpose, following analysis should be done:

(1) EBIT-EPS-MPS analysis: Chose a capital structure which maximizes market price per share. For that, start with same EBIT for all capital structures and calculate EPS. Thereafter, either multiply EPS by price earning ratio or divide it by cost of equity to arrive at MPS.

(2) Indifference Point analysis: In above analysis, we have considered value at a given EBIT only. What will happen if EBIT changes? Will it change your decision also? To answer this question, you can do indifference point analysis.

(3) Financial Break-Even Point (BEP) analysis: With change in capital structure, financial risk also changes. Though this risk has already been considered in PE ratio or in cost of equity in point one above, but one may calculate and consider it separately also by calculating Financial BEP.

12. Explain EBIT -EBT-MPS Analysis.

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

Given a level of EBIT, EPS will be different under different financing mix depending upon the extent of debt financing. The effect of leverage on the EPS emerges because of the existence of fixed financial charge i.e., interest on debt, financial fixed dividend on preference share capital. The effect of fixed financial charge on the EPS depends upon the relationship between the rate of return on assets and the rate of fixed charge. If the rate of return on assets is higher than the cost of financing, then the increasing use of fixed charge financing (i.e., debt and preference share capital) will result in increase in the EPS. **This situation is also known as favourable financial leverage or Trading on Equity.**

On the other hand, if the rate of return on assets is less than the cost of financing, then the effect may be negative and, therefore, the increasing use of debt and preference share capital may reduce the EPS of the firm.

The fixed financial charge financing may further be analysed with reference to the choice between the debt financing and the issue of preference shares. Theoretically, the choice is tilted in favour of debt financing for two reasons: (i) the explicit cost of debt financing i.e., the rate of interest payable on debt instruments or loans is generally lower than the rate of fixed dividend payable on preference shares, and (ii) interest on debt financing is tax-deductible and therefore the real cost (after-tax) is lower than the cost of preference share capital.

Thus, the analysis of the different types of capital structure and the effect of leverage on the expected EPS and eventually MPS will provide a useful guide to selection of a particular level of debt financing. The EBIT-EPS analysis is of significant importance and if undertaken properly, can be an effective tool in the hands of a financial manager to get an insight into the planning and designing of the capital structure of the firm.

13. Explain Financial BEP & Indifference Point Analysis

Financial break-even point is the minimum level of EBIT needed to satisfy all the fixed financial charges i.e. interests and preference dividends. It denotes the level of EBIT for which the company's EPS equals zero.

If the EBIT is less than the financial break-even point, then the EPS will be negative but if the expected level of EBIT is more than the break-even point, then more fixed costs financing instruments can be taken in the capital structure, otherwise, equity would be preferred.

EBIT-EPS break-even analysis is used for determining the appropriate amount of debt a company might carry.

Another method of considering the impact of various financing alternatives on earnings per share is to prepare the EBIT chart or the range of Earnings chart. This chart shows the likely EPS at various probable EBIT levels. Thus, under one particular alternative, EPS may be ` 2 at a given EBIT level. However, the EPS may go down if another alternative of financing is chosen even though the EBIT remains at the same level. At a given EBIT, earnings per share under various alternatives of financing may be plotted. A straight line representing the EPS at various levels of EBIT under the alternative may be drawn. Wherever this line intersects, it is known as break-even point. This point is a useful guide in formulating the capital structure. This is known as EPS equivalency point or indifference point since this shows that, between the two given alternatives of financing (i.e., regardless of leverage in the financial plans), EPS would be the same at the given level of EBIT.

Indifference Point can be calculated by

$$\frac{(EBIT-I_1)(1-t)}{E} = \frac{(EBIT-I_2)(1-t)}{E}$$

Where,
EBIT = Indifference point
E1 = Number of equity shares in Alternative 1
E2 = Number of equity shares in Alternative 2

I1 = Interest charges in Alternative 1
I2 = Interest charges in Alternative 2
t = Tax-rate

14. An EBIT-EPS indifference analysis chart is used for

If amount of equity share capital is same under two financial plans, then one of the following two situations will arise:

1. No indifference point: If after tax cost of the source other than equity shares is not same under both plans then there will be no indifference point between the two. Because one plan will be better than other at all levels of EBIT. For example, if two plans have equity shares of ` 1,00,000 each. Plan 1 has 10% debentures of ` 50,000 while plan 2 has 8% Term loan of ` 50,000. Then plan 2 will be better than plan 1 at any level of EBIT and there will be no indifference point.

2. Many indifference points: If after tax cost of the source other than equity shares is same under both plans then each EBIT will be an indifference point.

15. What is over-capitalisation?

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

Consequences of Under-Capitalisation: Under-capitalisation results in the following consequences:
(i) The dividend rate will be higher in comparison to similarly situated companies.
(ii) Market value of shares will be higher than value of shares of other similar companies because their earning rate being considerably more than the prevailing rate on such securities.
(iii) Real value of shares will be higher than their book value.

Effects of Under-Capitalisation: Under-capitalisation has the following effects:
(i) It encourages acute competition. High profitability encourages new entrepreneurs to come into same type of business.
(ii) High rate of dividend encourages the workers' union to demand high wages.
(iii) Normally common people (consumers) start feeling that they are being exploited.
(iv) Management may resort to manipulation of share values.
(v) Invite more government control and regulation on the company and higher taxation also.

Remedies for Under-Capitalisation: Following steps may be adopted to avoid the negative consequences of under-capitalization:
(i) The shares of the company should be split up. This will reduce dividend per share, though EPS shall remain unchanged.
(ii) Issue of Bonus Shares is the most appropriate measure as this will reduce both dividend per share and the average rate of earning.
(iii) By revising upward the par value of shares in exchange of the existing shares held by them.

16. What is over-capitalisation?

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

Causes of Over-Capitalisation: Over-capitalisation arises due to following reasons:
(i) Raising more money through issue of shares or debentures than company can employ profitably.
(ii) Borrowing huge amount at higher rate than rate at which company can earn.
(iii) Excessive payment for the acquisition of fictitious assets such as goodwill etc.
(iv) Improper provision for depreciation, replacement of assets and distribution of dividends at a higher rate.
(v) Wrong estimation of earnings and capitalisation.

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

Remedies for Over-Capitalisation: Following steps may be adopted to avoid the negative consequences of over-capitalisation:
(i) Company should go for thorough reorganization.
(ii) Buyback of shares.
(iii) Reduction in claims of debenture-holders and creditors.
(iv) Value of shares may also be reduced. This will result in sufficient funds for the company to carry out replacement of assets.

