



The Best CA/CMA Inter

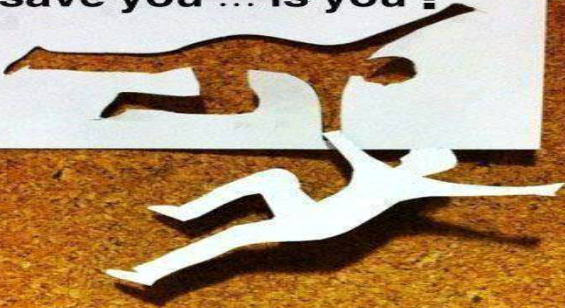


# F M

THEORY-DEC. 2021 ATTEMPT

इंसान कहता है कि पैसा आये तो मैं कुछ करके दिखाऊं और  
पैसा कहता है कि तू कुछ करके दिखा तो मैं आऊं

The only person that can  
save you ... is you !

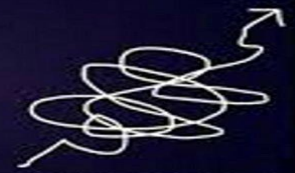


SUCCESS



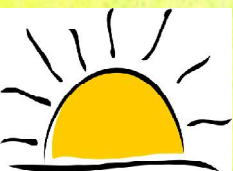
WHAT PEOPLE THINK  
IT LOOKS LIKE

SUCCESS



WHAT IT REALLY  
LOOKS LIKE

मीठा बोलो, मिलके चलो, सबसे करो स्नेह, कितने  
दिन का जीवन है, कितने दिन की देह



CA Aaditya Jain

*With Sunrise You Rise*



CA, MBA(FINANCE), RESEARCH ANALYST,  
INVESTMENT ADVISOR L-1 & L-2, NCFM, B.COM, M.COM  
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**NOV 2018 RTP**

**QUESTION:** The profit maximization is not an operationally feasible criterion . Discuss (CH-1, Q. NO.10)

**MAY 2019 RTP**

**QUESTION:** Write short notes on the following: Functions of Finance Manager (CH-1, Q. NO.18)

**QUESTION:** Write short notes on :Inter relationship between investment, financing & dividend decisions. (CH-1, Q. NO.07)

**QUESTION:** Write short notes on the following: Debt securitisation (CH-2, Q. NO.10)

**NOV 2019 RTP**

**QUESTION:** State the meaning of Payback Reciprocal. (CH-4, Q. NO.02)

**QUESTION:** State the function of treasury department. (CH-4, Q. NO.03)

**QUESTION:** Describe the inter relationship between investment, financing and dividend decision.

**MAY 2020 RTP**

**QUESTION:** The profit maximization is not an operationally feasible criterion . Explain. (CH-1, Q. NO.10)

**QUESTION:** Explain the basics of debt securitisation process. (CH-2, Q. NO.10)

**NOV 2020 RTP**

**QUESTION:** EXPLAIN agency problem and agency cost. How to address the issues of the same. (CH-1, Q. NO.17)

**QUESTION:** COMPARE between Financial Lease and Operating Lease. (CH-2, Q. NO.12)

**MAY 2021 RTP**

**QUESTION:** "Profit Maximization cannot be the sole objective of a company". COMMENT. (CH-1, Q. NO.10)

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

**MARCH 2018 MTP**

**QUESTION:** Discuss various sources of risk. (CH-3, Q. NO.02)

**QUESTION:** Explain Financial Distress and explain its relationship with insolvency. (CH-1, Q. NO.15)

**QUESTION:** State modified Internal Rate of Return method. (CH-4, Q. NO.03)

**APRIL 2018 MTP**

**QUESTION:** Discuss in briefly any two long term sources of finance for a partnership firm. (CH-4, Q. NO.06)

**QUESTION:** Discuss the limitations of financial ratios. (CH-4, Q. NO.07)

**QUESTION:** Explain the term Payback reciprocal. (CH-4, Q. NO.02)

**QUESTION:** "Operating risk is associated with cost structure, whereas financial risk is associated with capital structure of a business concern." Critically examine the statement. (CH-4, Q. NO.05)

**MARCH 2019 MTP**

**QUESTION:** List the factors determining the dividend policy of a company. (CH-4, Q. NO.08)

**QUESTION:** Explain the difference between Business risk and Financial Risk. (CH-4, Q. NO.05)

**QUESTION:** Explain as to how the wealth maximisation objective is superior to the profit maximisation objective. (CH-1, Q. NO.11)

**QUESTION:** Discuss the dividend-price approach to estimate cost of equity capital. (CH-4, Q. NO.09)



**APRIL 2019 MTP**

- QUESTION:** Explain the principles of "Trading on Equity." (CH-4, Q. NO.10)
- QUESTION:** Write short notes on Describe bridge finance. (CH-2, Q. NO.08)
- QUESTION:** Write short notes on State virtual Banking? Discuss its advantages. (CH-4, Q. NO.11)
- QUESTION:** Write short notes on Concentration Banking. (CH-4, Q. NO.12)

**OCT 2019 MTP**

- QUESTION:** What is debt securitisation? Explain the basics of debt securitisation process. (CH-2, Q. NO.10)
- QUESTION:** Explain the concept of discounted payback period. (CH-4, Q. NO.13)

**MAY 2020 MTP**

- QUESTION:** EXPLAIN in brief the Pecking order theory. (CH-4, Q. NO.14)
- QUESTION:** EXPLAIN Over-capitalisation. STATE its causes and consequences. (CH-4, Q. NO.15)
- QUESTION:** EXPLAIN in short the term Letter of Credit. (CH-2, Q. NO.22)
- QUESTION:** "Financing a business through borrowing is cheaper than using equity." Briefly EXPLAIN

**OCT 2020 MTP**

- (CH-2, Q. NO.21)
- QUESTION :** DISCUSS Agency Problem and Agency Cost. (CH-1, Q. NO.17)
- QUESTION:** EXPLAIN in brief the features of Commercial Papers. (CH-2, Q. NO.15)
- QUESTION:** EXPLAIN Billing float and Mail float with reference to management of cash. (CH-4, Q. NO.19)
- QUESTION:** STATE any four factors which need to be considered while planning for working capital requirement. (CH-4, Q. NO.20)

**MARCH 2021 MTP**

- QUESTION:** DISCUSS the advantages and disadvantages of Wealth maximization principle. (CH-1, Q. NO.11)
- QUESTION:** DISCUSS in brief the characteristics of Debentures. (CH-2, Q. NO.05)
- QUESTION:** DEFINE Security Premium Notes. (CH-2, Q. NO.18)
- QUESTION:** DEFINE Masala bond. (CH-2, Q. NO.07)

**APRIL 2021 MTP**

- QUESTION:** EXPLAIN in brief the features of Commercial Paper. (CH-2, Q. NO.15)
- QUESTION:** DESCRIBE how agency problem can be addressed. (CH-1, Q. NO.17)
- QUESTION:** DEFINE Debt Securitisation. (CH-2, Q. NO.10)
- QUESTION:** EXPLAIN the principles of "Trading on equity". (CH-4, Q. NO.10)

"There are three important things to remember about education. The first one is motivation, the second is motivation, and the third is motivation."

—AADITYA JAIN

Always find inner strength not to be superior than others, but to fight your biggest enemy, the doubts within yourself. Never let your doubts & fears hold you enslaved — instead conquer them — by working to build your strengths — instead of focusing on your weaknesses and you will achieve things which once seem impossible. If you hear a voice within you which says you can't do it, still do it and that voice will be silenced. Don't let others tell you what you can't do or let their limitations become yours. Your only & truest limitations are those you set upon yourself! **Positive Thinking Positive Life??**



## SCOPE AND OBJECTIVES OF FINANCIAL MANAGEMENT

### QUESTION NO.1 What are the various stages of decision making of starting any new business venture ?

→ For the **purpose of starting any new business/venture**, an entrepreneur goes through the following stages of decision making:-

**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 will be the **sources 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.

### QUESTION NO.2 What are 3 key questions enquired into by any business enterprise requiring money ?

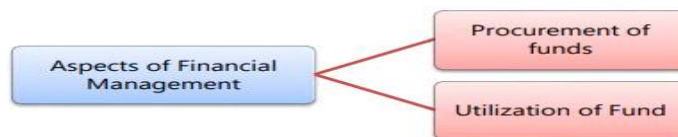
→ Any business enterprise requiring money and the 3 key questions being enquired into

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**)

### QUESTION NO.3 What are two basic aspects of financial management ? (May 2018 Question Paper)

→ There are two basic aspects of financial management are

(a) **Procurement of Funds** (b) **Effective Utilisation of Funds**



### QUESTION NO.4 Explain Procurement Of Funds ? OR Discuss some of the sources of funds ?

→ Since funds can be obtained from different sources therefore their **procurement is always considered as a complex problem by business concerns**.

→ **Some of the sources for funds for a business enterprise are:-**



We are constantly seeing new and creative sources of funds which are helping the modern businesses to grow faster. For example trading in Carbon Credits is turning out to be another source of funding.

→ Funds procured from different sources have different characteristics **in terms of risk, cost and control**. The **cost of funds** should be **at the minimum level** for that a **proper balancing of risk and control** factors must be carried out.

→ Another key consideration in choosing the source of new business finance is to **strike a balance between**

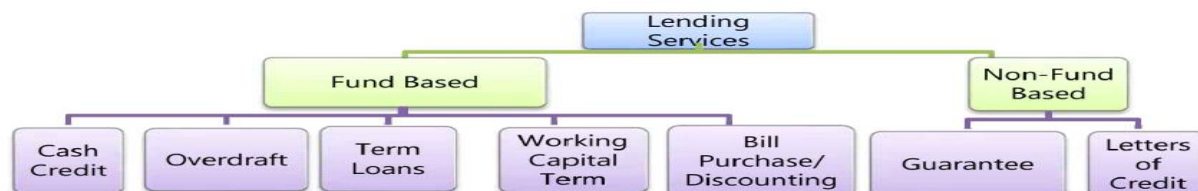
**equity and debt** to ensure the funding structure suits the business.

