

The Best CA Final MAFA

Suggestion-Nov09

By

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Undisputed Name For MAFA/SFM

Visiting Faculty Of ICAI

“It’s Time To Be Busy BECAUSE Today Will Be Yesterday Very Soon ”

When nothing seems to help,I go & look at a stonecutter hammering away at his rock , perhaps a hundred times, with no crack showing in it.Yet, at the hundred-and-one blow it will spilt into two , and I know it was not that blow that did it but all that had gone before.

Remember ,Failure is not final –until you make it final.

“I’ve missed more than 9000 shots in my career. I’ve lost almost 300 games. Twenty-six times I’ve been trusted to take the game winning shot and missed.

I’ve failed over and over and over again in my life.

And that is why I succeed.”

Michael Jordan

We make our own fortunes and call them fate.

From the desk of CA Aaditya Jain

The Importance Of Patience In CA Career



Sometimes in life there are situations which makes you to loose your patience. The best way to react at these situation is not to react at all. These situations are meant just to distract you from your goal. Believe it or not a one minute involvement in such situation will take away your 2-5 hours of precious time or sometimes even more. When ever you encounter such situation just keep your head cool and try to get out of the atmosphere if possible and afterwards just relax your mind by cracking a joke or by taking 14-15 long breathes in a single stroke.

Believe me it'll work. So be ready to face such situations

Murphy's Law " If anything can go wrong,it will ".....Everything for the first time looks tough.

REMEMBER

A, B , C , Dwas also tough for you one day

Practice makes a man perfect.....Follow the proper approach you will definitely succeed

Ending in this high note said by late Dhiru Bhai Ambani

" For Those Who Dare n Dream There is A Whole world to win "

Jinke honslo mein udaan hoti hai wo aasmaan ki uchayion se nahi darte

" I Welcome You as a Bright Future CA in This Amazing World of Finance "

**“In Every Man There is Something of Which I May Also Learn, and
in All That He is My Teacher”**

**I Wish All My Students to Always Aim High in Life.You have to grow
From Inside Out.None Can Teach You, None Can Make You
Spiritual. There is no Other Teacher But Your Own Soul.**

**"Life is not measured by the number of breaths we take,
but by the moments that take our breath away."**

**The only thing that will stop you from fulfilling your dreams is you
Now You Can Also Dream Of Scoring Good Marks In MAFA/SFM**

"Targetting 90+ In Mafa/SFM"

**"All your life you are told the things you cannot do. All your life they will say
you're not good enough or strong enough or talented enough; they will say
you're the wrong height or the wrong weight or the wrong type to play this or
be this or achieve this. THEY WILL TELL YOU NO, a thousand times no, until all
the no's become meaningless. All your life they will tell you no, quite firmly
and very quickly.**

AND YOU WILL TELL THEM YES."

**Winning isn't everything, neither is losing,
but the only thing is doing your best."**

QUESTION NO. 1 How project appraisal is done under inflationary conditions?

→ It is needless to mention that Inflation is a universal phenomena. In a developing country like India, it has become a part of life.

→ It is a well known fact that during inflationary conditions, project cost is bound to increase on all heads viz. labour, raw material, fixed assets such as equipments, plant & machinery, building material, remuneration of technicians & managerial personnel etc.

→ Under such circumstances, project appraisal has to be done generally keeping in view the following guidelines which are usually followed by Government agencies, banks and financial institutions:

(i) It is always advisable to make provisions for **cost escalation** on all heads of cost, keeping in view the rate of inflation during likely period of delay in project implementation.

(ii) The various **sources of finance** should be carefully scrutinised with reference to probable revision in the rate of interest by the lenders and the revision which could be effected in the interest bearing securities to be issued. All these factors will push up the cost of funds for the organisation.

(iii) Adjustments should be made in **profitability and cash flow projections** to take care of the inflationary pressures affecting future projections.

(iv) It is also advisable to examine the **financial viability of the project** at the revised rates and assess the same with reference to economic justification of the project. The rate of return should be acceptable which also accommodates the rate of inflation p.a

(v) In an inflationary situation, projects having early **payback periods** should be preferred because projects with longer pay-back period are more risky.

→ Under conditions of inflation, the project cost estimates that are relevant for a future date will suffer escalation. Either of the following two approaches may be used while appraising projects under such conditions.

(i) **Adjustment Of Cash Flows** : Projected Cash Flows should be adjusted to an inflation index, recognizing selling price increases and cost increases annually or

(ii) **Adjustment Of Cut-Off Rate** : "Acceptance Rate " (cut-off) should be adjusted for inflation, retaining cash flows projections at current price levels.

→ It must be noted that measurement of inflation has no standard approach nor is easy. This makes the job of appraisal a difficult one under such conditions.

QUESTION NO. 2 Write a note on "Credit Rating" in India? OR Briefly explain the meaning and importance of "Credit Rating"?

→ **Meaning** Credit Rating is an act of assigning values to credit instruments by assessing the solvency i.e. the ability of the borrower to repay debt. Thus Credit Rating is:

(1) An expression of opinion of a rating agency. (2) The opinion is in regard to a debt instrument. (3) The opinion is as on a specific date. (4) The opinion is dependent on risk evaluation. (5) The opinion depends on the probability of interest and principal obligations being met timely.

→ **What Credit Rating do not indicate** It may be noted that credit rating is only an opinion and not the guarantee or protection against default. It is not a recommendation to buy, or sell, or hold a security. Thus Credit Rating does not in any way linked with (1) **Performance Evaluation** of the rated entity unless called for. (2) **Investment Recommendation** by the rating agency to invest or not in the instrument to be rated. (3) **Legal Compliance** by the issuer-entity through audit. (4) **Opinion** on the holding company, subsidiaries or associates of the issuer entity.

→ **Credit Rating in India** Credit Rating is a specialised and technical work. There are five Credit Rating agencies in India (i) CRISIL (Credit Rating & Information Services of India Ltd.) (ii) ICRA (Investment Information and Credit Rating Agency of India) (iii) CARE (Credit Analysis and Research Limited) (iv) DCR (Duffs & Phelps Credit Rating India Ltd) (v) ONICRA (Onida Credit Rating Agency Ltd.)

CRISIL was the first credit rating agency in India, incorporated in 1987 jointly by ICICI and the UTI. CRISIL has pioneered the concept of Credit Rating in India.

The first private sector credit rating institution was set up as a joint venture between the JM Financials, Alliance Group and the

international rating agency Duffs and Phelps in 1995, known as Duffs & Phelps Credit Rating India Ltd. (DCR).

→ **Need of Credit Rating** : A firm has to ascertain the credit rating of prospective customers, to ascertain how much and how long can credit be extended. Credit can be granted only to a customer who is reliably sound. This decision would involve analysis of the financial status of the party, his reputation and previous record of meeting commitments.

→ **How Credit Ratings are Expressed**: Ratings are expressed in alphabetical or alphanumeric symbols like (AAA, BBB, P1, P2).

→ **Usefulness of Credit Rating** As a fee-based financial advisory service, credit rating is obviously extremely useful to the **Investors**, the **corporates (borrowers)** and **banks and financial institutions**.

To the investors (a) It is an indicator expressing the credit quality of the instruments (b) Fair and good Credit Rating motivate the public to invest their savings (c) It enables the investors to get superior information at low cost.

To the corporate borrowers (a) They can raise funds at a cheaper rate with good rating and enter the capital market confidently. (b) It minimize the role of name recognition and less known companies can also approach the market on the basis of their rating.

To banks and other financial institutions The fund ratings are useful to the banks and other financial institutions while deciding lending and investment strategies.

→ **Steps or Functions involved in Credit Rating** : The steps or functions involved in Credit Rating are :

(i) To gather sufficient information to evaluate the credit risk of the specific issues. The main sources of information to the credit rating agencies are : (a) Annual and Interim reports and other published data (b) Prospectus, letter of offer etc of particular security (c) Industry, Sectoral and Economic data from industry groups (d) Reports and data from Government agencies (ii) To analyse and come to a conclusion on the appropriate rating (iii) To monitor the credit quality of the rated issuer or security over time, deciding on the timely changes in rating if company fundamentals changes and (iv) To keep investors and market place informed

Hence we can say that Credit Rating has assumed an important place in the modern and developed financial market like India.

QUESTION NO. 3 Explain the factors/determinants for determining Dividend Policy?

The factors that affect the dividend policy of a company are as follows :

(i) **Legal Considerations** : The provisions of the Companies Act, 1956 must be kept in mind since they provide a major dimension to the dividend decision. Section 205 of the Companies Act prescribes the quantum of distributable profits. Further the provisions of the Income-tax Act specially as they relate to closely held companies may also be seen. In 1975, the Company Law Board issued certain rules regarding the payment of dividend out of reserves and the transfer of profits to the reserves over and above a stipulated amount.