6 CHAPTER LEVERAGE

Q.N	QUESTIONS
1.	**From the following information, calculate combined leverage:** **Sales ₹20,00,000** **Variable Cost 40%** **Fixed Cost ₹10,00,000** **Borrowings ₹10,00,000 @ 8%**
	(a) 10 times (b) 6 times (c) 1.667 times (d) 0.10 times
2.	**Output (units)= 3,00,000 Fixed cost =₹3,50,000 Unit variable cost= ₹1.00 Interest expenses= ₹25,000 Unit selling price = ₹3.00 Applicable tax rate is 35% Calculate Financial Leverage.**
	(a) 1.11 (b) 2.40 (c) 2.67 (d) 1.07
3.	**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%
4.	**Which of the following is correct**
	(a) CL= OL + FL (b) CL= OL - FL (c) CL = OL x FL (d) OL = OL / FL
5.	**Degree of combined leverage is the fraction of**
	(a) Degree of combined leverage is the fraction of (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
6.	**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
7.	**Operating leverage is 7 and financial leverage is 2.2858. How much change in sales will be required to bring 70% change in EBIT?**
	(a) 10% (b) 70% (c) 11.429% (d) 30%
8.	**If EBIT is ₹15,00,000, interest is ₹2,50,000, corporate tax is 40%, DFL is;**

	(a) 1.11	(b) 1.20
	(c) 1.31	(d) 1.41
9.	**Which of the following indicates business risk**	
	(a) Operating leverage	
	(b) Financial leverage	
	(c) Combined leverage	
	(d) Total leverage	
10.	**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%
11.	**There is no operating leverage if there is no .....**	
	(a) Profit	(b) Sales
	(c) Fixed cost	(d) EPS
12.	**A firm has a DOL of 4.5 at Q units. What does this tell us about the firm?**	
	(a) If sales rise by 4.5%, then EBIT will rise by 1%	
	(b) If EBIT rises by 4.5%, then EPS will rise by 1%.	
	(c) If EBIT rises by 1 %, then EPS will rise by 4.5%.	
	(d) If sales rise by 1 %, then EBIT will rise by 4.5%	
13.	**A firm with high operating leverage is characterized by..... while one with high financial leverage is characterized by .....State True or False:**	
	(a) Low fixed cost of production; low fixed financial costs	
	(b) High variable cost of production; high variable financial costs	
	(c) High fixed costs of production; high fixed financial costs	
	(d) Low costs of production; high fixed financial costs	
14.	**Financial Leverage is calculated as**	
	(a) EBIT / Contribution	(b) EBIT + PBT
	(c) EBIT / Sales	(d) EBIT / Variables Cost
15.	**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
16.	**Total assets of Alpha Company are ₹3,00,000. The company's total assets turnover ratio is 3, its fixed operating cost is ₹1,50,000 and its variable operating cost ratio is 50%. The income-tax rate is 50%. It also has long term debts of ₹1,20,000 on which interest@ 10% is payable. Operating, Financial & Combined Leverages of the company are -**	
	(a) 1.5; 1.042; 1.563 respectively	(b) 1.05; 1.42; 1.05625 respectively
	(c) 1.50; 1.42; 2.13 respectively	(d) 1.55; 1.042; 1.6151 respectively
17.	**The cash required during a specific period to meet interest expenses and principal payments is referred to as the:**	

	(a) Debt capacity	(b) Debt-service burden
	(c) Adequacy capacity	(d) Fixed-charge burden
18.	**A firm has sales of ₹75,00,000, variable cost of ₹42,00,000 and fixed cost of ₹6,00,000. It has a debt of ₹45,00,000 at 9% and equity of ₹55,00,000. Does it have favourable financial leverage?**	
	(a) ROI is less than interest on loan funds and hence it has no favourable financial leverage."	
	(b) ROI is equal to interest on loan funds and hence it has favourable financial leverage.	
	(c) ROI is greater than interest on loan funds and hence it has favourable financial leverage.	
	(d) ROI is greater than interest on loan funds and hence it has unfavourable financial leverage.	
19.	**Operating Leverage is calculated as**	
	(a) Contribution + EBIT	(b) EBIT/ PBT
	(c) EBIT / Interest	(d) EBIT / Tax
20.	There is no operating leverage if there is no	
	(a) Profit	(b) Sales
	(c) Fixed cost	(d) EPS

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

Q.N	THEORY QUESTIONS
1.	**Explain Difference between Business & Financial Risk.**
	Business Risk: It refers to the risk associated with the firm's operations. It is the uncertainty about the future operating income (EBIT) i.e., how well can the operating income be predicted? **Financial Risk:** It refers to the additional risk placed on the firm's shareholders because of use of debt i.e., the additional risk, a shareholder bears when a company uses debt in addition to equity financing. Companies that issue more debt instruments would have higher financial risk than companies financed mostly or entirely by equity.
2.	**What is Leverage & Different types of Leverage?**
	The term leverage represents influence or power. In financial analysis, leverage represents the influence of one financial variable over some other related financial variable. These financial variables may be costs, output, sales revenue, Earnings Before Interest and Tax (EBIT), Earning Per Share (EPS) etc. Generally, if we want to calculate the impact of change in variable X on variable Y, it is termed as Leverage of Y with X, and it is calculated as follows: $\frac{\text{Change in Y divided by Y}}{\text{Change in X divided by X}}$ There are three commonly used measures of leverage in financial analysis. These are: **(i) Operating Leverage:** It is the relationship between Sales and EBIT and indicates business risk. **(ii) Financial Leverage:** It is the relationship between EBIT and EPS and indicates financial risk. **(iii) Combined Leverage:** It is the relationship between Sales and EPS and indicates total risk i.e., both business risk and financial risk.
3.	**What is Trading on Equity?**
	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 an 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".
4.	**Financial Leverage is Double Edged Sword, Explain,**
	When the cost of 'fixed cost fund' is less than the return on investment, financial leverage will help to increase return on equity and EPS. The firm will also benefit from the saving of tax on interest on debts etc. However, when cost of debt will be more than the return it will affect return of equity and EPS

unfavourably and as a result firm can be under financial distress. Therefore, financial leverage is also known as "double edged sword".

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

*Financial BEP is the level of EBIT at which earning per share is zero. If a company has not issued preference shares, then Financial BEP is simply equal to amount of Interest.
When EBIT is much higher than Financial BEP, DFL will be slightly more than one. With decrease in EBIT, DFL will increase. At Financial BEP, DFL will be infinite. When EBIT is slightly less than Financial BEP, DFL will be negative infinite. With further reduction in EBIT, DFL will move towards zero. At zero EBIT, DFL will also be zero.

5. "Operating risk is associated with cost structure, whereas financial risk is associated with capital structure of a business concern." Critically EXAMINE this statement.

Business Risk: It refers to the risk associated with the firm's operations. It is the uncertainty about the future operating income (EBIT) i.e., how well can the operating income be predicted?

Financial Risk: It refers to the additional risk placed on the firm's shareholders because of use of debt i.e., the additional risk, a shareholder bears when a company uses debt in addition to equity financing. Companies that issue more debt instruments would have higher financial risk than companies financed mostly or entirely by equity.