**Let us discuss 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:** Different lending services provided by Commercial Banks are depicted as follows:-



**(d)International Funding:** 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).

#### QUESTION NO.5 Explain 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:** 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.

#### QUESTION NO.6 What are the stages of Evolution 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.**

**The Transitional Phase:** → During this phase, the **day-to-day problems** that financial managers faced were given importance. → The general problems **related to funds analysis, planning and control** were given more attention in this phase.

**The Modern Phase:** → Modern phase is **still going on.** → The **scope** of financial management has **greatly increased now.** → It is important to **carry out financial analysis** for a company. → This analysis **helps in decision making.** → During this phase, **many theories have been developed** regarding **efficient markets, capital budgeting, option pricing\*, valuation models** and also in several other important fields in financial management.

#### QUESTION NO.7 Write a short note on Finance function/Finance Decision ? OR Write short notes on the following: Inter relationship between investment, financing and dividend decisions.(MAY 2019 RTP)(NOV

**2019 QUESTIONS PAPER) (NOV 2019 RTP)**

- The finance functions are divided into three major decisions, viz., **investment, financing and dividend decisions.**
- It is correct to say that these decisions are inter-related because the underlying objective of these three decisions is the same, i.e. **maximisation of shareholders' wealth.**
- **An efficient financial management can ensure optimal joint decisions.**
- The finance functions are divided into long term and short term functions/decisions:

**Long term Finance Function Decisions**

**(i) 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.

**(ii) 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.

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

**Short- term Finance Decisions/Function**

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

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

**QUESTION NO.8 What is the Importance of Financial Management ? OR State four tasks involved to demonstrate the importance of good financial management.**

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

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

**QUESTION NO.9 What are the Scope of Financial Management ?**

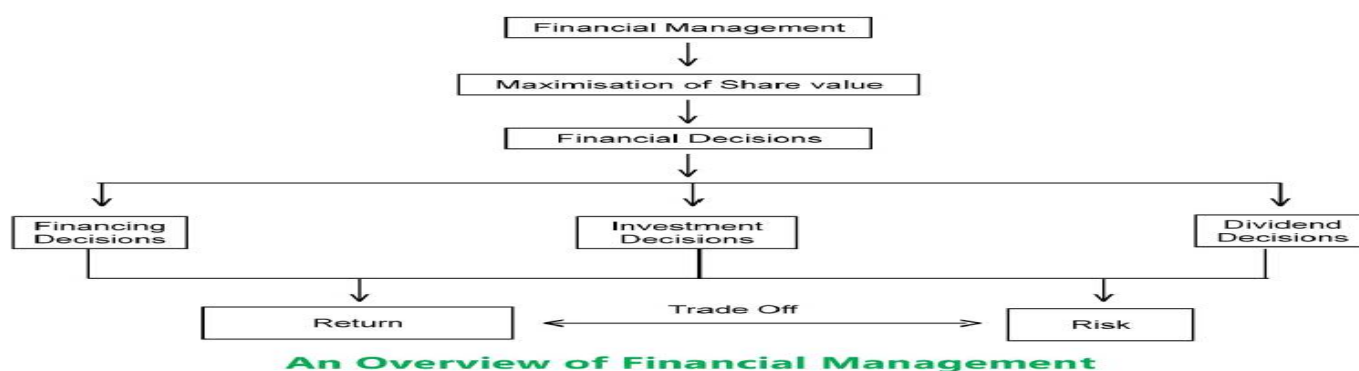
- Following aspects are taken up in detail under the study of financial management:

- (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.**

- The scope of financial management has undergone changes over the years. → Until the **middle of this century**, its scope was **limited to procurement of funds** for promotion, expansion, merger, etc. → In the **modern times**, the financial management includes besides procurement of funds, the **three different kinds of decisions as well**

namely investment, financing and dividend.

→ The given figure depicts the overview of the scope and functions of financial management.



**QUESTION NO.10** What are the Objectives of Financial Management ? OR The profit maximization is not an operationally feasible criterion.Explain. (MAY 2018 RTP)(NOV 2018 QUESTION PAPER)(NOV 2018 RTP)(MAY 2020 RTP)(MAY 2021 RTP)

→ There are two objectives of financial management : 1.Profit Maximisation 2.Wealth / Value 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**.

### Why The profit maximization is not an operationally feasible criterion ?

→ 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 **The profit maximization is not an operationally feasible criterion** hort 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**.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.

**In short:** (i)The term profit is vague\*; (ii)Ignores Risk Factor; (iii)Time Factor is Ignored; (iv)Ignores Social &



Moral Responsibility;(v) It ignores quality aspects.

**Wealth / Value Maximisation**

→ Shareholders wealth are the result of cost benefit analysis adjusted with their timing and risk i.e. time value of money.

→ Wealth = Present value of benefits - Present Value of Costs

Or, Value of a firm (V) = Number of Shares (N) x Market price of shares (MP)

Or, V = Value of equity (Ve) + Value of debt (Vd)

→ For measuring and maximising shareholders wealth finance manager should follow:

**1.Cash Flow approach not Accounting Profit 2.Cost benefit analysis 3.Application of time value of money.**

**QUESTION NO.11 Explain as to how the wealth maximisation objective is superior to the profit maximisation objective. What is difference/conflicts between Profit V/s Value Maximisation Principle ?(MARCH 2019 MTP)**

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

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

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

1. The value maximisation objective of a firm considers all future cash flows, dividends, earning per share, risk of a decision etc. whereas profit maximisation objective does not consider the effect of EPS, dividend paid or any other returns to shareholders or the wealth of the shareholder.

2. A firm that wishes to maximise the shareholders wealth may pay regular dividends whereas a firm with the objective of profit maximisation may refrain from dividend payment to its shareholders.

3. Shareholders would prefer an increase in the firm's wealth against its generation of increasing flow of profits.

4. The market price of a share reflects the shareholders expected return, considering the long-term prospects of the firm, reflects the differences in timings of the returns, considers risk and recognizes the importance of distribution of returns.

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

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

Goal	Objective	Advantages	Disadvantages
Profit Maximization	Large amount of profits	(i) Easy to calculate profits (ii) Easy to determine the link between financial decisions and profits.	(i) Emphasizes the short term gains (ii) Ignores risk or uncertainty (iii) Ignores the timing of returns (iv) Requires immediate resources.
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 shareholders' return.	(i) Offers no clear relationship between financial decisions and share price. (ii) Can lead to management anxiety and frustration.

**QUESTION NO.12 What is the Role of Finance Executive ?(MAY 2018 QUESTION PAPER)**

→ 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:-

(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.

**QUESTION NO.13 What is the Role of Finance executive in today's World vis-a-vis in the past ?**

→ Today, the role of chief financial officer, or CFO, **is no longer confined to accounting, financial reporting and risk management.** → It's about **being a strategic business partner of the chief executive officer, or CEO.**

→ Some of the **key differences that highlight the changing role of a CFO are as follow :-**

**What a CFO used to do?**

- Budgeting
- Forecasting
- Accounting
- Treasury (cash management)
- Preparing internal financial reports for management.
- Preparing quarterly, annual filings for investors.
- Tax filing
- Tracking accounts payable and accounts receivable.
- Travel and entertainment expense

**What a CFO now does?**

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

OR

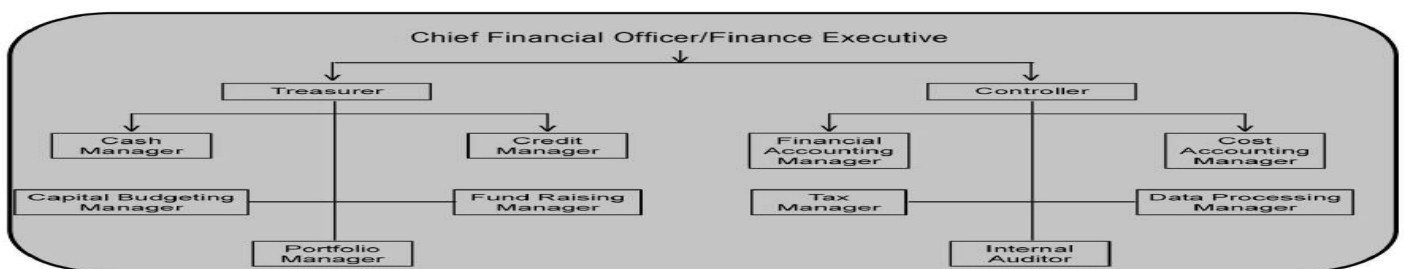
**QUESTION NO.13 List out the role of Chief Financial Officer in today's World.(NOV 2020 QUESTIONS PAPER)**

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

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

**QUESTION NO.14 How the finance function in a large organization may be organized.Explain with figure ?**

→ The figure below shows how the finance function in a large organization may be organized.



**Organisation of Finance Function**

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**QUESTION NO.15 What is Financial Distress and Insolvency? OR Explain Financial Distress and explain its relationship with insolvency. (MARCH 2018 MTP)**

**Financial Distress:** → There are various factors like price of the product/ service, demand, price of inputs e.g. raw material, labour etc., which is to be managed by an organisation on a continuous basis. → Proportion of debt also need to be managed by an organisation very delicately. Higher debt requires higher interest and if the cash inflow is not sufficient then it will put lot of pressure to the organisation. Both short term and long term creditors will put stress to the firm. → If all the above factors are not well managed by the firm, it can create situation known as distress, so financial distress is a position where Cash inflows of a firm are inadequate to meet all its current obligations.

**Insolvency:** → Now if distress continues for a long period of time, firm may have to sell its asset, even many times at a lower price. → Further when revenue is inadequate to revive the situation, firm will not be able to meet its obligations and become insolvent. → So, insolvency basically means inability of a firm to repay various debts and is a result of continuous financial distress.