All these provisions provide the legal framework within which the dividend policy has to be formulated. Under no circumstances, it is possible to declare a dividend higher than the amount legally permissible.

(ii) **Stability of Earnings** : A firm having stable income can afford to have higher dividend pay-out ratio as compared to a firm which does not have such stability in its earnings conditions.

(iii) **Opportunities for Reinvestment and Growth** : A company which sees a high growth potential for itself and, therefore, requires a large amount of funds for financing growth will declare lower dividends to conserve resources and maintain its debt equity ratio at a proper level. If, however, a company does not have immediate requirement for funds, it may decide to declare high dividends.

(iv) **Cashflow** : From the point of view of financial prudence, a company must consider its cash requirements before declaring a dividend. In case it has a strained liquidity position, it may declare a lower dividend.

(v) **Level of Inflation in the Economy** : The dividend decision is also linked up with the level of inflation in the economy. If a company declares a higher dividend, than what is warranted by the inflation figure of profits, it will not have enough funds to replace its capital assets and maintain its productivity and profitability. This will be harmful for the company in the long run.

(vi) **Effect on Market Prices** : Dividend decision is one of the major factors which affect the market price of shares. As per traditional approach the Market Price of the share is considered to be the Present Value of the future dividend.

(vii) **Tax Considerations** : The tax status of the major shareholders also affects the dividend decision sometimes. For example, if a company is owned by a few shareholders in the high income tax bracket, it would be in their interest not to receive too high an amount of dividends. Such shareholders may be interested in taking their return from the investment in the form of capital

gains rather than in the form of dividends.

(viii) Other Factors : There are many other factors such as dividend policy of other firms in the same industry; attitude of management on dilution of existing control; fear of being branded inefficient or conservative etc. which also affect the dividend policy of a company.

QUESTION NO. 4 An Indian company is desirous of obtaining foreign technology. Write a brief note explaining the important financial considerations it should take into account in this context.

Financial Consideration while Buying Foreign Technology :

(i) Lump Sum vs. Royalty : Whether to pay for the technology in a lump sum front-end or as royalty over a period of years, is an important issue.

Advantages of lump sum payment are **(a)** the amount will become certain **(b)** the amount can be discounted forward and therefore be less; **(c)** the forex exposure risk is avoided; **(d)** it provides an opportunity to reduce the per unit cost of technology by maximizing sales.

The main advantage of royalty payment is **(a)** it ensures that the sales benefit is realized before technology payment accrues; **(b)** it provides easy instalments for funding;

The advantages of lump sum model becomes the disadvantages of the royalty model and vice versa. It is for the organization to choose what is best under its circumstances.

(ii) Tax Issues : Deduction of tax at source is mandatory. This should be important from the receipt's point of view and should be made clear to them. If it is a lump sum upfront payment, tax also could be certain; whereas, in protracted royalty payment, there is a chance of tax uncertainty.

As to allowability in the hands of the payer, there have been various case laws and it would be advisable for the payer to obtain beforehand expert opinion as to how to plan its tax shield in the best manner possible.

(iii) Government Clearance: Automatic permission will be given for foreign technology agreements upto certain limits - currently, USD 2 million or royalty at 5% for domestic sales and 8% for export sales. In other cases approval will have to be obtained.

QUESTION NO. 5 Write a short note of "Bridge Finance" or " Bridge Loan" ?

→ **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.

QUESTION NO. 6 Write a short note on Systematic and Unsystematic Risk? OR Distinguish between 'Systematic risk' and 'Unsystematic risk? or Discuss the various kinds of Systematic and Unsystematic Risk ?

Total Risk = Systematic Risk + Unsystematic Risk

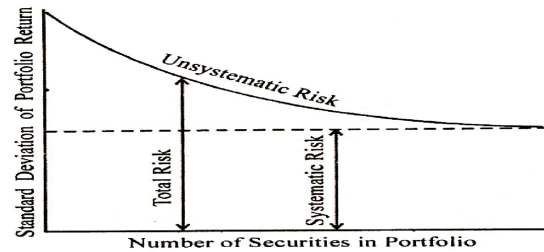
Systematic Risk or Non-Diversifiable Risk or Market Risk

→ 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.

Kinds of Systematic and Unsystematic Risk : There are two types of Risk -

Systematic (or non-diversifiable or General Risk) & Unsystematic (or diversifiable or Specific Risk) relevant for investment

Types of Systematic Risk

(i) **Market Risk** : Even if the earning power of the Corporate sector and the interest rate structure remain more or less uncharged , prices of securities, equity shares in particular, tend to fluctuate. Major cause appears to be the changing psychology of the investors. The irrationality in the security markets may cause losses unrelated to the basic risks. These losses are the result of changes in the general tenor of the market and are called market risks.

(ii) **Interest Rate Risk** : The change in the interest rate have a bearing on the welfare of the investors. As the interest rate goes up, the market price of existing fixed income securities falls and vice versa. This happens because the buyer of a fixed income security would not buy it at its par value or face value if its fixed interest rate is lower than the prevailing interest rate on a similar security.

(iii) **Social or Regulatory Risk** : The social or regulatory risk arises, where an otherwise profitable investment is impaired as a result of adverse legislation, harsh regulatory climate, or in extreme. instance nationalization by a socialistic government.

(iv) **Purchasing Power Risk** : Inflation or rise in prices lead to rise in costs of production, lower margins, wage rises and profit squeezing etc. The return expected by investors will change due to change in real value of returns.

Types of Unsystematic Risk

(i) **Business Risk** : As a holder of corporate securities (equity shares or debentures) one is exposed to the risk of poor business performance. This may be caused by a variety of factors like heightened competition, emergence of new technologies, development of substitute products, shifts in consumer preferences, inadequate supply of essential inputs. changes in governmental policies and so on. Often of course the principal factor may be inept and incompetent management.

(ii) **Financial Risk** : This relates to the method of financing. adopted by the company. high leverage leading to larger debt servicing problem or short term liquidity problems due to bad debts , delayed receivables and fall in current assets or rise in current liabilities.

(iii) **Default Risk** : Default risk refers to the risk accruing from the fact that a borrower may not pay interest and/or principal on time. Except in the case of highly risky debt instrument, investors seem to be more concerned with the perceived risk of default rather than the actual occurrence of default. Even though the actual default may be highly unlikely. they believe that a change in the perceived default risk of a bond would have an immediate impact on its market price.

QUESTION NO. 7 State the Objectives of Portfolio Management?

(i) **Security/Safety of Principal** The objective is to keep the capital / principal amount intact, in terms of value and in terms of purchasing power. The capital or the principal amount invested should not erode , either in value or in terms of purchasing power.

(ii) **Stability of Income** so as to facilitate planning more accurately & systematically the reinvestment or consumption of income.

(iii) **Capital Growth** which can be attained by reinvesting in growth securities or through purchase of growth securities.

(iv) **Marketability** i.e. the ease with which a security can be bought or sold. This is essential for providing flexibility to investment portfolio.

(v) **Liquidity** i.e. nearness to money. It is desirable for the investor so as to take advantage of attractive opportunities upcoming in the market.

(vi) **Diversification** : The basic objective of building a portfolio is to reduce the risk of loss of capital and income, by investing in various types of securities and over a wide range of industries.

(vii) **Favourable Tax Status** : The effective yield an investor gets from his investment depends on tax to which it is subject. By minimising the tax burden, yield can be effectively improved.

QUESTION NO. 8 State two basic principles for effective Portfolio Management?

Basic Principles of Portfolio Management : There are two basic principles for effective portfolio management.

Effective investment planning for the investment in securities by considering the following factors :

(a) Fiscal, Financial and Monetary Policies of the Government of India and the Reserve Bank of India.

(b) Industrial and economic environment and its impact on industry prospects in terms of prospective technological changes, competition in the market, capacity utilisation with industry and demand prospects etc.

(ii) **Constant Review of Investment** : Portfolio managers are required to review their investment in securities and continue selling and purchasing their investment in more profitable avenues. For this purpose they will have to carry the following analysis:

(a) **Assessment of quality of management of the companies** in which investment has already been made or is proposed to be made.

(b) **Financial & trend analysis of companies balance sheet/profit&loss account** to identify sound companies with optimum capital structure & better performance & to disinvest the holding of those companies whose performance is found to be slackening.

(c) **The analysis of securities market** and its trend is to be done on a continuous basis.