7 CHAPTER CAPITAL BUDGETING

Q.N	QUESTIONS
1.	**A project's net present value, ignoring income tax considerations, is normally affected by the**
	(a) Proceeds from the sale of the asset to be replaced (b) Carrying amount of the asset to be replaced by the project (c) Amount of annual depreciation on the asset to be replaced (d) Amount of annual depreciation on fixed assets used directly on the project
2.	**Which of these methods of capital budgeting are based on cash flows**
	(a) Payback Method (b) NPV (c) Profitability Index (d) All of the above
3.	**Capital Budgeting is important for the below reasons except**
	(a) They are irreversible (b) They involve substantial investment (c) They are for short period of time (d) They are complex & futuristic
4.	**With initial investment of" 100,000 and yearly cash inflows of" 27,000 for 5 years, the NPV of the project with cost of capital of 10% shall be approximately**
	(a) 35,000 (b) -2,357 (c) 2,357 (d) -35,000
5.	**With IRR criteria and no limitation on funds, one can accept projects which have**
	(a) IRR more than cost of capital (b) IRR less than cost of capital (c) IRR being equal to borrowing rate (d) All of the above
6.	**Using capital budgeting techniques, A project is accepted when**
	(a) Net Present Value is positive (b) Profitability Index is more than 1 (c) Its IRR is greater than Cost of Capital (d) Any of the above
7.	**Which of the following is not followed in discounting techniques of capital budgeting**
	(a) Cash Flow Principal (b) Accrual Principal (c) Interest Exclusion (d) Post Tax Principal
8.	**The Reinvestment assumption under NPV method assumes that the cash flows are reinvested at the**
	(a) Marginal Cost of Capital (b) Internal Rate of Return (c) Discount rate used to calculate NPV (d) Bank Borrowing rate
9.	**Which of the following events would decrease the internal rate of return of a proposed asset purchase?**
	(a) Decrease related working capital requirements (b) Shorten the payback period

(c) Decrease tax credits on the asset
(d) Use accelerated, instead of straight-line depreciation

10. With limited capital & number of available projects, one should select the project with

(a) IRR less than Cost of Capital
(b) Profitability Index less than 1
(c) Lowest Internal Rate of Return
(d) Highest Net Present Value

11. Which of these methods of capital budgeting are based on cash flows

(a) Payback Method
(b) NPV
(c) Profitability Index
(d) All of the above

12. Discounted payback period for a project shall be____ the payback period of the same project.

(a) Equal to
(b) More Than
(c) Less Than
(d) Half

13. The best methods to evaluate the projects with unequal lives can be

(a) ARR or Payback Period
(b) Replacement Chain or Equivalent Annualized Criteria
(c) NPV or Discounted Payback
(d) None of these

14. In considering the payback period for three projects, Sun Corp. gathered the following data about cash flows:

	Year 1	Year 2	Year 3	Year4	Year 5
Project X	{20,000}	6,000	6,000	6,000	6,000
Project Y	{50,000)	30,000	30,000	10,000	5,000
Project Z	{20,000}	10,000	10,000	5,000	

(a) Projects X, Y and Z.
(b) Projects Y and Z.
(c) Project Y only.
(d) Projects X and Z

15. Which of the following statement is not true for capital budgeting

(a) Irreversible decisions
(b) Sunk Cost is Relevant cost
(c) Affect future stability of firm
(d) Can relate to Business Expansion

16. Which of the following is one of the steps in capital budgeting process

(a) Controlling Selling Expenses
(b) Determination of Price
(c) Deciding the capital structure
(d) Estimation of Project cash flows

17. Bhaskar Ltd. estimated that a proposed project's 8-year net cash benefit will be ₹4,000 peryear for years 1 to 8, with an additional terminal benefit of ₹8,000 at the end of the eighth year. Assuming that these cash inflows satisfy exactly the required rate of return of 8 percent, the project's initial cash outflow is closest to which of the following four possible answers?

(a) ₹27,308
(b) ₹25,149
(c) ₹14,851
(d) ₹40,000

18. Which of the following is not a capital budgeting decision

	(a) Inventory Control	(b) Business Expansion
	(c) Acquisition of Long Term Asset	(d) Replacement of Existing Asset
19.	**Depreciation is taken into consideration in capital budgeting because**	
	(a) It reduces Tax liability	(b) It is unavoidable
	(c) It is a cash outflow	(d) t is a cash inflow

1.	(a)	**2.**	(d)	**3.**	(c)	**4.**	(c)	**5.**	(a)
6.	(d)	**7.**	(b)	**8.**	(c)	**9.**	(c)	**10.**	(d)
11.	(d)	**12.**	(b)	**13.**	(d)	**14.**	(b)	**15.**	(b)
16.	(d)	**17.**	(a)	**18.**	(a)	**19.**	(a)		

Q.N	THEORY QUESTIONS
1.	**Explain Capital Budgeting or Investing Decision.**
	Investment decision is concerned with optimum utilization of fund to maximize the wealth of the organization and in turn the wealth of its shareholders. Investment decision is very crucial for an organization to fulfil its objectives; in fact, it generates revenue and ensures long term existence of the organization. Even the entities which exist not for profit are also required to make investment decision though not to earn profit but to fulfil its mission. It requires a proper planning for capital, and it is done through a proper budgeting. A proper budgeting requires all the characteristics of budget. Due to this feature, investment decisions are very popularly known as Capital Budgeting, which means applying the principles of budgeting for capital investment. In simple terms, Capital Budgeting involves: **(i)** Identification of investment projects that are strategic to business' overall objectives; **(ii)** Estimating and evaluating post-tax incremental cash flows for each of the investment proposals; **(iii)** Selection of an investment proposal that maximizes the return to the investors.
2.	**Explain purpose of Capital Budgeting.**
	The capital budgeting decisions are important, crucial and critical business decisions due to the following reasons: **(i) Substantial Investment :** Investment decisions are related with fulfillment of long-term objectives and existence of an organization. To invest in a project(s), a substantial capital investment is required. Based on size of capital and timing of cash flows, sources of finance are selected. **(ii) Long time period:** The capital budgeting decision has its effect over a long period of time. These decisions not only affect the future benefits and costs of the firm but also influence the rate and direction of growth of the firm. **(iii) Irreversibility:** Most of the investment decisions are irreversible. Once the decision is implemented, it is very difficult and reasonably and economically not possible to reverse the decision. The reason may be upfront payment of amount, contractual obligations, technological impossibilities. **(iv) Complex decisions:** The capital investment decision involves an assessment of future events, which in fact is difficult to predict. Further, it is quite difficult to estimate in quantitative terms, all the benefits or the costs relating to a particular investment decision.
3.	**What is entire process of Capital Budgeting?**
	(i) Planning: The capital budgeting process begins with the identification of potential investment opportunities. The opportunity then enters the planning phase when the potential effect on the firm's fortunes is assessed and the ability of the management of the firm to exploit the opportunity is determined. **(ii) Evaluation:** This phase involves the determination of proposal and its investments, inflows and outflows. Investment appraisal techniques, ranging from the simple payback method and accounting rate of return to the more sophisticated discounted cash flow techniques, are used to appraise the

proposals. The technique selected should be the one that enables the manager to make the best decision in the light of prevailing circumstances.