**QUESTION NO.16 What is the Relationship of Financial Management and Accounting?**

**Similarity: Inputs**

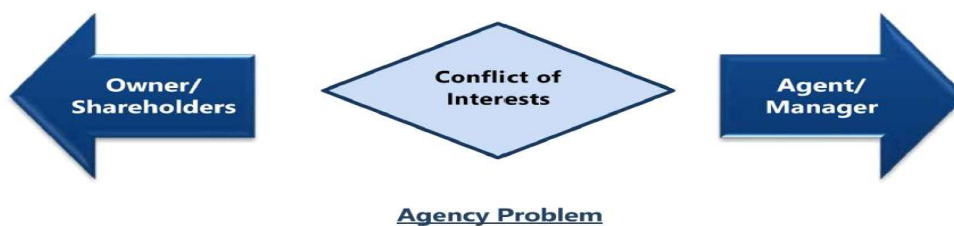
→ The relationship between financial management and accounting are closely related to the extent that accounting is an important input in financial decision making. The outcome of accounting is the financial statements such as balance sheet, income statement, and the statement of changes in financial position. → The information contained in these statements and reports helps the financial managers in evaluating the past performance and future directions of the organisation. In short these inputs helps financial managers in decision making.

**Differences:**

**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. An organisation which has earned profit (sales less expenses) may said to be profitable in the accounting sense but it may not be able to meet its current obligations due to shortage of liquidity as a result of say, uncollectible receivables. Such an organisation will not survive regardless of its levels of profits. → Whereas, the treatment of funds in financial management is based on cash flows. The revenues are recognised only when cash is actually received (i.e. cash inflow) and expenses are recognised on actual payment (i.e. cash outflow). This is so because the finance manager is concerned with maintaining solvency of the organisation by providing the cash flows necessary to satisfy its obligations .

**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 planning, controlling and decision making. Thus, in a way it can be stated that financial management begins where accounting ends.

**QUESTION NO.17 What is Agency Problem and Agency Cost ? (NOV 2020 RTP)(OCT 2020 MTP)**



→ **Agency Problem** is the chances that managers may place personal goals ahead of the goal of owners. Agency Problem leads to Agency Cost.

→ **Agency cost** is the additional cost borne by the shareholders to monitor the manager and control their

behaviour so as to maximise shareholders wealth.

→ **Agency Costs are of four types\*** (i) monitoring (ii) bonding (iii) opportunity (iv) structuring

### **Addressing the agency problem**

→ The agency problem arises **if manager's interests are not aligned to the interests of the debt lender and equity investors.**

→ The agency problem of debt lender would be addressed **by imposing negative covenants\* i.e. the managers cannot borrow beyond a point.**

→ 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:**

1. Managerial **compensation is linked to profit** of the company to some extent and also with the long term objectives of the company. 2. **Employee is also designed to address** the issue with the underlying assumption that **maximisation of the stock price** is the objective of the investors. 3. **Effecting monitoring** can be done.

### **QUESTION NO.18 Write short notes on the Functions of Finance Manager.? (MAY 2019 RTP)**

(i) Estimating the requirement of Funds: (ii) Decision regarding Capital Structure:

(iii) Investment Decision: (iv) Dividend decision:

(v) Evaluating financial performance: (vi) Financial negotiation:

(vii) Cash management: (viii) Keeping touch with stock exchange:

## TYPES OF FINANCING

### **QUESTION NO.1 What are the Financial Needs of a Business ?**

→ 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.

(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**. For example, if a company resorts to **extensive publicity and advertisement campaign** then such type of expenses may be written off over a period of 3 to 5 years. These are called deferred revenue expenses and funds required for these are classified in the category of medium term financial needs.

(iii) **Short- term financial needs:** Such type of financial needs arises to finance **current assets such as stock, debtors, cash**, etc. 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**.

### **QUESTION NO.2 What are Owners Capital or Equity Capital ?**

→ **Characteristics of Owners/Equity Share Capital are:-**

1. It is a **source of permanent capital**. The holders of such share capital in the company are called equity shareholders or ordinary shareholders.

2. Equity shareholders are practically **owners of the company** as they undertake the highest risk.

3. Equity shareholders are **entitled to dividends** after the income claims of other stakeholders are satisfied. The dividend payable to them is an appropriation of profits and not a charge against profits.

4. In the **event of winding up**, ordinary shareholders can exercise their **claim on assets** after the claims of the other suppliers of capital have been met.

5. The **cost of ordinary shares is usually the highest**. This is due to the fact that such shareholders expect a higher rate of return (as their risk is the highest) on their investment as compared to other suppliers of long-term funds.



6. Ordinary share capital also **provides a security to other suppliers of funds**. Any institution giving loan to a company would make sure the debt-equity ratio is comfortable to cover the debt.

7. There can be **various types of equity shares like New issue, Rights issue, Bonus Shares, Sweat Equity\***.

→ **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. (ii) Equity capital **increases the company's financial base** and thus helps further the borrowing powers of the company. (iii) The company is **not obliged legally to pay dividends**. Hence in times of uncertainties or when the company is not performing well, dividend payments can be reduced or even suspended. (iv) The company can make **further issue** of share capital by making a **right issue**.

→ **Disadvantages of Raising funds by issue of equity shares :**

(i) The **cost of ordinary shares is higher** because dividends are not tax deductible and also the floatation costs of such issues are higher. (ii) Investors find **ordinary shares riskier** because of uncertain dividend payments and capital gains. (iii) The issue of **new equity shares reduces the earning per share** of the existing shareholders until and unless the profits are proportionately increased. (iv) The issue of new equity shares can also **reduce the ownership and control** of the existing shareholders.

**QUESTION NO.3 Define Preference Share Capital in Brief ?**

→ **Characteristics of Preference Share Capital are:-**

1. **Long-term funds** from preference shares can be raised through a public issue of shares.
2. 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.
3. The **rate of dividend on preference shares is normally higher** than the rate of interest on debentures, loans etc.
4. Most of preference shares these days **carry a stipulation of period** and the funds have to be repaid at the end of a stipulated period.
5. Preference share capital is a **hybrid\* form of financing** which have **some characteristics of equity capital and some attributes of debt capital**. It is similar to equity because preference dividend, like equity dividend is not a tax deductible payment. It resembles debt capital because the rate of preference dividend is fixed.
6. **Cumulative Convertible Preference Shares (CCPs)** may also be offered, under which the shares would carry a cumulative dividend of specified limit for a period of say three years after which the shares are converted into equity shares. These shares are attractive for projects with a long gestation\* period.
7. Preference share capital **may be redeemed at a pre decided future date or at an earlier stage** from the profits of the company.

→ **Various types of Preference shares can be as below:**

Sl. No.	Type of Preference	Shares Salient Features
1	Cumulative	Arrear Dividend will accumulative
2	Non-cumulative	No right to arrear dividend
3	Redeemable	Redemption should be done
4	Participating	Participate also in the surplus of firm
5	Non- Participating	Only fixed rate of Dividend
6	Convertible	Option of Convert into equity Shares

→ **Advantages of raising funds by issue of preference shares are:** (MAY 2021 RTP)

(i) **No dilution in EPS**. (ii) There is **leveraging\* advantage** as it bears a fixed charge. (iii) There is **no risk of takeover** as the preference shareholders do not have voting rights. (iv) The preference **dividends are fixed and pre-decided**. Hence preference shareholders do not participate in surplus profits as the ordinary shareholders. (v) Preference capital **can be redeemed** after a specified period. (vi) Non-payment of preference dividends **does not force company into liquidity**.

→ **Disadvantages of raising funds by issue of preference shares:**

(MAY 2021 RTP)

(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 (saving) to the company. Hence a preference share is costlier to the company than debt e.g. debenture. (ii) Sometimes Preference dividends **issued are cumulative in nature**. This means that although these dividends may be omitted, they shall need to be 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 company concerned.

**QUESTION NO.4 Difference Between Equity Shares and Preference Shares ?**

Sl. No.	Basis of Distinction	Equity Share	Preference Share
1	Preference dividend	Equity Dividend paid after preference Dividend	Preference Dividend is paid before equity dividend
2	Rate of dividend	Fluctuating	Fixed
3	Convertibility	Not convertible	Convertible
4	Voting rights	Equity shareholders enjoy voting rights	They do not have voting rights

**QUESTION NO.5 What do you mean by Debentures ?**

→ **Characteristics of Debentures are:-**

1. Debentures are normally **issued in different denominations** ranging from Rs.100 to Rs.1,000 and carry different rates of interest.
2. Normally, debentures are issued on the basis of a **debenture trust deed** which lists the terms and conditions on which the debentures are floated.
3. Debentures are either **secured or unsecured**.
4. **May or may not be listed** on the stock exchange.
5. The **cost of capital raised through debentures is quite low** since the interest payable on debentures can be charged as an expense before tax.
6. From the investors' point of view, debentures offer a more attractive prospect than the preference shares since **interest on debentures is payable whether or not the company makes profits**.
7. Debentures are thus **instruments for raising long-term debt capital**.
8. 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 of their carrying the **attractive feature of getting themselves converted into shares**.

(iii) **Partly convertible debentures** - Those debentures which carry **features of both convertible and non-convertible debentures** belong to this category. The investor has the advantage of having both the features in one debenture.

→ **Other types of Debentures with their features are as follows:**

S.No.	Type of Debenture	Salient Feature
1	Bearer	Transferable like negotiable instruments
2	Registered	Interest payable to registered

3	Mortgage	person Secured by a charge on Asset(s)
4	Naked or simple	Unsecured
5	Redeemable	Repaid after a certain period
6	Non-Redeemable	Not repayable

→ **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 (inflation)**, debenture issue is advantageous for the company, as only fixed interest is required to be paid.