QUESTION NO. 9 Write short notes on the following: “Factor effecting investment decisions in Portfolio Management”

Factor effecting investment decisions in Portfolio Management are as follows :

(i) **Objectives of Investment Portfolio** : There can be many objectives of making an investment. The manager of a provident fund portfolio has to look for security (low risk) and may be satisfied with lesser return, An aggressive investment company may, however, be willing to take a high risk in order to have high capital appreciation. The objectives of an investment portfolio are normally expressed in terms of risk and return. Risk and return have direct relationships. Higher the return that one wishes to have from the investment portfolio, higher could be the risk that one has to take.

(ii) **Selection of Investment** :

(a) What types of securities to buy or invest in? There is a wide variety of investments opportunities available i.e, debentures, convertible bonds, preference shares, equity shares, government securities and bonds, income units, capital units etc.

(b) What should be the proportion of investment in fixed interest/dividend securities & variable interest/dividend bearing securities?

(c) In case investments are to be made in the shares or debentures of companies, which particular industries shows potential of growth?

(d) Once industries with high growth potential have been identified, the next step is to select the particular companies, in whose shares or securities investments are to be made.

(iii) **Timing of Purchase** : At what price the share is acquired for the portfolio depends entirely on the timing decision. It is obvious if a person wishes to make any gains, he should “buy cheap and sell dear” i.e, buy when the shares are selling at a low price and sell when they are at a high price.

QUESTION NO. 10 What is the Dow Jones Theory to Portfolio Management?

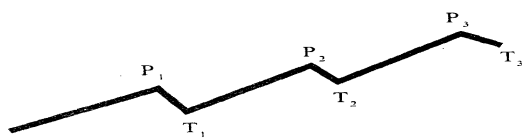
→ The Dow Jones Theory is probably the most popular theory regarding the behaviour of stock market prices. The theory

derives its name from Charles H. Dow, who established the Dow Jones & Co., and was the first editor of the Wall Street Journal- a leading publication on financial and economic matters in the U.S.A.

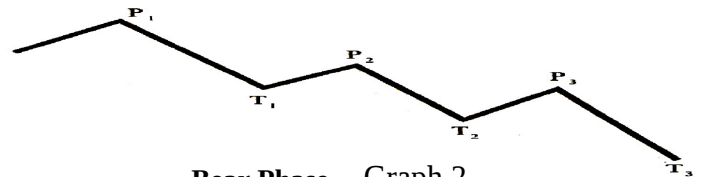
→ The Dow Jones theory classifies the movements of the prices on the share market into three major categories:

1. Primary Movements. 2. Secondary Movements. 3. Daily Fluctuations.

1. Primary Movements : They reflect the trend of the stock market & last from one year to three years, or sometimes even more. During a bull phase, the basic trend is that of rise in prices. Graph 1 above shows the behaviour of stock market prices in bull phase. As can be seen from the graph that prices do not rise consistently even in a bull phase. They rise for some time and after each rise, they fall. However, the falls are of a lower magnitude than rise. As a result, prices reach higher levels with each rise. Once the prices have risen very high, the bear phase is bound to start, i.e., price will start falling. Graph 2 shows the typical behaviour of prices on the stock exchange in the case of a bear phase. It would be seen that prices are not falling consistently and, after each fall, there is a rise in prices. However, the rise is not much as to take the prices higher than the previous peak.



Bull Phase Graph 1 .

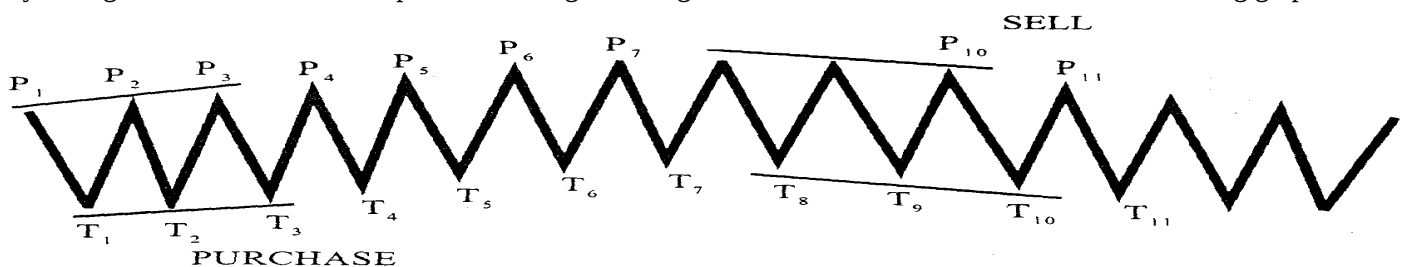


Bear Phase Graph 2 .

2. Secondary Movements : We have seen that even when the primary trend is upward, there are also downward movements of prices. Similarly, even where the primary trend is downward, there is upward movements of prices also. These movements are known as secondary movements and are shorter in duration and are opposite in direction to the primary movements. These movements normally last from three weeks to three months and ranges from 1/3 (33 %) to 2/3 (66 %) of the previous advance in a bull market or previous fall in the bear market.

3. Daily Movements : There are irregular fluctuations which occur every day in the market. These fluctuations are without any definite trend. Thus if the daily share market price index for a few months is plotted on the graph it will show both upward and downward fluctuations. These fluctuations are the result of speculative factors. An investment manager really is not interested in the short run fluctuations in share prices since he is not a speculator. It may be reiterated that anyone who tries to gain from short run fluctuations in the stock market, can make money only by sheer chance. Speculation is beyond the scope of the job of an investment manager.

Timing of investment decisions on the basis of Dow Jones Theory : Dow Jones theory identifies the turn in the market prices by seeing whether the successive peaks and troughs are higher or lower than earlier. Consider the following graph:



According to the theory, the investment manager should purchase investments when the prices are at T1. At this point, he can ascertain that the bull trend has started, since T2, is higher than T1 and P2 is higher than P1.

Similarly, when prices reach P7 he should make sales. At this point he can ascertain that the bearish trend has started, since P9 is lower than P8 and T8 is lower than T7.

Ideally speaking, the investment manager would like to purchase shares at a time when they have reached the lowest trough and sell them at a time when they reach the highest peak. However, in practice, this seldom happens. Therefore, he has to time his decision in such a manner that he buys the shares when they are on the rise and sells them when they are on the fall. It means that he should be able to identify exactly when the falling or the rising trend has begun.

→ **Benefit Of Dow- Jones Theory** :

(a) **Timings of Investments** : Investor can choose the appropriate time for his investment / divestment. Investment should be

made in shares when their prices have reached the lowest level, and sell them at a time when they reached the highest peak.

(b) Identification of Trend : Using Dow-Jones theory, the correct and appropriate movement in the market prices can be identified, and depending on the investors preference, decisions can be taken.

QUESTION NO. 11 Explain the Randon Walk Theory to Portfolio Management?

➔ Many investment managers and stock market analysts believe that stock market prices can never be predicted because they are not a result of any underlying factors but are mere statistical ups and downs. ➔ This hypothesis is known as Random Walk hypothesis which states that the behaviour of stock market prices is unpredictable and that there is no relationship between the present prices of the shares and their future prices. ➔ Proponents of this hypothesis argue that stock market prices are independent. ➔ In other words, the fact that there are peaks and troughs in stock exchange prices is a mere statistical happening - successive peaks and troughs are unconnected. ➔ In the layman's language it may be said that prices on stock exchange behave exactly the way a drunk would behave while walking in a blind lane, i.e., up and down, with an unsteady way going in any direction he likes, bending on the one side to other side .

The supporters of this theory put out a simple argument. It follows that :

(a) Prices of shares in stock market can never be predicted.

(b) The reason is that the price trends are not the result of any underlying factors, but that they represent a statistical expression of past data.

(c) There may be periodical ups or downs in share prices, but no connection can be established between two successive peaks (high price of stocks) and troughs (low price of stocks).

QUESTION NO. 12 What is interest rate risk, reinvestment risk & default risk & what are the types of risk involved in investments in G-Sec.?

Interest Rate Risk : Interest Rate Risk, market risk or price risk are essentially one and the same. These are typical of any fixed coupon security with a fixed period to maturity. This is on account of inverse relation of price and interest. As the interest rate rises the price of a security will fall. However, this risk can be completely eliminated in case an investor's investment horizon identically matches the term of security.

Re-investment Risk : This risk is again akin to all those securities, which generate intermittent cash flows in the form of periodic coupons. The most prevalent tool deployed to measure returns over a period of time is the yield-to-maturity (YTM) method. The YTM calculation assumes that the cash flows generated during the life of a security is reinvested at the rate of YTM. The risk here is that the rate at which the interim cash flows are reinvested may fall thereby affecting the returns.