(iii) Selection: Considering the returns and risks associated with the individual projects as well as the cost of capital to the organisation, the organisation will choose among the projects which maximises the shareholders' wealth.

(iv) Implementation: When the final selection is made, the firm must acquire the necessary funds, purchase the assets, and begin the implementation of the project.

(v) Control: The progress of the project is monitored with the aid of feedback reports. These reports will include capital expenditure progress reports, performance reports comparing actual performance against plans set and post completion audits.

(vi) Review: When a project terminates, or even before, the organisation should review the entire project to explain its success or failure. This phase may have implication for firm's planning and evaluation procedures.

4. What are various Capital Budgeting Decisions on basis of Firm's Existence?

The capital budgeting decisions are taken by both newly incorporated firms as well as by existing firms. The new firms may require decision making in respect of the selection of a plant to be installed. Whereas the existing firm may require taking decisions to meet the requirements of new environment or to face the challenges of competition. These decisions may be classified as follows:

(i) Replacement and Modernisation decisions: The replacement and modernisation decisions aims to improve operating efficiency and reduce cost. Generally, all types of plant and machinery require replacement either because the economic life of the plant or machinery is over or because it has become technologically outdated. The former decision is known as replacement decision and latter is known as modernisation decision. Both replacement and modernisation decisions are called as cost reduction decisions.

(ii) Expansion decisions: Existing successful firms may experience growth in demand of their product line. If such firms experience shortage or delay in the delivery of their products due to inadequate production facilities, they may consider proposal to add capacity to existing product line.

(iii) Diversification decisions: These decisions require evaluation of proposals to diversify into new product lines, new markets etc. for reducing the risk of failure by dealing in different products or by operating in several markets.

Both expansion and diversification decisions are called revenue expansion decisions.

5. What are various Capital Budgeting Decisions on basis of Situations?

The capital budgeting decisions on the basis of situations are classified as follows:

(i) Mutually exclusive decisions: The decisions are said to be mutually exclusive if two or more alternative proposals are such that the acceptance of one proposal will exclude the acceptance of the other alternative proposals. For instance, a firm may be considering proposal to install a semi-automatic or highly automatic machine. If the firm installs a semi-automatic machine, it excludes the acceptance of proposal to install highly automatic machine.

(ii) Accept-Reject decisions: The accept-reject decisions occur when proposals are independent and do not compete with each other. The firm may accept or reject a proposal on the basis of a minimum

return on the required investment. All those proposals which give a higher return than certain desired rate of return are accepted and the rest are rejected.

(iii) Contingent decisions: The contingent decisions are made when the proposals are dependable proposals. The investment in one proposal requires investment in one or more other proposals. For example, if a company accepts a proposal to set up a factory in remote area, it will have to invest in infrastructure, like building of roads, houses for employees etc. also.

6. Mention steps for Capital Budgeting.

1. Estimation of Cash flows over the entire life for each of the projects under consideration.
2. Evaluate each of the alternative, using different decision criteria.
3. Determining the minimum required rate of return (i.e., WACC) to be used as discount rate.

7. What are Advantages & Disadvantages of Payback Period?

Time required to recover the initial cash-outflow is called pay-back period. The payback period of an investment is the length of time required for the cumulative total net cash flows from the investment to equal the total initial cash outlays.

Advantages of Payback period

(i) It is easy to compute.
(ii) It is easy to understand as it provides a quick estimate of the time needed for the organization to recoup the cash invested.
(iii) The length of the payback period can also serve as an estimate of a project's risk; the longer the payback period, the riskier the project as long-term predictions are less reliable. In some industries with high obsolescence risk like software industry or in situations where an organization is short on cash, short payback periods often become the determining factor for investments.

Limitations of Payback period

(i) It ignores the time value of money. As long as the payback periods for two projects are the same, the payback period technique considers them equal as investments, even if one project generates most of its net cash inflows in the early years of the project while the other project generates most of its net cash inflows in the latter years of the payback period.
(ii) A second limitation of this technique is its failure to consider an investment's total profitability; it only considers cash inflows up-to the period in which initial investment is fully recovered and ignores cash flows after the payback period.
(iii) Payback technique places much emphasis on short payback periods thereby ignoring long-term projects.

8. What are Advantages & Disadvantages of ARR?

The accounting rate of return of an investment measures the average annual net income of the project (incremental income) as a percentage of the investment.

Advantages of ARR

(i) This technique uses readily available data that is routinely generated for financial reports and does not require any special procedures to generate data.

(ii) This method may also mirror the method used to evaluate performance on the operating results of an investment and management performance. Using the same procedure in both decision-making and performance evaluation ensures consistency.
(iii) Calculation of the accounting rate of return method considers all net incomes over the entire life of the project and provides a measure of the investment's profitability.

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

9. What are Advantages & Disadvantages of NPV Mehod?

The net present value technique is a discounted cash flow method that considers the time value of money in evaluating capital investments. An investment has cash flows throughout its life, and it is assumed that an amount of cash flow in the early years of an investment is worth more than an amount of cash flow in a later year.

The net present value method uses a specified discount rate to bring all subsequent cash inflows after the initial investment to their present values (the time of the initial investment is year 0).
The net present value of a project is the amount, in current value of amount, the investment earns after paying cost of capital in each period.
Net present value = Present value of net cash inflow - Total net initial investment

Advantages of NPV
(i) NPV method takes into account the time value of money.
(ii) The whole stream of cash flows is considered.
(iii) The net present value can be seen as the addition to the wealth of shareholders. The criterion of NPV is thus in conformity with basic financial objectives.
(iv) The NPV uses the discounted cash flows i.e., expresses cash flows in terms of current rupees. The NPVs of different projects therefore can be compared. It implies that each project can be evaluated independent of others on its own merit.

Limitations of NPV
(i) It involves difficult calculations.
(ii) The application of this method necessitates forecasting cash flows and the discount rate. Thus, accuracy of NPV depends on accurate estimation of these two factors which may be quite difficult in practice.

(iii) The decision under NPV method is based on absolute measure. It ignores the difference in initial outflows, size of different proposals etc. while evaluating mutually exclusive projects.

10. Explain Advantages & Disadvantages of PI Method.

In certain cases, we have to compare a number of proposals, each involving different amounts 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' or 'Present Value Index Method'. Mathematically: The Profitability Index (PI) is calculated as below:

$$\text{Profitability Index} = \frac{\text{Sum of discounted cash in flows}}{\text{Initial cash outlay or Total discounted cash outflow}}$$

Decision Rule:

If PI ≥ 1	Accept the Proposal
If PI ≤ 1	Reject the Proposal

Advantages of PI

(i) The method also uses the concept of time value of money.

(ii) In the PI method, since the present value of cash inflows is divided by the present value of cash outflow, it is a relative measure of a project's profitability.

Limitations of PI

(i) Profitability index fails as a guide in resolving capital rationing where projects are indivisible.