→ **Disadvantages of debenture financing are:**

(i) Debenture interest and capital repayment are **obligatory payments.** (ii) The **protective covenants\*** associated with a debenture issue may be restrictive. (iii) Debenture financing **enhances the financial risk** associated with the firm. (iv) Since debentures need to be paid during maturity, a **large amount of cash outflow** is needed at that time.

**QUESTION NO.6 Difference between Preference Shares and Debentures ?**

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

**QUESTION NO.7 Define Bonds\* ?**

→ Bond is fixed income security created to raise fund.

**Based on call**

Bond can be divided as:

(i) **Callable bonds** and (ii) **Puttable bonds**

(i) **Callable bonds:** A callable bond has a call option which **gives the issuer the right to redeem the bond before maturity** at a predetermined price known as the call price (Generally at a premium). Bonds are usually called when interest rates fall.

(ii) **Puttable bonds:** Puttable bonds **give the investor a put option (i.e. the right to sell the bond) back to the company before maturity.** if interest rates rise after bond purchase, this option is used by investor.

→ **Various Bonds with their salient feature are as follow:**

(I) **Foreign Bonds**

1. **Foreign Currency Convertible Bond (FCCB)**

(i) This bond comes at a **very low rate of interest.**

(ii) The advantage to the issuer is that the issuer **can get foreign currency at a very low cost.**

(iii) The **risk** is that in case the bond has to be redeemed on the date of maturity, the issuer has to make the payment and at that time the **issuer may not have the money.**

## 2. Plain Vanilla Bond\*

(i) The issuer **would pay the principal amount along with the interest rate.**

(ii) This type of bond would **not have any options.**

(iii) This bond can be issued in the form of **discounted bond (Deep Discount Bond)** or can be issued in the form of **coupon bearing bond.**

**Note:** Meaning of Deep Discount Bond will be explained afterwards.

## 3. Convertible Floating Rate Notes (FRN)

(i) A convertible FRN gives an **option to the holder to convert** it their bond into longer term debt security with a specified coupon.

(ii) It **protects an investor against falling interest rate.**

(iii) The long- term debt security **can also be sold in the market and the investor can earn profit.**

(iv) Capital gain is **not applicable to FRN,**

## 4. Drop Lock Bond

(i) It is a Floating Rate Note with a **normal floating rate.**

(ii) This floating rate bond would be **automatically converted into fixed rate bond** if interest rate falls below a predetermined level.

(iii) The new fixed rate **stays till the drop lock bond reaches its maturity.**

(iv) The difference between the convertible floating rate note and drop lock bond is that the former is **long option holder structure** and the later one is the **short option structure.**

## 5. Variable Rate Demand Obligations

(i) It is a normal floating rate note with a **nominal maturity.**

(ii) The holder of the floating rate note **can sell the obligation back to the trustee at: At par Plus accrued interest.**

(iii) It **gives the investor an option to exit, so more liquid than the normal FRN.**

## 6. Yield Curve Note (YCN)

(i) It is a **structured debt security.**

(ii) **Yield increases when prevailing interest rate declines.**

(iii) **Yield decreases when prevailing interest rate increases.**

(iv) This is used to **hedge\* the interest rate.**

(v) This works like **inverse floater\*.**

## 7. Euro Bond (NOV 2018 QUESTION PAPER)

(i) Euro bonds are debt instruments which are not denominated in the currency of the country in which they are issued. This means that the bond uses a certain currency, but operates **outside the jurisdiction of the central bank that issues that currency.**

(ii) Eurobonds are **issued by multinational corporations**, for example, **1.** a British company may issue a Euro-bond in Germany, denominating it in U.S. dollars. **2.** a Yen note floated in Germany.

(iii) It is important to note that the **term has nothing to do with the euro**, and the prefix "euro" is used more generally to refer to deposit outside the jurisdiction of the domestic central bank.



**8. Yankee Bond**

- (i) **It is a Bonds denominated in dollars.**
- (ii) Bonds **issued by non- US banks and non-US corporations.**
- (iii) **Bonds are issued in USA .**
- (iv) Bonds are to be **registered in SEC (Securities and Exchange Commission)\*.**
- (v) Bonds are issued in **tranches\*.**
- (vi) It may take up to **14 weeks** for a Yankee bond to be offered to the public.
- (vii) **Interest rate is fixed at LIBOR(London Inter bank Offering Rate).\***

**9. Samurai Bond**

- (i) **Denominated in Japanese Yen (JPY).**
- (ii) **Issued in Tokyo.**
- (iii) **Issuer is a Non- Japanese Company**
- (iv) **Regulations:** Japanese
- (v) **Purpose :** To Access Capital available in Japanese market.
- (vi) Issue proceeds can be **used to fund Japanese operation**
- (vii) Issue proceeds can also be used to **fund a company's local opportunities.**
- (viii) It can also be used to **hedge\* foreign exchange risk.**

**10. Bulldog Bond**

- (i) Denominated in **Pound Sterling/Great Britain Pound(GBP).**
- (ii) **Issued in London .**
- (iii) **Issuer Non-UK Company.**
- (iv) **Regulations :** Great Britain
- (v) **Purpose :** To access capital available in UK market.
- (vi) Issue proceeds **can be used to fund UK operation**
- (vii) Issue proceeds **can also be used to fund a company's local opportunities.**

**(II) Indian Bonds****1. Masala Bond (MAY 2018 QUESTION PAPER)**

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

**2. Municipal Bonds**

- (i) Municipal bonds are **used to finance urban infrastructure** which are increasingly important in India.
- (ii) **Ahmedabad Municipal Corporation** issued a first historical Municipal Bond in Asia to raise 100 crore from the capital market for part financing a water supply project.

**3. Government or Treasury Bonds**

Government or Treasury bonds are bonds **issued by Government of India, Reserve Bank of India, any state Government or any other Government department.**

**QUESTION NO.8 What is Bridge Finance ?(MAY 2018 RTP) (APRIL 2019 MTP)**

→ **Meaning : Bridge Finance** refers to loans taken by a company normally from commercial banks **for a short period, pending disbursement of loans sanctioned by financial institutions.**

→ **Why it is Taken** : Normally, it takes time for financial institutions to disburse loans to companies. However, once the loans are approved “**in-principle**” by the term lending institutions, companies, in order not to lose further time in starting their projects, arrange short term loans from commercial banks. **Bridge loans are also provided by financial institutions pending the signing of regular term loan agreement**, which may be delayed due to non-compliance of conditions stipulated by the institutions while sanctioning the loan.

→ **Terms** :

(a) **Interest** : The **rate of interest on bridge finance is higher** as compared with that on term loans.

(b) **Repayment** : The **bridge loans are repaid/adjusted out of the term loans** as and when disbursed by the concerned institutions.

(c) **Security** : Bridge loans are **normally secured by hypothecating movable assets, personal guarantees and promissory notes**.

→ **Example** : **Tata Motors acquired Jaguar & Land Rover** for \$ 2 billion under Bridge Loan Arrangement.

### **QUESTION NO.9 What is Venture Capital Financing ?(NOV 2020 QUESTIONS PAPER)**

→ **Meaning of Venture Capital Financing** : The venture capital financing refers to **financing of new high risky venture promoted by qualified entrepreneurs** who lack experience and funds to give shape to their ideas.

→ **Characteristics of Venture Capital Financing**

1. It is basically an **equity finance** in new companies.
2. It can be viewed as a **long term investment** in growth-oriented small/medium firms.
3. 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.

→ **Methods of Venture Capital Financing**

(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**.

(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**.

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

### **QUESTION NO.10 What is the Meaning of Debt Securitisation? OR What is debt securitisation? Explain the basics of debt securitisation process. (MAY 2019 QUESTION PAPER) (MAY 2020 RTP) (OCT 2019 MTP)**

**Meaning:**

→ Securitisation is a process in which **illiquid assets are pooled into marketable securities that can be sold to investors**.

→ It is a **method of recycling of funds**. Assets generating steady cash flows **are packaged together and against this asset pool, market securities can be issued**, e.g. housing finance, auto loans, and credit card receivables.

→ These assets **are generally secured by personal or real property such as automobiles, real estate, or equipment loans** but in some cases are unsecured.

→ The whole process is carried out in such a way that the **ultimate debtors- the car owners - may not be aware of the transaction**. They shall continue making payments the way they were doing before, however, these payments shall reach the new investors instead of the company they (the car owners) had financed their car from.

**Example of Debt Securitisation:** A finance company has issued a large number of **car loans**. It desires to raise further cash so as to be in a position to issue more loans. The company pools a large number of these loans and sells interest in the pool to investors.

#### **Advantage:**

→ This process **helps the company to raise finances and get the loans off its Balance Sheet**.

→ These finances shall **help the company disburse further loans**.

→ Similarly, the process is beneficial to the investors as it **creates a liquid investment in a diversified pool of auto loans**, which may be an attractive option to other fixed income instruments.

#### **Process of Debt Securitisation**

(i) The origination function - A borrower seeks a loan from a finance company, bank, HDFC.

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

(iii) The securitisation function - SPV will structure and issue securities on the basis of asset pool. The securities carry a coupon and expected maturity. These are generally sold to investors through merchant bankers. Investors are - pension funds, mutual funds, insurance funds.

#### **QUESTION NO.11 What are the Types of Lease Contracts ?**

→ **Types of Lease Contracts:** Broadly lease contracts can be divided into following two categories:

(a) **Operating Lease:** will be explained in next questions

(b) **Financial Lease:** will be explained in next questions

#### → **Other 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.

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

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

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

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

**QUESTION NO.12 What is the difference between Financial Lease & Operating Lease ? (NOV 2020 RTP)****Finance 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.
2. The lessee 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.
4. The lessor enters into the transaction only as financier. He does not bear the 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.