Default Risk : This type of risk in the context of a Government security is always zero. However, these securities suffer from a small variant of default risk i.e. maturity risk. Maturity risk is the risk associated with the likelihood of government issuing a new security in place of redeeming the existing security. In case of Corporate Securities it is referred to as credit risk.

Types of risk involved in investments in G-Sec. : G. Secs are usually referred to as risk free securities. However, these securities are subject to only one type of risk i.e. interest rate risk. Subject to changes in the overall interest rate scenario, the price of these securities may appreciate or depreciate.

QUESTION NO. 13 Write a short note on Lease? What are the characteristic features of Financial and Operating Lease?

➔ **Meaning :** Lease can be defined as a right to use an equipment or capital goods on payment of periodical amount.

➔ **Parties to a Lease Agreement :** There are two principal parties to any lease transaction as under :

Lessor : Who is actual owner of equipment permitting use to the other party on payment of periodical amount.

Lessee : Who acquires the right to use the equipment on payment of periodical amount.

➔ **Type of Leasing :** The different leasing options may however, be grouped in two broad categories as under:

Operating Lease : Salient features of Operating Lease

(i) The lease term is significantly less than the economic life of the equipment.

(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.

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 : Salient features of Financial Lease

(i) It is an intermediate term to 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.

→ Advantages of Leasing

(i) **Flexibility** : The first and foremost advantage of a lease agreement is its flexibility. The leasing company in most of the cases would be prepared to modify the arrangement to suit the specific requirements of the lessee. The ownership of the leased equipment gives them added confidence to enable them to be more accommodative than the banks and other financial institutions.

(ii) **100% Financing** : The leasing company may finance 100% of cost of the equipment without insisting for any initial disbursement by the lessee, whereas 100% finance is generally never allowed by banks/financial institutions.

(iii) **Timely & Easy Availability of Finance** : Banks & financial institutions may involve lengthy appraisal and impose stringent terms and conditions to the sanctioned loan. The process is time consuming. In contrast leasing companies may arrange for immediate purchase of equipment on mutually agreeable terms.

(iv) **Simple Documentation** : Lengthy and time consuming documentation procedure is involved for term loans by banks/institutions. The lease agreement is very simple in comparison.

(v) **Safeguarded Against the Risk of Obsolescence** : In short-term lease (operating lease) the lessee is safeguarded against the risk of obsolescence. It is also an ideal method to acquire use of an asset required for a temporary period.

(vi) **Does not affect the Borrowing Capacity** : The use of leased assets does not affect the borrowing capacity of the lessee as lease payment may not require normal lines of credit and are payable from income during the operating period. This neither affects the debt equity ratio or the current ratio of the lessee.

(vii) **Off the Balance Sheet Financing** : Leased equipment is an 'off the balance sheet' asset being economically used by the lessee and does not affect the debt position of lessee.

(viii) **Sale and Lease Back Arrangement** : By employing 'sale and lease back' arrangement, the lessee may overcome a financial crisis by immediately arranging cash resources for some emergent application or for working capital.

(ix) **Piecemeal Financing** of small equipments is conveniently possible through lease arrangement only, as debt financing for such items is impracticable.

(x) **Tax Benefits** may also sometimes accrue to the lessee depending upon his tax status.

→ Disadvantages of Leasing :

(i) the lease rentals become payable soon after the acquisition of assets and no moratorium period is permissible as in case of term loans from financial institutions. The lease arrangement may, therefore, not be suitable for setting up of the new projects as it would entail cash outflows even before the project comes into operation.

(ii) The leased assets are purchased by the lessor who is the owner of equipment. The seller's warranties for satisfactory operation of the leased assets may sometimes not be available to lessee.

(iii) Lessor generally obtain credit facilities from banks etc. to purchase the leased equipment which are subject to hypothecation charge in favour of the bank. Default in payment by the lessor may sometimes result in seizure of assets by banks causing loss to the lessee.

(iv) Lease financing has a very high cost of interest as compared to interest charged on term loans by financial institutions/banks.

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

(v) **Restriction on Use** : The Lessor generally imposes certain restrictions on the leased assets. The Lessee may not be permitted to make addition on alterations to suit his needs.

QUESTION NO. 14 Mention few points of differences between :-

(a) Operating Lease & Finance Lease:

<u>Basis</u>	<u>Finance Lease</u>	<u>Operating Lease</u>
1. Life of contract	Approximates the economic life of the asset	Shorter than the economic life of the asset.
2. Maintenance	The burden of the costs of maintenance, repairs, taxes, insurance etc. are borne by the lessee unless the contract provides to the contrary.	The burden of all these expenses are borne by the lessor.
3. Cancellation	It is a non-revocable contract i.e. it cannot be cancelled by the lessee prior to its expiration date.	It is a revocable one i.e. it can be cancelled by the lessee prior to its expiration date.
4. Duration	In this case, the lease period is usually related to the useful life of the asset.	It is usually of a shorter duration & bears no relation to the economic life of the asset.
5. Risk of Obsolescence	The lessee has to take the risk of obsolescence in the case of Financial lease.	The lessee is protected against risk of obsolescence.
6. Cost of Asset	The lease rental would cover the lessor's original investment cost plus return on investment.	The lease rental is generally not sufficient to fully amortise the cost of the asset.

QUESTION NO. 15 Write a short note on factoring?

→ **Meaning** : Factoring means an arrangement between a factor and his client which includes the following services to be provided by the factor.

(a) Finance (b) Maintenance of debt (c) Collection of debts (d) Protection against credit risk

In other words Factoring is an arrangement in which a financial intermediary called 'Factor' collects the account receivables on behalf of the seller of goods and services. Factoring is thus an alternative to in-house management of receivables.

→ **Types/Forms of Factoring** : Depending upon the features built into the factoring arrangement to cater to the varying needs of trade there can be different kinds of factoring. Some of which are :

Recourse and Non-Recourse Factoring : Under a recourse factoring arrangement, the factor has recourse to the client (firm) if the purchased/receivable factored turns out to be irrecoverable. In other words, the factor does not assume credit risks associated with the receivables. The factor does not have the right to recourse in the case of non-recourse factoring. The loss arising out of irrecoverable receivables is borne by him, as a compensation for which he charges a higher commission.

Advance and Maturity Factoring : In advance factoring the factor paid a pre specified portion, ranging between three-fourths to nine tenths, of the factored receivables in advance, the balance being paid upon on the guaranteed payment date. The client has to pay interest on the advance between the date of such payment and the date of actual collection from the customers or the guaranteed payment date, determined on the basis of the prevailing short-term rate, the financial standing of the client and the volume of the turnover.

In maturity factoring the factor does not make any advance or prepayment. The factor pays the client either on a guaranteed payment date or on date of collection from the customer.

Full Factoring : Full Factoring is the most comprehensive form of factoring combining the features of all the factoring specially those of non-recourse and advance factoring. It is also known as old line factoring. In this type of factoring all the components of service like short term finance, administration of sales ledger and credit protection are available to the client .

Disclosed and Undisclosed Factoring : In disclosed factoring, the name of the factor is disclosed in the invoice by the supplier manufacturer of the goods asking the buyer to make payment to the factor. The name of the factor is not disclosed in the invoice in undisclosed factoring although the factor maintains the sales ledger of the supplier-manufacturer. The entire realization of the

business transaction is done in the name of the supplier company but all control remains with the factor.

Domestic and Export/Cross Border Factoring: If the three parties involved, namely, customer (buyer), client, (seller-supplier) and factor (financial intermediary) are domiciled in the same country then it is known as domestic factoring. There are usually four parties involved to a cross border factoring transaction. They are:

- (a) Exporter (client) (b) Importer (customer) (c) Export factor (d) Import Factor

It is also known as two-factor system.

→ **Functions of a Factor:** The main functions of a factor could be classified into five categories :

(i) **Maintenance/Administration of Sales Ledger :** The factor maintains the clients' sales ledgers. The ledger is generally maintained under the open-item method in which each receipt is matched against the specific invoice. The factor also gives periodic reports to the client.

(ii) **Collection Facility :** The factor undertakes to collect the receivables on behalf of the client relieving him of the problems involved in collection, and enables him to concentrate on other important functional areas of the business. It also enables the client to reduce the cost of collection by way of savings in manpower, time and efforts. Also, the debtors are more responsive to the

demands from a factor being a credit institution.

(iii) **Financing Trade Debts :** The unique feature of factoring is that a factor purchases the trade debts of its clients at a price and the debts are assigned in favour of factor who is usually willing to grant advances to the extent of 80% of the assigned debts.