(ii) Once a single large project with high NPV is selected, possibility of accepting several small projects which together may have higher NPV than the single project is excluded.

(iii) Also, situations may arise where a project with a lower profitability index selected may generate cash flows in such a way that another project can be taken up one or two years later, the total NPV in such case being more than the one with a project with highest Profitability Index.

The Profitability Index approach thus cannot be used indiscriminately but all other type of alternatives of projects will have to be worked out.

11. What are Advantages & Disadvantages of IRR Method?

Internal rate of return for an investment proposal is the discount rate that equates the present value of the expected cash inflows with the initial cash outflow.

Advantages of IRR

(i) This method makes use of the concept of time value of money.

(ii) All the cash flows in the project are considered.

(iii) IRR is easier to use as instantaneous understanding of desirability can be determined by comparing it with the cost of capital

(iv) IRR technique helps in achieving the objective of maximisation of shareholder's wealth.

Limitations of IRR

(i) 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.

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

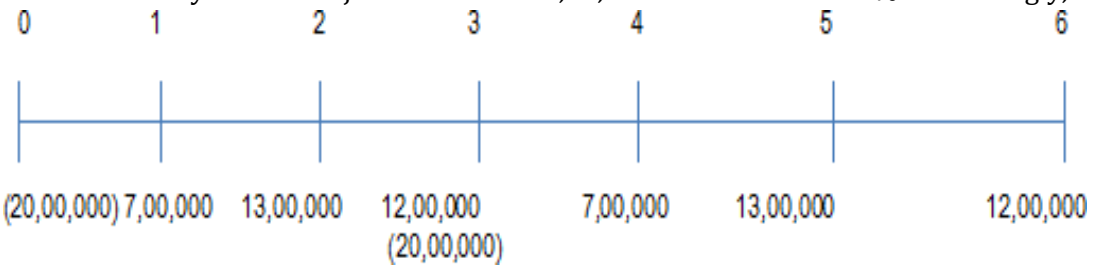
(iii) It is assumed that under this method all the future cash inflows of a proposal are reinvested at a rate equal to the IRR. It ignores a firm's ability to re-invest in portfolio of different rates.

(iv) 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.

12. Explain Replacement Chain & Equivalent Annualised Criterion when life of projects are different.

(i) Replacement Chain (Common Life) Method: Since the life of the Project A is 6 years and Project B is 3 years, to equalize lives, we can have second opportunity of investing in project B after one time investing. The position of cash flows in such situation shall be as follows:

NPV of extended life of 6 years of Project B shall be ` 8,82,403 and IRR of 25.20%. Accordingly, with



extended life NPV of Project B it appears to be more attractive.

(ii) Equivalent Annualized Criterion: The method discussed above has one drawback when we have to compare two projects with one has a life of 3 years and other has 5 years. In such case, the above method shall require analysis of a period of 15 years i.e. common multiple of these two values. The simple solution to this problem is use of Equivalent Annualised Criterion involving following steps:

(a) Compute NPV using the WACC or discounting rate.

(b) Compute Present Value Annuity Factor (PVAF) of discounting factor used above for the period of each project.

(c) Divide NPV computed under step (a) by PVAF as computed under step (b) and compare the values.

13. Explain MIRR method.

As we know there are several limitations attached with the concept of the conventional Internal Rate of Return (IRR). The MIRR addresses some of these deficiencies e.g., it eliminates multiple IRR rates;

it addresses the reinvestment rate issue and produces results which are consistent with the Net Present Value method. This method is also called Terminal Value method.

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

The decision criterion of MIRR is same as IRR i.e. you accept an investment if MIRR is larger than required rate of return and reject if it is lower than the required rate of return.

8 CHAPTER DIVIDEND DECISIONS

Q.N	QUESTIONS
1.	**Mature companies having few investment opportunities will show high payout ratios, this statement is**
	(a) False (b) True (c) Partial true (d) None of these
2.	**Determine the market price of share of XYZ ltd as per gordon's model, given equity capitalisation rate =11% expected earning =Rs. 20 rate of return on investement =10% & retention ratio =30%**
	(a) 165 (b) 175 (c) 185 (d) 195
3.	**Compute EPS according to Graham & Dodd approach from the given information:** **Market Price Rs 56** **Dividend Payout 60%** **Multiplier 2**
	(a) Rs 30 (b) Rs 56 (c) Rs 28 (d) Rs 84
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 financing requirements are to be executed through debt (relatively cheaper source of finance), then it would be preferable to distribute……..**
	(a) More Dividend (b) Less dividend (c) No Dividend (d) None of the above
6.	**The cost of capital of a firm is 12% & its expected earning per share at the end of the year is Rs 20. Its existing payout ratio is 25%. the company is planning to increase its payout ratio to 50% what will be the effect of this change on the market price of equity share (MPS) of the company as per Gordon model ,If the reinvestment rate of the company is 15%**
	(a) lt will increase by Rs 444.45 (b) It will decrease by Rs 444.45 (c) lt will increase by Rs 222.22 (d) It will decrease by Rs 222.22
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. According to the residual dividend theory ,dividend payment is determined based on

(a) The availability of excess fund after all investment opportunities with positive NPV are undertaken
(b) The preference of shareholder for a consistent dividend payout ratio
(c) The desire to maintain a stable dividend payout ratio regardless of investment opportunity.
(d) The goal of maximizing shareholder wealth by paying out all available earning as dividend

9. Determine the market price of share of XYZ ltd as per gordon's model, given equity capitalisation rate =11% expected earning =Rs. 20 rate of return on investment =10% & retention ratio =30%

(a) 165 (b) 175
(c) 185 (d) 195

10. All of the following are true of stock splits except:

(a) More Dividend (b) Less dividend
(c) No Dividend (d) None of the above

11. Which of the following is the irrelevance theory?

(a) Walter model (b) Gordon model
(c) M.M. hypothesis (d) Linter's model

12. 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

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

(a) Ke > g (b) Retention ratio,once decide upon is constant
(c) Firm is an all equity firm (d) All of the above

14. The 'Dividend-Payout Ratio' is equal to

(a) The Dividend yield plus the capital gains yield (b) DPS divided by Earning per Equity Share
(c) DPS divided by par value per share (d) DPS divided by current price per share

15. 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

16. 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

17. **Which of the following is the limitation of Linter's mode**

(a) Market price per share is reduced after the split. (b) the number of o/s shares is increased.
(c) Retained earnings are changed. (d) Proportional ownership is unchanged.