**Operating Lease**

- The lessee is only provided the use of the asset for a certain time. Risk incident to ownership belong wholly to the lessor.
- The lessor bears the risk of obsolescence. As the lessor does not have difficulty in leasing the same asset to other willing lessor, the lease is kept cancelable by the lessor.
- Usually, the lessor bears cost of repairs, maintenance or operations.
- The lease is usually non-payout, since the lessor expects to lease the same asset over and over again to several users.

**QUESTION NO.13 What are the characteristic features of Financial and Operating Lease?****→ Operating Lease : Features of Operating Lease**

- (i) It is a **short-term arrangement**.
  - (ii) It **can be cancelled** by the lessee prior to its expiration date.
  - (iii) The lease rental is generally **not sufficient to fully amortize the cost** of the asset.
  - (iv) The **cost of maintenance, taxes, insurance are the responsibility of the lessor**.
  - (v) The **lessee is protected against the risk of obsolescence**.
  - (vi) The lessor has the **option to recover the cost of the asset from another party on cancellation** of the lease by leasing out the asset.
  - (vii) The lease term is **significantly less than the economic life** of the equipment.
- These Agreements may generally be preferred by the lessee in the following circumstances:
- (a) When the **long-term suitability of asset is uncertain**.
  - (b) When the asset is **subject to rapid obsolescence**
  - (c) When the asset is required for **immediate use to tide over a temporary problem**.

**Computers & other office equipments** are very common assets which form subject matter of many operating lease agreements.

**→ Financial Lease : Features of Financial Lease**

- (i) It is a **long-term arrangement**.
- (ii) During the primary lease period, **the lease cannot be cancelled**.
- (iii) The lease is more or less **fully amortized** during the primary lease period.
- (iv) The **cost of maintenance, taxes, insurance etc., are to be incurred by the lessee** unless the contract provides otherwise.
- (v) The lessee is required to take the **risk of obsolescence**.
- (vi) The **lessor is only the Financier** and is not interested in the asset.
- (vii) The lease term generally **covers the full economic life** of the equipment.

**QUESTION NO.14 What are the sources of short term financial requirement of the company? (MAY 2018 QUESTION PAPER)(NOV 2019 QUESTIONS PAPER)**

- (i) Trade Credit:/(ii) Accrued Expenses and Deferred Income:/(iii) Advances from Customers/(iv) Commercial Paper:
- (v) Treasury Bills:/(vi) Certificates of Deposit (CD):/(vii) Bank Advances:

**Note:** You need to write 2 to 3 lines for each. Details given in next question.



**QUESTION NO.15 Write short notes on :**

**(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'**. → Trade credit is preferred as a source of finance because it is **without any explicit cost** and till a business is a going concern it **keeps on rotating**. Another very important characteristic of trade credit is that it **enhances automatically with the increase in the volume of business**.

**(ii) Accrued Expenses and Deferred Income :** → Accrued expenses **represent liabilities which a company has to pay for the services** which it has already received like **wages, taxes, interest and dividends**. → Such expenses arise out of the **day-to-day activities** of the company and hence represent a **spontaneous source of finance**. → Deferred income, on the other hand, reflects the amount of **funds received by a company in lieu of goods and services to be provided in the future**. → Since these receipts **increase a company's liquidity**, they are also considered to be an **important source of spontaneous 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 :** (**OCT 2020 MTP**) → A Commercial Paper is an **unsecured money market instrument** issued in the form of a **promissory note**. → The Reserve Bank of India introduced the commercial paper scheme in the year 1989 with a view to **enabling highly rated corporate borrowers** to diversify their sources of **short-term borrowings** and to provide an **additional instrument to investors**. → Subsequently, in addition to the **Corporate, Primary Dealers and All India Financial Institutions** have also been allowed to issue Commercial Papers. → Commercial papers are issued in **denominations of Rs. 5 lakhs or multiples** thereof and the **interest rate is generally linked to the yield on the one-year government bond**. → All eligible issuers are **required to get the credit rating** from Credit Rating Information Services of India Ltd, (**CRISIL**), or the Investment Information and Credit Rating Agency of India Ltd (**ICRA**) or the Credit Analysis and Research Ltd (**CARE**) or the **FITCH** Ratings India Pvt. Ltd or any such other credit rating agency as is specified by the Reserve Bank of India.

**(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**. → 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**.

**(ix) Bank Advances :** **Some of the facilities provided by banks are**

- |                              |                                    |  |
|------------------------------|------------------------------------|--|
| <b>(a) Short Term Loans:</b> | <b>(b) Overdraft:</b>              | <b>(c) Clean Overdrafts:</b>           |
| <b>(d) Cash Credits:</b>     | <b>(e) Advances against goods:</b> | <b>(f) Bills Purchased/Discounted:</b> |

**QUESTION NO.16 Write a short note on Financing of Export Trade by Banks ?**

→ **The advances by commercial banks for export financing are in the form of:**

(i) Pre-shipment finance i.e., before shipment of goods. (ii) Post-shipment finance i.e., after shipment of goods.  
**Pre-shipment Finance : (Packing Credit) : Types of Packing Credit :** (a) Clean packing credit: (b) Packing credit against hypothecation\* of goods: (c) Packing credit against pledge\* of goods: (d) E.C.G.C. guarantee: (e) Forward exchange contract:

**Post-shipment Finance: Types** (a) Purchase/discounting of documentary export bills: (b) E.C.G.C. Guarantee: (c) Advance against export bills sent for collection: (d) Advance against duty draw backs, cash subsidy, etc.:

### QUESTION NO.17 Write a short note on Packing Credit ? (MAY 2018 RTP)

→ This generally takes the **form of packing credit facility**; → Packing credit is an **advance extended by banks to an exporter** for the purpose of buying, manufacturing, processing, packing, shipping goods to overseas buyers. → Any exporter, having at hand a firm **export order** placed with him by his foreign buyer or an irrevocable letter of credit\* opened in his favour, **can approach a bank for availing of packing credit**. → An advance so taken by an exporter is **required to be liquidated within 180 days** from the date of its commencement by negotiation of export bills or receipt of export proceeds in an approved manner. → Thus packing credit is essentially a **short-term advance**. → Normally, banks insist upon their customers to lodge with them **irrevocable letters of credit** opened in favour of the customers by the overseas buyers. → The letter of credit and firm sale contracts not only **serve as evidence of a definite arrangement** for realisation of the export proceeds but also indicate the amount of finance required by the exporter. → Packing credit, in the case of **customers of long standing**, may also be granted against firm contracts entered into by them with overseas buyers.

**Types of Packing Credit :** Explained in Previous Question

### QUESTION NO.18 What are the other sources of Financing ?

#### (i) Seed Capital Assistance :

→ **Scheme For:** 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.

→ **Applicability :** All the **projects eligible for financial assistance from IDBI**, directly or indirectly through refinance are eligible under the scheme.

→ **Amount Of Finance :** The project cost should not exceed **Rs. 2 crores** and the maximum assistance under the project will be restricted to **50% of the required promoter's contribution or Rs. 15 lacs whichever is lower**.

→ **Interest & Charge :** The Seed Capital Assistance is **interest free but carries a service charge of one per cent per annum for the first five years** and at increasing rate thereafter.

→ **Repayment :** The repayment schedule is fixed **depending upon the repaying capacity of the unit with an initial moratorium\* upto five years**.

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

(iii) **Zero Coupon Bonds :** → A Zero Coupon Bonds **does not carry any interest** but it is **sold by the issuing company at a discount**. → The **difference between the discounted value and maturing or face value represents the interest** to be earned by the investor on such bonds.

**Note:** Conceptually both Deep Discount Bonds & Zero Coupon Bonds are same.

#### (iv) Secured Premium Notes :

(a) **Meaning:** Secured Premium Notes are **debt instruments issued along with a detachable warrant\*** and is

**redeemable** after a specified period (**4 to 7 Years**)

**(b) Option to Convert:** SPN's carry **an option to convert into Equity Shares**, i.e. the detachable warrant can be converted into Equity Shares.

**(c) Period for Conversion:** Conversion of detachable warrant into Equity Shares **should be done within a time period specified by the company.**

**(d)** This was **first introduced by TISCO** in India.

**(v) Zero Interest Fully Convertible Debentures :**

→ These are fully convertible debentures which **do not carry any interest.**

→ The debentures are **compulsorily and automatically converted** after a specified period of time and holders thereof are entitled to new equity shares of the company at predetermined price.

→ **From the point of view of company** this kind of instrument is beneficial in the sense that **no interest is to be paid on it,**

→ **From the point of view of holder :** if the share price of the company in the market is very high than the investors **tends to get equity shares of the company at the lower rate.**

**(vi) Option Bonds :**

→ These are **cumulative and non-cumulative bonds** where interest is payable on maturity or periodically.

→ **Redemption premium** is also offered to attract investors.

→ These were recently issued by **IDBI, ICICI** etc.

**(vii) Inflation Bonds :**

→ Inflation Bonds are the bonds in which **interest rate is adjusted for inflation.**

→ Thus, the investor gets **interest which is free from the effects of inflation.**

→ **For example,** if the interest rate is **11 per cent and the inflation is 5 per cent, the investor will earn 16 per cent** meaning thereby that the investor is protected against inflation.