(iv) **Credit Control and Credit Protection :** Assumptions of credit risk is one of the most important functions of the factor. This service is provided where debts are factored without recourse. The factor in consultation with the client fixes credit limits for approved customers. Within these limits, the factor undertakes to purchase all trade debts of the customer without recourse.

(v) **Advisory Services :** By virtue of their specialized knowledge and experience in finance and credit dealings and access to extensive credit information; factors can provide the following information services to the clients:

(a) Customer's perception of the clients products, changing in marketing strategies, emerging trends etc.

(b) Audit of the procedures followed for invoicing, delivery and dealing with sales returns.

(c) Introduction to the credit department of a bank/subsidiaries of banks engaged in leasing, hire-purchase, merchant banking.

→ **Advantages of Factoring :** Factoring offers the following advantages which makes it quite attractive to many firms :

(a) **Convertibility :** The firm can convert receivables into cash without bothering about repayment.

(b) **Definite Pattern Of Cash Inflows :** Factoring ensures a definite pattern of cash in flows for the company.

(c) **Reduction in Collection & Administration Costs :** Continuous factoring virtually eliminates need for the credit department.

(d) **Compensating Balance are Not Required :** Unlike an unsecured loan, compensating balances are not required in this case.

QUESTION NO. 16 What is Forfeiting?

→ Forfeiting is a form of financing of receivables pertaining to international trade.

→ It is French term and implies, 'surrendering or relinquishing rights to something'.

→ In the field of exports, it implies surrender by an exporter of the rights to claim payment for goods or services rendered to an importer in return for cash payment for those goods or services from the forfaiter (generally a bank), who takes over the importer's promissory note or the exporter's bills of exchange.

→ Forfeiting arrangement eliminates virtually all (a) Credit Risks (b) Interest Rate Risk, that the interest rate may fluctuate (c) Foreign currency risk that of any adverse movement (d) Political Risk (e) Business Risk, that the business conditions may weaken in the importer's country.

→ **Features :** (a) Forfaiter discounts the entire value of the note/bill. (b) The forfaiter's decision to provide financing depends upon the financing standing of the availing bank. (c) Forfeiting is a pure financial agreement (d) Forfeiting spreads over 3-5 years.

(e) It is always without recourse (f) There exists a secondary market in forfeiting. This adds depth and liquidity to forfeiting.

→ Foreign banks are major players in the Forfeiting market. Recently RBI permitted EXIM Bank and Authorised Dealers (Banks) to offer Forfeiting services in India. Global Trade Finance Pvt. Ltd., a joint venture of EXIM Bank (India), WESTLB (Germany) and IFC (Washington), is a leading player in this field.

QUESTION NO. 17 What are the difference between Factoring & Forfaiting?

- (a) **Extent of Finance** : Forfeiter discounts the entire value of the note/bill. In a factoring arrangement the extent of financing available is 75-80%.
- (b) **Credit Worthiness** : The forfeiter's decision to provide financing depends upon the financing standing of the availing bank. On the other hand in a factoring deal the export factor bases his credit decision on the credit standards of the exporter.
- (c) **Services Provided** : Forfaiting is a pure financial agreement while factoring includes ledger administration and collection also.
- (d) **Maturity** : Factoring is a short-term financial deal. Forfaiting spreads over 3-5 years.
- (e) **Market** : Factoring is applicable to domestic receivables. However the forfaiting as a system of financing of receivables arising out of export business or international business.
- (f) **Recourse** : Factoring may be with or without recourse, while forfaiting is always without recourse.
- (g) **Liquidity** : Factoring tends to be a case of sell of debt obligation to the factor, with no secondary market. There exists a secondary market in forfaiting. This adds depth and liquidity to forfaiting.
- (h) **Cost** : The seller (client) bears the cost of factoring. The overseas buyer bears the cost of forfaiting.

QUESTION NO. 18 Write a short note about functions of Merchant Banker ? OR Explain the role of Merchant Bankers in Public issue?

→ **Meaning** : In modern times, importance of merchant banker has gained legitimacy because it is the key intermediary between the company and the issue of capital. SEBI Act 1992 defines a Merchant Banker as follows: - Merchant Banker means a person who is engaged in the business of issue management either by making arrangements regarding selling, buying or subscribing to securities as manager, consultant, advisor or rendering corporate advisory service in relation to such issue management.

→ The company has to select a Merchant Banker keeping in view the following points:

- (a) the support of financial institutions by participating in the issue. (b) proposed size of the issue. (c) the background, expertise and infrastructure facilities of the Merchant banker. (d) the condition of primary and secondary markets.

The Merchant Banker will have to liaison with the company, institutions, bankers, Stock Exchange, underwriters, brokers, registrars to the issue, the printers and establish rapport with all these persons to make the issue a success.

→ **Activities/Functions of Merchant Banker** : Merchant Banker may undertake the following activities:

- (a) Managing of Public Issue of securities. (b) Underwriting concerned with the aforesaid Public Issue Management Business. (c) Managing & Advising International offerings of Debt, Equity, i.e., GDRs, ADRs, bonds and other instruments. (d) Private Placement of securities. (e) Primary or Satellite dealership of Government Securities. (f) Corporate Advisory Services relating to Securities Market, e.g., takeovers, acquisitions, Disinvestment. (g) Stock-broking (h) Advisory services for projects (i) Syndication of rupee term loans (j) International Financial Advisory Services

Other Services which are generally performed by Merchant Bankers in India include :

1. Project promotion services.
2. Project finance.
3. Management and marketing of new issues.
4. Underwriting of new issue.
5. Syndication of credit.
6. Leasing services.
7. Corporate advisory services.
8. Providing venture capital.
9. Operating mutual funds and off shore funds.
10. Investing management of portfolio management services
11. Bought out deals.
12. Providing assistance for technical and financial collaborations and joint ventures.
13. Management of and dealing in commercial papers.
14. Investment services for non-resident Indians.

→ **Role of Merchant Bankers in Public Issue**

In the present day capital market scenario the merchant bank plays an encouraging and supporting force to the entrepreneurs, corporate sectors and the investors. Several new institutions have appeared in the financial spectrum and merchant bankers have joined to expand the range of financial services. Moreover, the activities of these Merchant Bankers have developed considerably both horizontally and vertically to cope with the changing environment. Merchant Banks help in promoting and sustaining capital markets and money markets, and they provide a variety of financial services to the corporate sector.

Management of the public issues of shares, debentures or even an offer for sales, has been the traditional service rendered by merchant bankers. Some of the services under issue management are:

- (i) Deciding on the size and timing of a public issue in the light of the market conditions.
 - (ii) Preparing the base of successful issue marketing from the initial documentation to the preparation of the actual launch.
 - (iii) Optimum underwriting support.
 - (iv) Appointment of bankers and brokers as well as issue houses.
 - (v) Professional liaison with share market functionaries like brokers, portfolio managers and financial press for pre-selling and media coverage.
 - (vi) Preparation of draft prospectus and other documents.
 - (vii) Wide coverage throughout the country for collection of applications.
 - (viii) Preparation of advertising and promotional material.
- The merchant bankers presence in all the major financial centres as well as his long established relationships with the underwriter and broker fraternities, makes possible the high degree of synchronisation required to ensure the success of an issue.

QUESTION NO. 19 Write short notes on the role of Mutual Funds in the financial market?

Mutual Funds is a method of channeling the savings of a layman person directly to the productive capacities of the country. Though still at a nascent stage, Indian MF industry offers a plethora of schemes and serves broadly all types of investors. Mutual Funds have opened new doors to investors and imparted much needed liquidity to the system. In this process they have challenged

the dominant role of the commercial banks in the financial market and national economy.

Mutual Funds and Household Savings : They are the ideal route for many household to invest their savings for a higher return in Mutual Fund rather than normal term deposits with Banks. The share of mutual fund in household financial assets is over 5% in India. The most significant growth was in respect of UTI.

Mutual Funds and the Capital Market : According to Center for Monitoring Indian Economy (CMIE), "Mutual Funds" cornered 12% of the total market capitalization. Mutual funds have strongly supported the equity market. While non UTI mutual funds have tended more towards equities and debentures, UTI due to its special structure, has rendered better support to government securities market.

Mutual Funds and the Money Market : Money market is an important part of financial market. It plays a crucial role in maintaining the equilibrium between the short-term demand & supply of money. It is a market for short-term money. Such schemes invest in safe highly liquid instruments included in commercial papers, certificates of deposits & governments securities.