18. **If a firm declared 25% dividend on share of face value of Rs 10 its growth rate is 5% & its rate of capitaliation is 12% its expected price would be Rs...**

(a) 31.2 (b) 33.50
(c) 36 (d) 37.50

19. **Which of the following statement is correct with respect to Gordon's model**

(a) When IRR > cost of capital, the price per share increases and dividend pay-out decreases.
(b) When IRR > cost of capital, the price per share decreases and dividend pay-out increase
(c) When IRR = cost of capital, the price per share increases and dividend pay-out decreases
(d) When IRR < cost of capital, the price per share increases and dividend pay-out decreases

1.	(b)	**2.**	(b)	**3.**	(a)	**4.**	(c)	**5.**	(a)
6.	(b)	**7.**	(c)	**8.**	(a)	**9.**	(b)	**10.**	(a)
11.	(c)	**12.**	(a)	**13.**	(d)	**14.**	(b)	**15.**	(c)
16.	(a)	**17.**	(c)	**18.**	(d)	**19.**	(a)		

Q.N	THEORY QUESTIONS
1.	**Mature companies having few investment opportunities will show high payout ratios, this statement is**
	(a) False (b) True (c) Partial true (d) None of these
2.	**What are various types of Dividend?**
	Generally, the dividend can be of the following forms **1. Cash dividend:** It is the most common form of dividend. Cash here means cash, cheque, warrant, demand draft, pay order or directly through Electronic Clearing Service (ECS) but not in kind. **2. Share repurchases:** A share repurchase is transaction in which company buys back its own shares using corporate cash. This is done by lot of corporates these days. The bought back shares as above can be classified as a. treasury shares which are kept for re-issuance in future or b. cancelled shares if they would be retired from issued share capital. Share repurchases are also viewed as one form dividend distribution **3. Stock dividend (Bonus Shares):** It is a distribution of shares in lieu of cash dividend. When the company issues new shares to its existing shareholders without any consideration it is called bonus shares. Such shares are distributed proportionately thereby retaining proportionate ownership of the company.
3.	**What are conditions of Bonus Isuue or Stock Issue?**
	To issue Bonus shares, a Company needs to fulfil all the conditions given by Security Exchange Board of India (SEBI). As per SEBI, the bonus shares are issued not in lieu of cash dividends. A bonus issue should be authorised by Article of Association (AOA) and not to be declared unless all partly paid-up shares have been converted into fully paid-up shares. The Company should not have defaulted in re-payment of loan, interest and any statutory dues. Bonus shares are to be issued only from share premium and free reserves and not from capital reserve on account of fixed assets revaluation. Bonus shares are used by companies to prevent investors from selling its shares as short term capital gains is 15% and long term capital gains is 10% and the period of holding for bonus shares starts from date of issue of bonus shares. In such a scenario an investor would not immediately sale bonus shares as they might lose 5% on account of taxation. This generally helps companies indirectly as their prices would not fall further due selling activity from investor's end.
4.	**Explain Advantages of Stock Dividend.**
	There are many advantages both to the shareholders and company. Some of the main advantages are listed as under: **(1) To Shareholders:** **(a)** No tax is payable by shareholders on stock dividend received from domestic company as it is not treated as dividend but capital asset under Income Tax Act, 1961.

(b) Policy of paying fixed dividend per share and its continuation even after declaration of stock dividend will increase total cash dividend of the shareholders in future.
(c) Bonus shares improves liquidity in the hands of shareholders as bonus shares leads to breaking down of higher priced shares into lower priced shares and hence give a choice to shareholders to sell some of the lower priced shares and get some liquidity.

(2) To Company:
(a) Conservation of cash for meeting profitable investment opportunities.
(b) Suitable in case of cash deficiency and restrictions imposed by lenders to pay cash dividend.

5. What are Limitations of Stock Dividend?

Limitations of stock dividend to shareholders and company are as follows:
1. To Shareholders: Stock dividend does not affect the wealth of shareholders and therefore it has no value for them. This is because the declaration of stock dividend is a method of capitalising the past earnings of the shareholders and is a formal way of recognising earnings which the shareholders already own. It merely divides the company's ownership into a large number of share certificates. James Porterfield regards stock dividends as a division of corporate pie into a larger number of pieces. Stock dividend does not give any extra or special benefit to the shareholder. His proportionate ownership in the company does not change at all. Stock dividend creates a favourable psychological impact on the shareholders and is greeted by them on the ground that it gives an indication of the company's growth.
2. To Company: Stock dividends are costlier to administer than cash dividends. It is disadvantageous if periodic small stock dividends are declared by the company as earnings.

6. Explain Significance of Dividend Policy.

Dividend policy of a firm is governed by:
(i) Long Term Financing Decision:
As we know that one of the financing options is 'Equity'. Equity can either be raised externally through issue of new equity shares or can be generated internally through retained earnings. For Equity, retained earnings are preferable because they do not involve any floatation costs (issue expenses).
But whether to retain or distribute the profits, forms the basis of this decision. Further, payment of cash dividend reduces the amount of funds required to finance profitable investment opportunities thereby restricting its financing options.
In this backdrop, the decision is based on the following:
1. Whether the organization has opportunities in hand to invest the profit, if retained?
2. Whether the return on such investment (ROI) will be higher than the expectations of shareholders i.e. Ke?

(ii) Wealth Maximization Decision:
Under this decision, we are facing the problem as to what amount of dividend shall be distributed i.e. the Dividend Payout ratio (D/P) in relation to Market price of the shares (MPS)? This decision is based on the following:
1. Because of market imperfections and uncertainty, shareholders give more importance to near dividends than future dividends and capital gains. Payment of dividends influences the market price

of the share directly. Higher dividends increase the value of shares and low dividends decrease it. A proper balance has to be struck between these two approaches.

2. When the firm increases its retained earnings, shareholders' dividends decreases and consequently market price is affected. Use of retained earnings to finance profitable investments increases the future earnings per share. This is because, shareholders expect that profitable investments made by the company may lead to higher return for them in future. On the other hand, increase in dividends may cause the firm to forego investment opportunities for lack of funds and thereby decrease the future earnings per share.

Thus, management should develop a dividend policy which divides net earnings into dividends and retained earnings in an optimum way so as to achieve the objective of wealth maximization for shareholders. Such a policy will be influenced by investment opportunities available to the firm and value of dividends as against capital gains to shareholders.

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

The dividend policy is affected by the following factors:

1. Availability of funds: If the business is in requirement of funds, then retained earnings could be a good source. The reason being the saving of floatation cost and prevention of dilution of control which happens in case of new issue of equity shares to public.

2. Cost of capital: If the financing requirements are to be executed through debt (relatively cheaper source of finance), then it would be preferable to distribute more dividend. On the other hand, if the financing is to be done through fresh issue of equity shares, then it is better to use retained earnings as much as possible.

3. Capital structure: An optimum Debt Equity ratio should also be considered for the dividend decision.

4. Stock price: Stock price here means market price of the shares. Generally, higher dividends increase market value of shares and low dividends decrease the value.

5. Investment opportunities in hand: The dividend decision is also affected if there are investment opportunities in hand. In that situation, the company may prefer to retain more earnings.

6. Trend of industry: The investors depend on some industries for their regular dividend income. Therefore, in such cases, the firms have to pay dividend in order to survive in the market.

7. Expectation of shareholders: The shareholders can be categorised into two categories: (i) those who invests for regular income, & (ii) those who invests for growth. Generally, the investor prefers current dividend over the future growth.