**(viii) Floating Rate Bonds : (MAY 2018 RTP)**

→ This as the name suggests is bond where the **interest rate is not fixed and is allowed to float depending upon the market conditions.**

→ This is an ideal instrument which can be resorted to by the issuer to **hedge\* themselves against the volatility\* in the interest rates.**

→ This has become more **popular as a money market instrument** and **has been successfully issued by financial institutions like IDBI, ICICI etc.**

**QUESTION NO.19 Write a short notes on Sources Of International Financing ?**

→ Some of which are

**(a) Fully Hedged Bonds:** → As mentioned above, **in foreign bonds, the risk of currency fluctuations exists.**

→ Fully hedged bonds **eliminate the risk by selling in forward markets** the entire stream of principal and interest payments. **(NOV 2018 QUESTION PAPER)**

**(b) Floating Rate Notes (FRN):** → These are issued **up to seven years maturity.** → Interest rates **are adjusted to reflect the prevailing exchange rates.** → They provide **cheaper money than foreign loans.** **(NOV 2018 QUESTION PAPER)**

**(c) Euro Commercial Papers (ECP):** → ECPs are **short term money market instruments.** → They are **for maturities**

less than one year. → They are **usually designated in US Dollars.**

(NOV 2018 QUESTION PAPER)

**(d) Euro Convertible Bonds:** → A convertible bond is a **debt instrument which gives the holders of the bond an option to convert the bonds** into a pre-determined number of equity shares of the company. → Usually the price of the equity shares at the time of conversion **will have a premium element.** → These bonds **carry a fixed rate of interest** and → if the issuer company so desires **may also include a Call Option** (where the issuer company has the option of calling/ buying the bonds for redemption prior to the maturity date) **or → a Put Option** (which gives the holder the option to put/sell his bonds to the issuer company at a pre-determined date and price).

**(e) External Commercial Borrowings (ECB):** → ECBs refer to **commercial loans** [in the form of bank loans, buyers credit, suppliers credit, securitised instruments (e.g. floating rate notes and fixed rate bonds)] **availed from non-resident lenders with minimum average maturity of 3 years.** → **Borrowers can raise ECBs through internationally recognised sources like (i) International banks (ii) International capital markets (iii) Multilateral financial institutions such as the IFC, ADB etc (iv) Export credit agencies. (v) Suppliers of equipment, (vi) foreign collaborators and (vii) Foreign equity holders.** → **External Commercial Borrowings can be accessed under two routes viz (i) Automatic route and (ii) Approval route.** → Under the **Automatic route there is no need to take the RBI/Government approval whereas such approval is necessary under the Approval route.** → Company's registered under the **Companies Act and NGOs** engaged in micro finance activities are eligible for the **Automatic Route whereas Financial Institutions and Banks** dealing exclusively in infrastructure or export finance and the ones which had participated in the textile and steel sector restructuring packages as approved by the government are required to **take the Approval Route.**

**(f) Euro Issues by Indian Companies :**

**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. → ADRs are **issued by an approved New York bank or trust** company against the deposit of the original shares. → These are **deposited in a custodial account** in the US. → Such receipts have to be issued in accordance with the provisions stipulated by the **Security Exchange Commission USA.** → ADRs can be traded either by **trading existing ADRs** or **purchasing the shares in the issuer's home market and having new ADRs created,** based upon availability and market conditions. → When trading in **existing ADRs,** the trade is executed on the **secondary market on the New York Stock Exchange (NYSE) through Depository Trust Company (DTC)** without involvement from foreign brokers or custodians. → The process of **buying new, issued ADRs goes through US brokers, Helsinki Exchanges and DTC as well as Deutsche Bank.** → When transactions are made, the **ADRs change hands, not the certificates.** This eliminates the actual transfer of stock certificates between the US and foreign countries. → **Example of Indian ADRs : Infosys Technologies** became the first Indian company to issue

**Global Depository Receipts (GDRs):**

→ These are **negotiable certificate** 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.** → **Indian Example :** Among the Indian companies, **Reliance Industries Ltd. was the first company** (1992) to raise funds through a GDR Issue.



**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. → **Recent Example: Standard Chartered** issued Indian Depository Receipts (IDRs). The UK bank received an approval from the RBI for the issue. → **Listing:** These IDRs is **listed on stock exchanges in India and is freely transferable.** → **Benefits to Indian Investors:** IDR is an **additional investment opportunity** for Indian investors for overseas investment.

**QUESTION NO.20 Why GDR is more popular than ADR?**

→ In a bid to bypass the **stringent disclosure norms** mandated by the SEC for equity shares, the Indian companies have however, chosen the indirect route to tap the vast American financial market through private debt placement of GDRs listed in London and Luxembourg Stock Exchanges.

→ The Indian companies have preferred the GDRs to ADRs because the **US market exposes them to a higher level or responsibility** than a European listing in the **areas of disclosure, costs, liabilities and timing.**

→ The SECs regulations set up to protect the retail investor base 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.**

→ ADRs are **also costlier** than Global Depository Receipts (GDRs). **Legal fees** are considerably high for US listing. **Registration fee** in USA is also substantial. **Hence ADRs are less popular than GDRs.**

**QUESTION NO.21 "Financing a business through borrowing is cheaper than using equity." Briefly EXPLAIN. (MAY 2020 MTP)**

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

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

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

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

**QUESTION NO.22 EXPLAIN in short the term Letter of Credit. (MAY 2020 MTP)**

→ 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.

**RISK ANALYSIS IN CAPITAL BUDGETING****QUESTION NO.1 What are the three types of decision making in risk analysis in capital budgeting ?**

(i) **Decision making under certainty** : When cash flows are certain

(ii) **Decision making involving risk** : When cash flows involve risk and probability can be assigned.

(iii) **Decision making under uncertainty** : When the cash flows are uncertain and probability cannot be assigned.

**QUESTION NO.2 What are Some of the sources of risk ? (MARCH 2018 MTP)**

**1. Project-specific risk**- Risks which are related to a particular project and affects the project's cash flows, includes completion of the project in scheduled time, error of estimation in resources and allocation, estimation of cash flows etc. For example, a nuclear power project of a power generation company has different risks than hydel projects.



**2. Company specific risk-** Risk which arise due to company specific factors like downgrading of credit rating, changes in key managerial persons, cases for violation of Intellectual Property Rights (IPR) and other laws and regulations, dispute with workers etc. All these factors affect the cash flows of an entity and access to funds for capital investments. For example, two banks have different exposure to default risk.

**3. Industry-specific risk-** These are the risks which effects the whole industry in which the company operates. The risks include regulatory restrictions on industry, changes in technologies etc. For example, regulatory restriction imposed on leather and breweries\* industries.

**4. Market risk -** The risk which arise due to market related conditions like entry of substitute, changes in demand conditions, availability and access to resources etc. For example, a thermal power project gets affected if the coal mines are unable to supply coal requirements of a thermal power company etc.

**5. Competition risk-** These are risks related with competition in the market in which a company operates. These risks are risk of entry of rival, product dynamism and change in taste and preference of consumers etc.

**6. Risk due to Economic conditions -** These are the risks which are related with macro-economic conditions like changes in monetary policies by central banks, changes in fiscal policies like introduction of new taxes and cess, inflation, changes in GDP, changes in savings and net disposable income etc.

**7. International risk -** These are risk which are related with conditions which are caused by global economic conditions like restriction on free trade, restrictions on market access, recessions, bilateral agreements, political and geographical conditions etc. For example, restriction on outsourcing of jobs to overseas markets.

### QUESTION NO.3 What are the Reasons for Adjustment of Risk in Capital Budgeting Decision ?(NOV18 QUESTIONS PAPER)

→ Main reasons for considering risk in capital budgeting decisions are as follows

1. There is an **opportunity cost** involved while investing in a project for the level of risk. Adjustment of risk is necessary to help make the decision as to whether the returns out of the project are proportionate with the risks borne and whether it is worth investing in the project over the other investment options available.
2. Risk adjustment is required to know the **real value** of the Cash Inflows.

### QUESTION NO.4 Write short notes on following :

#### Risk Adjusted Discount Rate (NOV 2020 QUESTIONS PAPER)

→ The use of risk adjusted discount rate is based on the concept that **investors demands higher returns from the risky projects.**

→ The required return of return on any investment should include compensation equal to **risk free rate of return, plus compensation** for any kind of risk taken on.

→ A risk adjusted discount rate is a **sum of risk free rate and risk premium.**

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

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

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

→ **Advantages of Risk-adjusted discount rate :**(1) It is **easy to understand.** (2) It **incorporates risk premium** in the discounting factor.

→ **Limitations of Risk-adjusted discount rate :**(1) **Difficulty in finding risk premium and risk-adjusted discount rate.** (2) Assumption that **investors are risk averse\*** is always not true.

#### Certainty Equivalent (CE) Method for Risk Analysis (MAY 2018 QUESTION PAPER)

→ The certainty equivalent is a **guaranteed return** that the management would accept **rather than accepting a**

**higher but uncertain return.**

→ In this approach a **set of risk less cash flow** is generated in **place of the original cash flows**.

→ It is important to note that the value of Certainty Equivalent **Coefficient lies between 0 & 1**. Certainty Equivalent Coefficient 1 **indicates that the cash flow is certain** or management is risk neutral.

**Steps in the Certainty Equivalent (CE) approach**

**Step 1** : Remove risk by **substituting equivalent certain cash flows from risky cash flows**. This can be done by multiplying each risky cash flow by the appropriate  $\alpha_t$  value (CE coefficient)

$$\alpha_t = \frac{\text{Certain CashFlow}}{\text{Risky or Expected CashFlow}_t}$$

**Step 2** : Obtain **discounted value of cash flow by applying riskless rate of interest**.

**Step 3** : Apply normal capital budgeting method to **calculate NPV by using the firm's required rate of return**.

$$NPV = \sum_{t=0}^n \frac{\alpha_t NCF_t}{(1+k_f)^t} - I$$

Where,  $NCF_t$  = the forecasts of net cash flow without risk-adjustment;  $\alpha_t$  = the risk-adjustment factor or the certainty equivalent coefficient;  $K_f$  = risk-free rate assumed to be constant for all periods.

**Advantages of Certainty Equivalent Method**

(1) The certainty equivalent method is **simple and easy to understand and apply**. (2) It can easily be calculated for **different risk levels applicable to different cash flows**. For example, if in a particular year, a higher risk is associated with the Cash Flow, it can be easily adjusted and the NPV can be recalculated accordingly.