Money market MF schemes generally provide high returns and highest safety to the ordinary investors. Money market MF schemes are active players of the money market. They channelise the idle short funds, particularly of corporate world, to those who require such funds. This process helps those who have idle funds to earn some income without taking any risk and with surety that that whenever they will need their funds, they will get the same. Short-term / emergency requirements of various firms are met by such MFs. participation of such MFs provide a boost to money market and help in controlling the volatility.

Mutual Funds and Corporate Finance : According to the flow of funds statistics published by the RBI, the share of the banking sector in filling the resource gap of the corporate sector has declined from 54.24% in 1988-89 to 2.3% in 1991-92 while of the other financial sector (including mutual funds) has increased from 39.9% to 102.58%. RBI has noted that "The rapid growth of mutual funds and increase in term lending by other financial institutions appear to have contributed to this trend". Due to participation of Mutual Fund in a large scale, it has transformed the Financial Market Transactions into a much more organized market .

QUESTION NO. 20 What are the advantages of investing in Mutual Fund?

The major advantages of investing in Mutual Fund are discussed below:

1. **Professional Management** One of the major advantage of the mutual fund is the availability of low cost highly professional and skilled management services. The managers have sound knowledge and wide experience in investment.
2. **Low Cost High Value Portfolio Diversification** Market related risk can be reduced by diversification of portfolio. For a small investor appropriate portfolio diversification is not possible due to shortage of minimum required funds. But with

investments in mutual funds, portfolio of even a small investor gets automatically diversified.

3. Reduction/Diversification of Risk When an investor invests in a mutual fund he is actually investing in a pool of funds. These funds will in turn be invested in securities. So the individual investor will share the losses with other investors.

4. Reduction in Transaction Cost A mutual fund can offer economies of search & verification due to size & scale of operations.

5. Liquidity Mutual fund invests in a number of securities but not all the securities are easily sellable. When an investor invests in a mutual fund, he can sell his units any time to the fund, in case of open ended schemes or cash his investment by selling in secondary market, in case of close ended schemes, thus mutual fund investments are quite liquid.

6. Tax Benefits There are many tax benefits available under Income Tax Act 1961 for investing in Mutual Fund Schemes.

7. Convenient Administration : Investing in a MF reduces paper work and helps investors to avoid many problems such as bad deliveries, delayed payments and unnecessary follow up with brokers and Companies .

8. Transparency : Investors get regular information on the value of their investment in addition to disclosure on the specific investments made by scheme , the proportion invested in each class of assets and the Fund Manager's investment strategy and outlook.

9. Return Potential : MF has the potential to provide a higher return as they invest in a diversified basket of selected securities.

QUESTION NO. 21 How to establish a Mutual Fund?

→ The Mutual Fund has to be established as a Trust & instrument of trust shall be in the form of a deed. The deed shall be executed by the sponsor in favour of the trustees named in the instrument of trust. The trust deed shall be duly registered under the provisions of Indian Registration Act, 1908. The trust deed shall contain clauses specified in the Third Schedule of the Regulations.

→ An AMC who holds an approval from SEBI, is to be appointed to manage the affairs of the Mutual Fund and it should operate the schemes of such fund.

→ The sponsor should contribute at least 40% to the networth of the AMC.

The Trustee should hold the property of the Mutual Fund in trust for the benefit of the unit holders.

QUESTION NO. 22 Who can be appointed as an Asset Management Company (AMC)?

A Company formed and registered under the Companies Act, 1956 and which has obtained the approval of SEBI to function as an AMC may be appointed by the sponsor of the mutual fund as such.

If the trust deed of a Mutual Fund authorises the trustee, the latter shall appoint the aforesaid AMC. The appointment of an AMC can be terminated by majority of the trustees or by 75% of the unit holders of the scheme. Any change in the appointment of the AMC shall be subject to prior approval of SEBI and unit holders.

QUESTION NO. 23 What are the conditions to be fulfilled by an AMC?

The following conditions are to be fulfilled by AMC :

(i) Restrictions for Directors : Any director of the AMC shall not hold the place of a director in another AMC unless such person is independent director referred to in the Regulations and approval of the Board of AMC of which such person is a director, has been obtained.

(ii) Information about any material change : The AMC shall forthwith inform SEBI of any material change in the information or particulars previously furnished which have a bearing on the approval granted by SEBI.

(iii) Prior approval before appointment : No appointment of a director of an AMC shall be made without the prior approval of the trustees.

(iv) Compliance of Regulations : The AMC undertakes to comply with SEBI (Mutual Funds) Regulations, 1996.

(v) Change in controlling interest : No change in controlling interest of the AMC shall be made unless prior approval of the trustees and SEBI is obtained and :

(a) a written communication about the proposed change is sent to each unit holder and an advertisement is given in one English daily newspaper having nation wide circulation and in a newspaper published in the language of the region where the head office of the mutual fund is situated.

- (b) the unit holders are **given an option to exit** at the prevailing Net Asset Value without any exit load.
 (c) the AMC shall **furnish such information** and documents to the trustees as and when required by the trustees.

QUESTION NO. 24 What are the Obligations of the AMC?

The following are the obligations of AMC :

- (i) AMC shall **manage the affairs** of the Mutual Fund and operate the schemes of such Fund.
- (ii) The AMC shall take all reasonable steps and **exercise due diligence** to ensure that the investment of the mutual funds pertaining to any scheme is not contrary to the provisions of SEBI Regulations and the trust deed of the Mutual Fund.
- (iii) The AMC shall **exercise due diligence and care** in all its investment decisions as would be exercised by other persons engaged in the same business.
- (iv) **Recording of Investment Decisions** - SEBI has advised AMC to maintain records in support of each investment decision
- (v) The AMC shall be responsible for the **acts of commissions and omissions** by its employees or the person whose services have been obtained by that company.

QUESTION NO. 25 Write short note on NAV (Net Asset Value)?

→ **Meaning** : It is the amount which a unit holder would receive if the mutual fund were wound up. An investor in mutual fund is a part owner of all its assets and liabilities. It is the basis for assessing the return that an investor has earned.

→ There are three aspects which need to be highlighted :

- (i) It is the net value of all assets less liabilities. NAV represents the market value of total assets of the Fund less total liabilities attributable to those assets.
- (ii) NAV changes daily. The value of assets and liabilities changes daily. NAV today will not be NAV tomorrow or day later.
- (iii) NAV is computed as a value per unit of holding.

→ **Asset Values : Valuation Rule**

Nature of Asset

Liquid Assets e.g. cash held
 All listed and traded securities
 Debentures and Bonds
 Illiquid shares or debentures

Fixed Income Securities

→ **Netting the Asset Values** : The asset values obtained from above have to be adjusted as follows :

Additions

Dividends and Interest accrued
 Other receivables considered good
 Other assets (owned assets)

→ **Computation of NAV** : It is value of net assets of the funds. The investors subscription is treated as the unit capital in the balance sheet of the fund and the investments on their behalf are treated as assets. The funds net assets are defined as the assets less liabilities.

→ **Symbolically** : $NAV = \frac{\text{Net asset of the scheme}}{\text{Number of units outstanding}}$

Where net assets of the scheme is defined as below.

Net Assets of the Scheme = Market value of investments + Receivables + Other accrued income + other assets - Accrued Expenses - Other Payables - Other Liabilities

→ **Example** : If total assets of a scheme are Rs. 200 lacs and liabilities are Rs. 20 lacs and there are 10 lacs unit holders, the NAV per unit is Rs. 18

Valuation Rule

As per books.
 Closing Market Price (other than those held as not for sale)
 Closing traded price or yield
 Last available price or book value whichever is lower.
 Estimated Market Price approach to be adopted if suitable benchmark is available.
 Current Yield.

Deductions for Liabilities

Expenses accrued
 Liabilities towards unpaid assets
 Other short term or long term liabilities

QUESTION NO. 26 What are important Investor's Rights, Legal limitation, & Obligations under Mutual Fund?

→ **Investors Rights** The offer documents of a scheme lays down the investors rights. The important rights of the unit holders are

1. unit holders have a **proportionate right in beneficial ownership** of the schemes assets as well as any dividend or income declared under the scheme.

2. they have the **right to information** regarding any adverse happening

3. they are **entitled to receive dividend warrants** within 42 days of the date of dividend declaration.

4. **Right to terminate** : AMC can be terminated by 75% of the unit holders of the scheme present and voting at a special meeting.

5. **Right to inspect** : The holders have the right to inspect major documents of the fund i.e. material contracts, the investment management agreement, the custodian services agreement, registrar and transfer agency agreement, memorandum and articles of association of the AMC, recent audited financial statements and the offer document of the scheme.