8. Legal constraints: Section 123 of the Companies Act, 2013 which provides for declaration of dividend sates that Dividend shall be declared or paid by a company for any financial year only:

(a) out of the profits of the company for that year arrived at after providing for depreciation in accordance with the relevant provisions , or

(b) out of the profits of the company for any previous financial year or years arrived at after providing for depreciation in accordance with the relevant provisions and remaining undistributed, or

(c) out of both, or

(d) out of money provided by the Central Government or a State Government for the payment of dividend by the company in pursuance of a guarantee given by that Government.

8.	**According to the residual dividend theory ,dividend payment is determined based on**
	(a) The availability of excess fund after all investment opportunities with positive NPV are undertaken (b) The preference of shareholder for a consistent dividend payout ratio (c) The desire to maintain a stable dividend payout ratio regardless of investment opportunity. (d) The goal of maximizing shareholder wealth by paying out all available earning as dividend

9 CHAPTER WORKING CAPITAL

Q.N	QUESTIONS
1.	**Increase in which of the following shall reduce the net operating cycle**
	(a) Accrued Income (b) Cash & Bank (c) Short term advances to creditors (d) Bank Overdraft
2.	**Increase in which of the following shall reduce the net operating cycle**
	(a) Work in Process holding period (b) Raw Material Storage period (c) Receivables collection period (d) Credit period allowed by Suppliers
3.	**As per Miller-Orr cash management model, when cash balance reaches lower limit then**
	(a) It may be invested in securities (b) Loan may be taken (c) Some marketable securities may be liquidated (d) Creditor payments should be put on hold
4.	**Operating in double shifts may not impact which of the below (in terms of units at least)**
	(a) Work in Process Inventory (b) Raw Material Inventory (c) Finished Goods Inventory (d) Receivables
5.	**Increase in which of the following shall reduce the net operating cycle**
	(a) Work in Process holding period (b) Raw Material Storage period (c) Receivables collection period (d) Credit period allowed by Suppliers
6.	**What is the relationship between the allowance for doubtful accounts and working capital**
	(a) When bad debts expense is recorded for the period, working capital decreases. (b) When bad debts expense is recorded for the period, cash increases (c) When an account is written off against the allowance, working capital decreases (d) When an account is written off against the allowance, cash decreases
7.	**Which of the following is not a determinant of working capital**
	(a) Nature of Business (b) Target Profit (c) Type of Product (d) Credit Policy

8.	**Strict credit policy with customers may not result in**	
	(a) Faster Collections	(b) Decline in Sales
	(c) Increase in Sales	(d) Lower Collection Period
9.	**Electronic funds transfer may eliminate most types of floats except**	
	(a) Billing Float	(b) Mail Float
	(c) Cheque Processing Float	(d) Bank Processing Float
10.	**Which of these ratios could be a better indicator of Working Capital**	
	(a) Current Assets to Fixed Assets	(b) Interest Coverage Ratio
	(c) Debt Equity Ratio	(d) Financial Leverage
11.	**Need for cash can be categorized as any of these except**	
	(a) Transaction	(b) Entertainment
	(c) Speculative	(d) Precautionary
12.	**An organization carrying higher levels of inventory is most probably following which policy of working capital management**	
	(a) Conservative	(b) Aggressive
	(c) Moderate	(d) Opportunistic
13.	**Which of these components of Working Capital require consideration of Cash Cost**	
	(a) Raw Material Inventory	(b) Receivables
	(c) Work in Progress Inventory	(d) Trade Payables
14.	**Current Liabilities can be settled by**	
	(a) Creation of a new current liability	(b) Use of Non-current assets
	(c) Creation of Non-Current Liability	(d) Proceeds of Long-Term Investments
15.	**Gross Working Capital refers to**	
	(a) Current Assets - Current Liabilities	(b) Current Liabilities - Current Assets
	(c) Current Assets	(d) Current Liabilities
16.	**How can a company improve its accounts receivable turnover?**	
	(a) Extend payment terms for customers	(b) Increase credit limits for customers
	(c) Offer discounts for early payment	(d) All of the above

17.	**If a company has profits with a certain cash conversion or net operating cycle, considering reducing cash conversion cycle further, with other things remaining the same, would**
	(a) Increase the profits which might not be in the same proportion as the number of days reduced in cash conversion cycle. (b) Reduce the profits in the same proportion as the number of days reduced in cash conversion cycle. (c) Convert profits to losses which might not be in the same proportion as the number of days reduced in cash conversion cycle (d) Increase profits in the same proportion as the number of days reduced in cash conversion cycle
18.	**An organization carrying higher levels of inventory is most probably following which policy of working capital management**
	(a) Conservative (b) Aggressive (c) Moderate (d) Opportunistic
19.	**All of these are methods of cash budgeting except**
	(a) Adjusted Balance Sheet Method (b) Adjusted Income Method (c) Receipts & Payment Method (d) Taxable Income Method
20.	Strict credit policy with customers may not result in
	(a) Faster Collections (b) Decline in Sales (c) Increase in Sales (d) Lower Collection Period

ANSWERS

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

Q.N	THEORY QUESTIONS

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

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

1. Need for Cash: Identify the cash balance which allows for the business to meet day-to-day expenses but reduces cash holding costs (example – loss of interest on long term investment had the surplus cash invested therein).

2. Desired level of Inventory: Identify the level of inventory which allows for uninterrupted production but reduces the investment in raw materials and hence increases cash flow. The techniques like Just in Time (JIT) and Economic order quantity (EOQ) are used for this.

3. Receivables: Identify the appropriate credit policy, i.e., credit terms which will attract customers, such that any impact on cash flows and the cash conversion cycle will be offset by increased revenue and hence Return on Capital (or vice versa). The tools like Early Payment Discounts and allowances are used for this.

4. Short-term Financing Options: Inventory is ideally financed by credit granted by the supplier. However, depending on the cash conversion cycle, it may be necessary to utilize a bank loan (or overdraft), or to "convert debtors to cash" through "factoring" in order to finance working capital requirements.

5. Nature of Business: For e.g. in a business of restaurant, most of the sales are in Cash. Therefore, need for working capital is very less. On the other hand, there would be a higher inventory in case of a pharmacy or a bookstore.

6. Market and Demand Conditions: For e.g. if an item's demand far exceeds its production, the working capital requirement would be less as investment in finished goods inventory would be very less with continuous sales.

7. Technology and Manufacturing Policies: For e.g. in some businesses the demand for goods is seasonal, in that case a business may follow a policy for steady production throughout the whole year or rather may choose a policy of production only during the demand season.

8. Operating Efficiency: A company can reduce the working capital requirement by eliminating waste, improving coordination, process improvements etc.

9. Price Level Changes & Exchange Rate Fluctuations: For e.g. rising prices necessitate the use of more funds for maintaining an existing level of activity. For the same level of current assets, higher cash outlays are required.