**Disadvantages of Certainty Equivalent Method**

1. → There is **no Statistical model available to estimate certainty Equivalent**. → **Assumption of risk being subjective**, it varies on the perception of the risk by the management because of bias and individual opinions involved. 2. There is **no objective or mathematical method to estimate certainty equivalents**. 3. Certainty equivalents are decided by the management based on their perception of risk. However the **risk perception of the shareholders who are the money lenders for the project is ignored**. Hence it is not used often in corporate decision making.

**Sensitivity Analysis (MAY 2019 QUESTION PAPER)**

→ Definition of sensitivity analysis: As per CIMA terminology, "A modeling and risk assessment procedure in which **changes are made to significant variables** in order to determine the effect of these changes on the planned outcome. → **Particular attention** is thereafter paid to variables identified as being of special significance"

→ Sensitivity analysis put in simple terms is a **modeling technique which is used in Capital Budgeting decisions** which is used to study the impact of changes in the variables on the outcome of the project. → In a Project, **several variables like Weighted average cost of capital, consumer demand, price of the product, cost price per unit etc. operate simultaneously**. The changes in these variables impact the outcome of the project. → It therefore becomes very **difficult to assess change in which variable impacts the project outcome** in a significant way. → In Sensitivity Analysis, the **project outcome is studied after taking into change in only one variable**.

→ The **more sensitive is the NPV, the more critical is that variable**. → So, Sensitivity analysis is a way of **finding impact in the project's NPV (or IRR) for a given change in one of the variables**.

→ **Steps involved in Sensitivity Analysis**: 1. **Finding variables**, which have an influence on the NPV (or IRR) of the project 2. **Establishing mathematical relationship** between the variables. 3. **Analysis the effect of the change in each of the variables** on the NPV (or IRR) of the project.

→ **Advantages of Sensitivity Analysis** : (1) **Critical Issues** : This analysis identifies critical factors that impinge on a project's success or failure. (2) **Simplicity** : This analysis is quite simple.

→ **Disadvantage of Sensitivity Analysis** : (1) **Assumption of Independence**: This analysis assumes that all variables are independent i.e. they are not related to each other, which is unlikely in real life. (2) **Ignore probability**: This analysis does not look to the probability of changes in the variables. (3) **Not so reliable**: This analysis provides information on the basis of which decisions can be made but does not point directly to the correct decision.

### Scenario Analysis

→ Although **sensitivity analysis** is probably the most widely used risk analysis technique, **it does have limitations**. Therefore, we need to extend sensitivity analysis to deal with the **probability distributions** of the inputs. In addition, it would be useful to **vary more than one variable at a time** so we could see the combined effects of changes in the variables. → Scenario analysis **provides answer to these situations of extensions**. This analysis brings in the **probabilities** of changes in key variables and **also allows us to change more than one variable** at a time. → This analysis **begins with base case or most likely** set of values for the input variables. Then, go for **worst case scenario** (low unit sales, low sale price, high variable cost and so on) and **best case scenario**. → So, in a nutshell **Scenario analysis examine the risk of investment**, so as to analyse the impact of alternative combinations of variables, **on the project's ,NPV (or IRR).**

### Risk-adjusted Discount Rate Vs. Certainty-Equivalent

→ Certainty Equivalent Method is superior to Risk Adjusted Discount Rate Method as it **does not assume that risk increases with time at constant rate**. → **Each year's** Certainty Equivalent Coefficient is **based on level of risk impacting its cash flow**. → Despite its soundness, it is **not preferable** like Risk Adjusted Discount Rate Method. It is **difficult to specify a series of Certainty Equivalent Coefficients** but **simple to adjust discount rates**.

### Scenario Analysis Vs Sensitivity Analysis

→ Sensitivity analysis and Scenario analysis **both help to understand the impact of the change in input variable** on the outcome of the project. → However, there are certain **basic differences between the two**. → Sensitivity analysis calculates the impact of the change of a **single input variable** on the outcome of the project viz., NPV or IRR. The sensitivity analysis thus enables to identify that single critical variable that can impact the outcome in a huge way and the range of outcomes of the project given the change in the input variable. → Scenario analysis, on the other hand, **is based on a scenario**. The scenario **may be recession or a boom** wherein depending on the scenario, **all input variables change**. Scenario Analysis calculates the outcome of the project considering this scenario where the **variables have changed simultaneously**. Similarly, the outcome of the project would also be considered for the **normal and recessionary situation**. The variability in the outcome under the three different scenarios would **help the management to assess the risk a project carries**. **Higher deviation** in the outcome can be assessed as **higher risk** and lower to medium deviation can be assessed accordingly. → **Scenario analysis is far more complex than sensitivity analysis** because in scenario analysis **all inputs are changed simultaneously** considering the situation in hand while in **sensitivity analysis only one input is changed and others are kept constant**.

**Note:** For more details on Scenario Analysis and Sensitivity Analysis, please refer class practical questions.

## MISCELLANEOUS

### QUESTION NO.1 Why "Financial Leverage is a double-edged sword" DISCUSS. (MAY 2018 RTP)

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



sword".

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

### **QUESTION NO.2 What is PAYBACK PERIOD RECIPROCAL ? (NOV 2019 RTP)(APRIL 2018 MTP)**

→ **Meaning** : It is the reciprocal of payback period.

→ **Formula** : Payback Reciprocal =  $\frac{1}{\text{Payback Period}}$

→ **Decision** : The higher the Payback Period Reciprocal ( and hence lower the payback period ) the more worthwhile the project becomes .

→ **Close Approximation of IRR**: It is generally argued that the reciprocal of the payback would be a close approximation of the internal rate of return if the life of the project is more than twice the payback period and the project generates equal amount of the annual cash inflows.

→ **Example** - Suppose a project requires an initial investment of Rs.20,000 and it would give annual cash inflow of Rs.4000. The useful life of the project is 15 years. Payback Period is 5 years.

Payback Reciprocal =  $\frac{1}{\text{Payback Period}} = \frac{1}{5} = 20\%$  ; If we calculate IRR of this project it will be approximately 19%

### **QUESTION NO.3 State the function of treasury department.(NOV 2019 RTP)**

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

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

3. **Fund Management**: Treasury department is responsible for planning and sourcing the company's short, medium and long-term cash needs.

4. **Banking**: It is important that a company maintains a good relationship with its bankers. Treasury department carry out negotiations with bankers 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.

### **QUESTION NO.4 State modified Internal Rate of Return method.(MARCH 2018 MTP)**

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

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

→ 
$$\text{MIRR} = \sqrt[n]{\frac{\text{Terminal Cash Flow}}{\text{Initial Outflow}}} - 1$$

### **QUESTION NO.5: "Operating risk is associated with cost structure, whereas financial risk is associated with capital structure of a business concern." Critically examine the statement. OR Explain the difference between Business risk and Financial Risk. (APRIL 2018 MTP)(MARCH 2019 MTP)**

→ "Operating risk is associated with cost structure whereas financial risk is associated with capital structure of

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

**QUESTION NO.6 Discuss in briefly any two long term sources of finance for a partnership firm.?(APRIL 18 MTP)**

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

→ **Loans from Commercial Banks:** Commercial banks provide long term loans **for the purpose of expansion or setting up of new units**. Their repayment is usually scheduled over a long period of time. The liquidity of such loans is said to depend on the anticipated income of the borrowers. As part of the long term funding for a partnership firm, the banks also fund the long term **working capital requirement (it is also called WCTL i.e. working capital term loan)**.

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

**QUESTION NO.7 Discuss the limitations of financial ratios.?(APRIL 2018 MTP)**

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

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

(iii) Seasonal factors may also influence financial data.

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

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

(vi) There is no standard set of ratios against which a firm's ratios can be compared: Sometimes a firm's ratios are compared with the industry average. But if a firm desires to be above the average, then industry average becomes a low standard. On the other hand, for a below average firm, industry averages become too high a standard to achieve.

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

**QUESTION NO.8 List the factors determining the dividend policy of a company.?(MARCH 2019 MTP)**

(i) **Liquidity:** In order to pay dividends, a company will require access to cash. Even very profitable companies might sometimes have difficulty in paying dividends if resources are tied up in other forms of assets.

(ii) **Repayment of debt:** Dividend payout may be made difficult if debt is scheduled for repayment.

(iii) **Stability of Profits:** Other things being equal, a company with stable profits is more likely to pay out a higher percentage of earnings than a company with fluctuating profits.

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**(iv)Control:** The use of retained earnings to finance new projects preserves the company's ownership and control. This can be advantageous in firms where the present disposition of shareholding is of importance.

**(v)Legal consideration:** The legal provisions lay down boundaries within which a company can declare dividends.

**(vi)** Likely effect of the declaration and quantum of dividend on market prices.

**(vii)** Tax considerations and

**(viii)** Others such as dividend policies adopted by units similarly placed in the industry, management attitude on dilution of existing control over the shares, fear of being branded as incompetent or inefficient, conservative policy Vs non-aggressive one.

**(ix)Inflation:** Inflation must be taken into account when a firm establishes its dividend policy.

**QUESTION NO.9 Discuss the dividend-price approach to estimate cost of equity capital.?(MARCH 2019 MTP)**

→ In dividend price approach, cost of equity capital is computed by dividing the expected dividend by market price per share. This ratio expresses the cost of equity capital in relation to what yield the company should pay to

attract investors. It is computed as:  $K_e = \frac{D_1}{P_0}$  Where,  $D_1$  = Dividend per share in period 1;  $P_0$  = Market price per share today.

**QUESTION NO.10 Explain the principles of "Trading on Equity."?(APRIL 2019 MTP)**

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

**QUESTION NO.11 State virtual Banking?Discuss its advantages.?(APRIL 2019 MTP)**

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

→ **The advantages of virtual banking services are as follows:**

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

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

**QUESTION NO.12 Explain Concentration Banking.(APRIL 2019 MTP)**

→ **Concentration Banking:** In concentration banking the company establishes a number of strategic collection centres in different regions instead of a single collection centre at the head office. This system reduces the period between the time a customer mails in his remittances and the time when they become spendable funds with the company. Payments received by the different collection centers are deposited with their respective local banks which in turn transfer all surplus funds to the concentration bank of head office.