6. With the consent of 75% of the unit holders they have the **right to approve** any changes in the close ended scheme.

7. Every unit holder has the **right to receive a copy of the annual statements & periodic statements** regarding his transaction.

→ **Legal Limitations to Investors' Rights**

1. **No Right to Sue Trust** : Unit holders **cannot sue the trust** but they can initiate proceedings against the trustees, if they feel that they are being cheated.

2. **No Right to Sue for Lower Returns** : Except in certain circumstances AMC **cannot assure a specified level of return** to the investors AMC cannot be sued to make good any shortfall in such schemes.

→ **Investors' Obligations**

1. **Study Of Risk Factors** : An investor should **carefully study the risk factors** & other information provided in the offer document. Failure to study will not entitle him for any rights thereafter.

2. **Monitoring the Scheme** : It is the responsibility of investor to **monitor his schemes** by studying the reports & other financial statements of the funds.

QUESTION NO. 27 What is a Takeover by Reverse Bid or Reverse Takeover?

→ **Meaning** : It is the act of a smaller company gaining control over a larger one .In ordinary case, the company taken over is the smaller company; in a 'Reverse Takeover', a smaller company gains control of a larger one. The concept of takeover by reverse bid, or of reverse merger, is thus not the usual case of amalgamation of a sick unit which is non-viable with a healthy or prosperous unit but is a case whereby the entire undertaking of the healthy and prosperous company is to be merged and vested in the sick company which is non viable.

→ **Tests For Identifying Takeover by Reverse Bid** :

The three tests in a takeover by reverse bid that are required to be satisfied are, namely,

- (i) the assets of the transferor company are greater than the transferee company,

- (ii) equity capital to be issued by the transferee company pursuant to the acquisition exceeds its original issued capital, and

- (iii) the change of control in the transferee company through the introduction of a minority holder or group of holders.

Takeover by reverse bid could happen where already a significant percent of the shareholding is held by the transfer company, to exploit economies of scale, to enjoy better trading advantages and other similar reasons.

→ **Application of the concept of 'takeover by reverse bid'** The concept of takeover by reverse bid has been successfully employed in schemes formulated for revival and rehabilitation of sick industrial companies under the Sick Industrial Companies (Special Provisions) Act 1985.

→ **Recent Example**: A recent example of a non-sick unit 'reverse merger' was that of ICICI Bank (smaller unit) merging with ICICI Ltd. (larger unit) to form ICICI Bank Ltd. The aim was to give the company an identity of a 'Universal Banking Company'.

QUESTION NO. 28 Write a short note on Leveraged Buyouts

A **Leveraged buy-out (LBO)** is an acquisition of a company in which the acquisition is substantially financed through debt. Typically in the LBO 90% or more of the purchase price is financed with debt.

→ While some leveraged buyouts involve a company in its entirety most involve a business unit of a company. After the buyout, the company invariably becomes a Private Company.

→ A large part of the borrowings is secured by the firms assets, and the lenders, because of a high risk, take a portion of the firms equity. Junk bonds have been routinely used to raise amounts of debt needed to finance LBO transaction.

→ The success of the entire operation depends on their ability to improve the performance of the unit, curtail its business risk, exercise cost controls and liquidate disposable asset. If they fail to do so, the high fixed financial costs can jeopardize the venture.

→ An attractive candidate for acquisition through leveraged buyout should possess three basic attributes :

(a) It firm have a good position in its industry with a solid profit history and reasonable expectations of growth.

(b) The firm should have a relatively low level of debt and a high level of bankable assets that can be used as loan collateral.

(c) It must have a stable and predictable cash flows that are adequate to meet interest and principle payment of the debt and provide adequate working capital.

→ **Recent example:** India has experienced a number of buyouts and leveraged buyouts . A successful example of LBO is the acquisition of Tetley brand, the biggest tea brand of Europe by TATA Tea of India at 271 million pounds. It was one of the biggest cross border acquisition by an Indian Company. Another recent example of a leveraged buyout is **Tata Steel** (India) acquiring **Corus** (United Kingdom) for \$11.3 billion .

QUESTION NO. 29 Mention various products which are available in the market to cover exchange rate risks?

Various products (tools) which are available in the market to cover exchange rate risks.

- | | | |
|--|------------------------------|---------------------------------|
| (i) Currency & Interest Rate Swaps | (ii) Rupee Forward Contracts | (iii) Rupee Roll-Over Contracts |
| (iv) Cross-Currency Forward Contracts | (v) Currency Futures | (vi) Cross-Currency Options |
| (vii) Cross Currency Roll Over Contracts | (viii) Arbitrage | (ix) Spot Contracts |

QUESTION NO. 30 Write a short note on the following topics :

Exposure Netting

→ **Meaning : Exposure Netting** refers to offsetting exposures in one currency with Exposures in the same or another currency, where exchange rates are expected to move in such a way that losses or gains on the first exposed position should be offset by gains or losses on the second currency exposure.

→ **Objective :** The objective of the exercise is to offset the likely loss in one exposure by likely gain in another.

→ **Hedging Tool :** This is a manner of hedging forex exposures though different from forward and option contracts. This method is similar to portfolio approach in handling systematic risk.

→ **Example :** let us assume that a company has an export receivables of US\$ 10,000 due 3 months hence, if not covered by forward contract, here is a currency exposure to US\$.

Further, the same company imports US\$ 10,000 worth of goods/commodities and therefore also builds up a reverse exposure. The company may strategically decide to leave both exposures open and not covered by forward, it would be doing an exercise in exposure netting.

→ **Application Of Exposure Netting in Banking Transactions :** For years now, banking transactions have been based on the principle of netting. A Bank generally offsets its position in a currency , by taking a opposite position in the same currency . In banking terms this is known as settlement risk or settlement netting where only the difference of the summed transactions between the parties is actually transferred. In Banking transaction Exposure Netting occurs where outstanding positions are netted against one another in the event of counter party default.

Euro Convertible Bonds

→ **Euro Convertible Bonds** are quasi-debt securities (unsecured) which can be converted into depository receipts or local shares. ECBs offer the investor an option to convert the bond into equity at a fixed price after the minimum lock in period. The price of equity shares at the time of conversion will have a premium element. The bonds carry a fixed rate of interest.

→ These are bearer securities and generally the issue of such bonds may carry two options viz., call option and put option

Call Options : (Issuer's Option) - where the terms of issue of the bonds contain a provision for call option, the issuer company has the option of calling (buying) the bonds for redemption before the date of maturity of the bonds.

Put Options - (Holder's Option)- A provision of put option gives the holder of the bonds a right to put (sell) his bonds back to

the issuer company at a pre-determined price and date.

➔ **Application of Put Option** : If the market interest rate increases, then the investor will exercise the put option on the Bonds for redemption earlier to the date of maturity.

➔ **Application of Call Option** : If the market interest rate decreases, then the company will exercise the call option on the Bonds and re-market it for the remaining maturity period.

➔ In case of Euro-convertible bonds, the payment of interest and the redemption of the bonds will be made by the issuer company in US dollars. ECBs issues are listed at London or Luxemburg stock exchange.

➔ Indian companies which have opted ECBs issue are Jindal Strips, Reliance, Essar Gujarat, Sterlite etc. Indian companies are increasingly looking at Euro-Convertible bond in place of Global Depository Receipts because GDRs are falling into disfavour among international fund managers.

➔ **Prior Government Approval** : Company desirous of issuing ECB, should obtain the prior permission of Ministry of Economic Affairs. Certain restrictions are imposed on the eligibility norms such as good financial track record, nature of industry etc.

➔ **Application Of Proceeds** : Proceeds of ECBs can be applied only for the following :

(a) Import of Capital Goods (b) Retiring Foreign Currency Debts (iii) Capitalizing Indian Joint Venture Abroad (iv) Application for Working Capital and Others is restricted to 25 % of total proceeds.

QUESTION NO. 31 Name few types of Credit Instruments used in for effecting foreign remittances?

There are many types of credit instruments used in effecting foreign remittances. They differ in the speed, with which money can be received by the creditor at the other end after it has been paid in by the debtor at his end. The following are some of the international credit instruments in practice for the remittance of funds from one place to another.

- | | | |
|---|-----------------------|--|
| (i) Telegraphic or Cable Transfer | (ii) Mail Transfer | (iii) Banker's Draft or Banker's Cheques |
| (iv) Personal Cheques | (v) Bills of Exchange | (vi) Letter of Credit |
| (vii) Other means of foreign payments like (a) Currency Notes and Coins (b) Bullion (c) International Money Order | | |

QUESTION NO. 32 Write short note on Debt Route for foreign exchange funds?