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

Components of Working Capital	Advantages of Higher side profitability	Trade off between profitabiloity & liquidity	Advantages of lower side liquidity
Inventory	Less stock out increase profitability	Use techniques like EOQ, JIT	Lower inventory requires less capital but there are chances

			of stock out & loss of goodwill.
Receivables	High credit period attract customers & increase revenue but can lead to more bad debt	Evaluate credit policy use services of debt management.	Cash sales provide liquidity but fail to boost sales
Prepay of Expenses	Reduce uncertainty & profitable in inflationary env.	Cash benefit analysis required	Improves or maintains liquidity.
Cash & Cash Eq	Payables are honoured in time, improves good will & helps in getting discounts	Cash Budget & Other techniques may be used	Cash can be used in some other investment avenues
Payables & Exp	Capital can be used in some other investment avenues	Evaluate credit policy & related cost.	Payables are honoured in time, improve goodwill & help in getting discount.

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

Operating cycle is one of the most reliable methods of Computation of Working Capital. However, other methods like ratio of sales and ratio of fixed investment may also be used to determine the Working Capital requirements. These methods are briefly explained as follows:

(i) Current Assets Holding Period: To estimate working capital needs based on the average holding period of current assets and relating them to costs based on the company's experience in the previous year. This method is essentially based on the Operating Cycle Concept.
(ii) Ratio of Sales: To estimate working capital needs as a ratio of sales on the assumption that current assets change with changes in sales.
(iii) Ratio of Fixed Investments: To estimate Working Capital requirements as a percentage of fixed investments.

A number of factors will, however, be impacting the choice of method of estimating Working Capital. Factors such as seasonal fluctuations, accurate sales forecast, investment cost and variability in sales price would generally be considered. The production cycle and credit and collection policies of the firm will have an impact on Working Capital requirements. Therefore, they should be given due weightage in projecting Working Capital requirements.

4. Explain briefly the functions of Treasury Department.

The treasury department have evolved in importance over number of years from being responsible for only cash handling issues to technical areas revolving around hedging forex risks, composition of capital structure etc. The fundamental tasks for which treasury department of any enterprise is responsible are :-

1. Cash Management: It involves efficient cash collection process and managing payment of cash both inside the organisation and to third parties. There may be complete centralization within a group treasury or the treasury may simply advise subsidiaries and divisions on policy matter viz., collection/payment periods, discounts, etc.
2. Currency Management: The treasury department manages the foreign currency risk exposure of the company. In a large multinational company (MNC) the first step will usually be to set off intra-group indebtedness.
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.
5. Corporate Finance: Treasury department is involved with both acquisition and divestment activities within the group. In addition, it will often have responsibility for investor relations. The latter activity has assumed increased importance in markets where share-price performance is regarded as crucial and may affect the company's ability to undertake acquisition activity or, if the price falls drastically, render it vulnerable to a hostile bid.

5. Explain Baumol's Model of Cash Management

According to this model, optimum cash level is that level of cash where the carrying costs and transactions costs are the minimum.

The carrying costs refer to the cost of holding cash, namely, the opportunity cost or interest foregone on marketable securities. The transaction costs refer to the cost involved in getting the marketable securities converted into cash. This happens when the firm falls short of cash and has to sell the securities resulting in clerical, brokerage, registration and other costs.

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

$$\sqrt{\frac{2XUXP}{S}}$$

Where,
C = Optimum cash balance
U = Annual (or monthly) cash disbursement
P = Fixed cost per transaction.
S = Opportunity cost of one rupee p.a. (or p.m.)
The model is based on the following assumptions:
(i) Cash needs of the firm are known with certainty.
(ii) The cash is used uniformly over a period of time and it is also known with certainty.

(iii) The holding cost is known and it is constant.
(iv) The transaction cost also remains constant.

6. State the advantage of Electronic Cash Management System.

Electronic-scientific cash management results in:

1. Significant saving in time.
2. Increase in interest earned & decrease in interest expense.
3. Reduces paper-work & hence manpower.
4. Greater accounting accuracy as it allows easy detection of book-keeping errors.
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 centralized 'Cash Management'.
14. Produces faster electronic reconciliation.
15. Reduces the number of cheques issued.

7. Discuss 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.

1. When the cash balance reaches the upper limit, the transfer of cash equal to h – z is invested in marketable securities account.
2. When it touches the lower limit, a transfer from marketable securities account to cash account is made.
3. During the period when cash balance stays between (h, z) and (z, 0) i.e. high and low limits no transactions between cash and marketable securities account is made.

The high and low limits of cash balance are set up on the basis of fixed cost associated with the securities transactions, the opportunity cost of holding cash and the degree of likely fluctuations in cash balances. These limits satisfy the demands for cash at the lowest possible total costs.

The MO Model is more realistic since it allows variations in cash balance within lower and upper limits. The finance manager can set the limits according to the firm's liquidity requirements i.e., maintaining minimum and maximum cash balance.

8. Describe Factoring.

Factoring: Factoring is a relatively new concept in financing of accounts receivables. This refers to outright sale of accounts receivables to a factor or a financial agency. A factor is a firm that acquires the receivables of other firms. The factoring lays down the conditions of the sale in a factoring agreement. The factoring agency bears the risk of collection and services the accounts for a fee.

Factoring arrangement can be either on a recourse basis or on a non-recourse basis:
- Recourse: In case factor is unable to collect the amount from receivables then, factor can turn back the same to the organization for resolution (which generally is by replacing those receivables with new receivables)
- Non-Recourse: The factor bears the ultimate risk of loss in case of default and hence in such cases they charge higher commission.

There are a number of financial institutions providing factoring services in India. Some commercial banks and other financial agencies provide this service. The biggest advantages of factoring are the immediate conversion of receivables into cash and predicted pattern of cash flows. Financing receivables with the help of factoring can help a company having liquidity without creating a net liability on its financial condition and hence no impact on debt equity ratio. Besides, factoring is a flexible financial tool providing timely funds, efficient record keepings and effective management of the collection process. This is not considered as a loan. There is no debt repayment and hence no compromise to balance sheet, no long-term agreements or delays associated with other methods of raising capital. Factoring allows the firm to use cash for the growth needs of business.

9. Describe the various forms of bank credit in financing the working capital of a business organization.

The bank credit will generally be in the following forms:

- **Cash Credit:** This facility will be given by the banker to the customers by giving certain amount of credit facility on continuous basis. The borrower will not be allowed to exceed the limits sanctioned by the bank.
- **Bank Overdraft:** It is a short-term borrowing facility made available to the companies in case of urgent need of funds. The banks will impose limits on the amount they can lend. When the borrowed funds are no longer required they can quickly and easily be repaid. The banks issue overdrafts with a right to call them in at short notice.
- **Bills Discounting:** The Company which sells goods on credit will normally draw a bill on the buyer who will accept it and sends it to the seller of goods. The seller, in turn discounts the bill with his banker. The banker will generally earmark the discounting bill limit.
- **Bills Acceptance:** To obtain finance under this type of arrangement a company draws a bill of

exchange on bank. The bank accepts the bill thereby promising to pay out the amount of the bill at some specified future date.

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