**QUESTION NO.13 Explain the concept of discounted payback period.(OCT 2019 MTP)**

→ Payback period is time taken to recover the original investment from project cash flows. It is also termed as break even period. The focus of the analysis is on liquidity aspect and it suffers from the limitation of ignoring time value of money and profitability. Discounted payback period considers present value of cash flows, discounted

at company's cost of capital to estimate breakeven period i.e. it is that period in which future discounted cash flows equal the initial outflow. The shorter the period, better it is. It also ignores post discounted payback period cash flows.

### **QUESTION NO.14 EXPLAIN in brief the Pecking order theory.(MAY 2020 MTP)**

- This theory states that firms prefer to issue debt when they are positive about future earnings. Equity is issued when they are doubtful and internal finance is insufficient.
- The pecking order theory argues that the capital structure decision is affected by manager's choice of a source of capital that gives higher priority to sources that reveal the least amount of information.

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

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

**Rule 1:** Use internal financing first.

**Rule 2:** Issue debt next

**Rule 3:** Issue of new equity shares at last

### **QUESTION NO.15 EXPLAIN Over-capitalisation. STATE its causes and consequences.(MAY 2020 MTP)**

#### **Over-capitalization and its Causes and Consequences:**

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

#### **Causes/Reasons of Over Capitalization:**

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

#### **Consequences of Over-Capitalisation:**

- (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.

### **QUESTION NO.16 Explain the steps while using the equivalent annualized criterion.(NOV 2019 QUESTIONS PAPER)**

**Equivalent Annualized Criterion:** This method involves the following steps-

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

### **QUESTION NO.17 Explain the significance of Cost of Capital.(NOV 2019 QUESTIONS PAPER)**

→ **Significance of the Cost of Capital:** The cost of capital is important to arrive at correct amount and helps the management or an investor to take an appropriate decision. The correct cost of capital helps in the following decision making:

- (i) **Evaluation of investment options:** The estimated benefits (future cashflows) from available investment



opportunities (business or project) are converted into the present value of benefits by discounting them with the relevant cost of capital. Here it is pertinent to mention that every investment option may have different cost of capital hence it is very important to use the cost of capital which is relevant to the options available. Here Internal Rate of Return (IRR) is treated as cost of capital for evaluation of two options (projects).

**(ii) Performance Appraisal:** Cost of capital is used to appraise the performance of a particular project or business. The performance of a project or business is compared against the cost of capital which is known here as cut-off rate or hurdle rate.

**(iii) Designing of optimum credit policy:** While appraising the credit period to be allowed to the customers, the cost of allowing credit period is compared against the benefit/profit earned by providing credit to customer of segment of customers. Here cost of capital is used to arrive at the present value of cost and benefits received.

### **QUESTION NO.18 Distinguish between Unsystematic Risk AND systematic Risk.(NOV 2020 EXAM PAPER)**

#### **Solution:**

→ **Total Risk = Systematic Risk + Unsystematic Risk**

#### **Systematic Risk or Non-Diversifiable Risk or Market Risk**

→ This risk affects **all companies** operating in the market.

→ They are **beyond the control** by the management of entity.

→ **Example** : Interest Rate; Inflation ; Taxation; Political Development ; Credit Policy.

→ Systematic Risk is also called **non-diversifiable risk** as it cannot be reduced with the help of diversification.

#### **Unsystematic Risk or Diversifiable Risk or Specific Risk**

→ This risk affects only a **particular security / company** .

→ They **can be controlled** by the management of entity.

→ **Example** : Strikes, change in management, special export order, the research & development expert of company leaves; a formidable competitor enters the market, the company loses a big contract in a bid etc .

→ Unsystematic Risk are also called **Diversifiable Risk** as they can be eliminated through Diversification.

### **QUESTION NO.19 EXPLAIN Billing float and Mail float with reference to management of cash.**

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

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

### **QUESTION NO.20 STATE any four factors which need to be considered while planning for working capital requirement.**

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

**(i) Cash:** Identify the cash balance which allows for the business to meet day- to-day expenses, but reduces cash holding costs.

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

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

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

**(v) Nature of Business:** For e.g. in a business of restaurant, most of the sales are in Cash. Therefore, need for working capital is very less.

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

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

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

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

### **QUESTION NO.21 Explain Electronic Cash Management System ?**

Most of the cash management systems now-a-days are electronically based, since 'speed' is the essence of any cash management system. Electronically, transfer of data as well as funds play a key role in any cash management system. Various elements in the process of cash management are linked through a satellite. Various places that are interlinked may be the place where the instrument is collected, the place where cash is to be transferred in company's account, the place where the payment is to be transferred etc. Certain networked cash management system may also provide a very limited access to third parties like parties having very regular dealings of receipts and payments with the company etc. A finance company accepting deposits from public through sub-brokers may give a limited access to sub-brokers to verify the collections made through him for determination of his commission among other things.

#### **Electronic-scientific cash management results in:**

- Significant saving in time.
- Increase in Interest earned & Decrease in interest expense.
- Reduces paper work & hence manpower.
- Greater accounting accuracy as it allows easy detection of book-keeping errors.
- More control over time and funds.
- Supports electronic payments.
- Faster transfer of funds from one location to another, where required.
- Speedy conversion of various instruments into cash.
- Making available funds wherever required, whenever required.
- Reduction in the amount of 'idle float' to the maximum possible extent.
- Ensures no idle funds are placed at any place in the organization.
- It makes inter-bank balancing of funds much easier.
- It is a true form of centralized 'Cash Management'.
- Produces faster electronic reconciliation.
- Reduces the number of cheques issued.

### **QUESTION NO.22 Define Internal Rate of Return (IRR) ?**

The internal rate of return method considers the time value of money, the initial cash investment, and all cash flows from the investment. But unlike the net present value method, the internal rate of return method does not use the desired rate of return but estimates the discount rate that makes the present value of subsequent cash inflows equal to the initial investment. This discount rate is called IRR.

IRR Definition: 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.

This IRR is then compared to a criterion rate of return that can be the organization's desired rate of return for evaluating capital investments.

**Calculation of IRR:** Lower Rate +  $\frac{\text{Lower Rate NPV}}{\text{Lower Rate NPV} - \text{Higher Rate NPV}} \times (\text{Higher Rate} - \text{Lower Rate})$

**QUESTION NO.23 Explain in brief the following bonds: (i) Callable Bonds (ii) Puttable Bonds**

Based on call Bond can be divided as

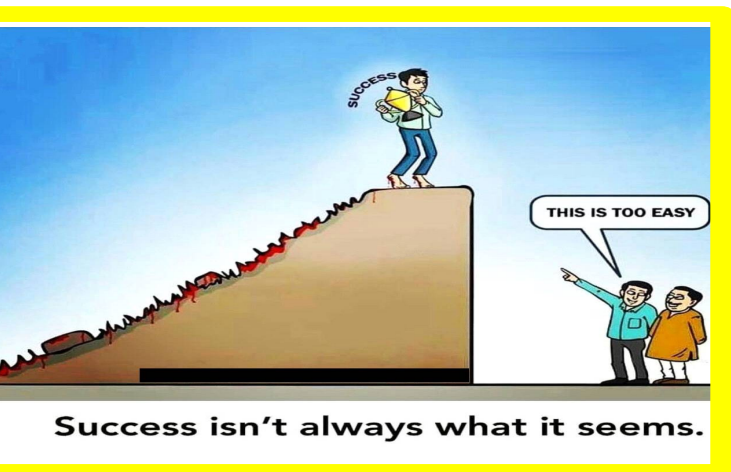
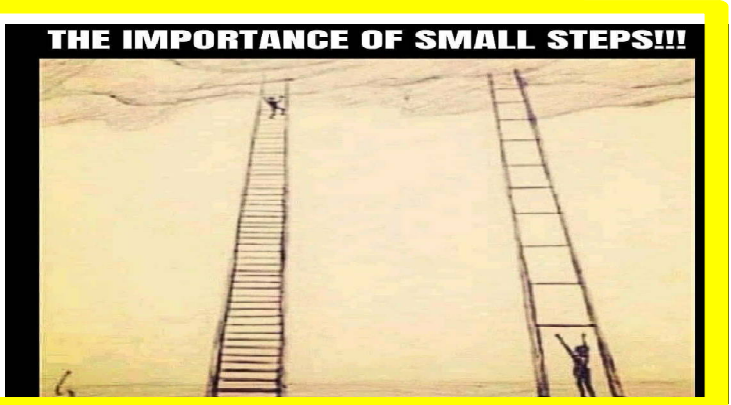
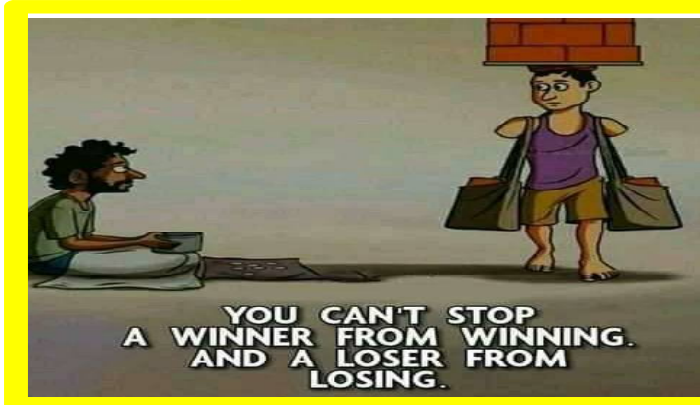
(i) Callable bonds and (ii) Puttable bonds

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

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

**Speak 5 lines to YOURSELF Every Morning**

1. I am the Best.
2. I Can do it.
3. God is always with Me.
4. I am a Winner.
5. Today is my Day.



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