The following are some of the instruments used for borrowing of funds from the international market :

(i) **Syndicated Bank Loans** : The borrower should obtain a good credit rating from the rating agencies. Large loans can be obtained in a reasonably short period with few formalities. Duration of the loan is generally 5 to 10 years. Interest rate is based on L1BOR plus spread depending upon the rating. Some covenants are laid down by the lending institutions like maintenance of key financial ratios.

(ii) **Euro Bonds** : These are basically debt instruments denominated in a currency issued outside the country of the currency. For example, Yen bond floated in France. Primary attraction of these bonds is the shelter from tax and regulations which provide scope for arbitraging yields. These are usually bearer bonds and can take the form of :

(a) traditional fixed rate bonds (b) floating rate notes (FRN's) (c) Convertible bonds.

(iii) **Foreign Bonds** : Foreign Bonds, are foreign currency bonds which are sold at the country of that currency and are subject to the restrictions as placed by that country on the foreigners' funds.

(iv) **Euro Commercial Papers** : These are short term money market securities usually issued at a discount, for maturity in less than one year.

(v) **External Commercial Borrowings (ECB's)** : These include commercial bank loans, buyer's credit and supplier's credit, securitised instruments such as floating rate notes and fixed rate bonds, credit from official export credit agencies and commercial borrowings from multi-lateral financial institutions like IFCI, ADS etc. External Commercial borrowings have been a popular source of financing for most of capital goods imports. They are gaining importance due to liberalization of restrictions. ECB's are subject to overall ceilings with sub-ceilings fixed by the government from time to time.

(vi) All other loans are approved by the government.

QUESTION NO. 33 What is the role of Financial Advisor in PSU?

The financial adviser occupies an important position in all public sector undertakings (PSU). He functions as the principal advisor to the chief executive of the enterprise on all financial matters. The committee on public sector undertakings has specified the following functions and responsibilities for a financial adviser:

- (i) **Determination of financial needs** of the firm and the ways these needs are to be met.
- (ii) **Formulation of a programme** to provide most effective cost-volume profit relationship.
- (iii) **Analysis of financial results** of all operations and recommendations concerning future operations.
- (iv) **Examination of feasibility studies** & detailed project reports from the point of view of overall economic viability of the project.
- (v) **Conduct of special studies** with a view to reduce costs and improve efficiency and profitability.

QUESTION NO. 34 What are the Advantages and Disadvantages of a Depository? or Explain Briefly the advantage of holding security in Demat form rather than in physical form ?

Benefits/Advantages of depository system are as follows:

For the Capital Market:

- (i) It helps to eliminate voluminous paperwork, (ii) It eliminates bad delivery (iii) It helps in quick settlement and reduces settlement time, (iv) It facilitates stock lending, (v) It helps to eliminate the problems of odd lot (vi) It is speedier and avoids delay in transfers. (vii) It avoids lot of paper work. (viii) It saves on stamp duty.

For the Investor:

- (i) It reduces risks associated with loss, theft and forgery of physical shares, (ii) It ensures liquidity by speedier settlements of trades, (iii) It makes the investors free from physical holding of shares, (iv) It reduces the transaction costs, (v) It helps investors to get preference in getting loan against securities. (vi) Benefit accruing from issue of bonus shares, consolidation, split or merger is credited without much difficulty (vii) Change of address will be recorded very soon.

For the Issuers:

- (i) It provides up-to-date knowledge of shareholder's names and addresses, (ii) It enhances image of the company, (iii) It increases efficiency of registrars and transfer agents, (iv) It reduces the cost of secretarial department, (v) It provides better facilities of communication with shareholders. (vi) Savings in printing certificates, postage expenses. (vii) Stamp duty waiver. (viii) Easy monitoring of buying/selling patterns in securities, increasing ability to spot takeover attempts & attempts at price rigging.

Disadvantages of Depository are as follows: Risks associated with derivatives are as follows :

1. **Systemic failure** – Input control, process control and output control being parts of computerized environment apply equally to the dematerialization process. Unforeseen failures, intentional or otherwise, on the part of the individuals entrusted with protecting data integrity, could lead to chaos.
2. **Additional record keeping** – In built provisions for rematerialization exist to take care of the needs of individuals who wish to hold securities in physical form. Companies will invariably need to maintain records on a continuous basis for securities held in physical form. Periodical reconciliation between demat segment and physical segment is very much necessary.
3. **Cost of Depository Participant (DP)** – For transacting business, investors have to deal not only with brokers but also with depository participant which acts as an additional tier in the series of intermediaries. A one time fee is levied by the depository participant which small investors consider to be an avoidable cost.
4. **Human Fraud** – Dematerialization is not a remedy for all ills. Unlawful transfers by individuals against whom insolvency proceedings are pending or transfers by attorney holders with specific or limited powers are possible.
5. There is a rare possibility of setting up of a single depository. Multiple Depository system raises the problem of co-ordination between different accounts of a single individual and deduction of TDS and other statutory dues. It may increase the number of frauds

QUESTION NO. 35 Explain the term “Derivatives”? or Explain Briefly : (i) What are derivatives ? (ii) Who are the users and what are the purposes of use ? (iii) Enumerate the basic differences between cash and derivatives market ?

→ **Meaning** : A **derivative** is a financial instrument which derives its value from some other financial price. In other words it does not have any value of its own but its value, in turn, depends on the value of other physical assets which are called the

underlying assets. The underlying assets can be Equity, Forex, Commodity.

→ A derivative is defined as a contract that has all the following characteristics:

- (i) Its value changes in response to a specified underlying, e.g. an exchange rate, interest rate or share price; (ii) It requires little or no initial net investment; (iii) It is settled at a future date;

The most common derivatives are currency forwards, futures, options, interest rate swaps etc.

For instance : A wheat farmer may wish to contract to sell his harvest at a future date to eliminate the risk of a change in prices by that date. The price for such a contract would obviously depend upon the current spot price of wheat. Such a transaction could take place on a wheat forward market. Here, the wheat forward is the 'derivative' and wheat on the spot market is 'the underlying'.

The terms 'derivative contract', 'derivative product', or 'derivative' are used interchangeably.

→ **User & Purpose** : Derivative serve as a method to hedge and reduce risks .

Users

- (i) Corporation
- (ii) Individual
- (iii) Institutional Investor
- (iv) Dealers

Purpose

- To hedge currency risk and inventory risk
- Investors For speculation, hedging and yield enhancement.
- For hedging asset allocation, yield enhancement and to avail arbitrage opportunities.
- For hedging position taking, exploiting inefficiencies and earning dealer spreads.

→ **Differences between Cash and the Derivative Market** : The basic differences between Cash and the Derivative market are as follows :

- (a) In cash market tangible assets are traded whereas in derivative markets contracts based on tangible or intangibles assets like index or rates are traded.
- (b) In cash market, we can purchase even one share whereas in Futures and Options minimum lots are fixed.
- (c) Cash market is more risky than Futures and Options segment because in "Futures and Options" risk is limited upto 20%.
- (d) Cash assets may be meant for consumption or investment. Derivative contracts are for hedging, arbitrage or speculation.
- (e) The value of derivative contract is always based on and linked to the underlying security. Though this linkage may not be on point-to-point basis.
- (f) In the cash market, a customer must open securities trading account with a securities depository whereas to trade futures a customer must open a future trading account with a derivative broker.
- (g) Buying securities in cash market involves putting up all the money upfront whereas buying futures simply involves putting up the margin money.
- (h) With the purchase of shares of the company in cash market, the holder becomes part owner of the company. While in future it does not happen.

→ **Example** : The most important derivatives are Futures, Options, Forward, Swaps

→ **Types of Derivative Market** : (a) Exchange Traded Derivatives (b) OTC (Over the Counter) Derivatives

Exchange-traded derivatives : Derivatives which trade on an exchange are called '**Exchange-traded derivatives**'. Trades on an exchange generally take place with anonymity. Trades at an exchange generally go through the clearing corporation. **Example** : Interest Rate Futures, Interest Rate Options, Currency Futures, Currency Options.

OTC derivative : A derivative contract which is privately negotiated is called an **OTC derivative**. OTC trades have no anonymity, and they generally do not go through a clearing corporation. **Example** : Interest rate swaps, Currency swaps, Caps, collars, floors, forward.

→ **Risk Associated With Derivative Market** : The various risks associated with them. The different types of derivatives risks are: (a) Credit Risk (i) Pre-settlement Risk (ii) Settlement Risk (b) Market Risk (c) Liquidity Risk (i) Market liquidity Risk (ii) Funding liquidity Risk (d) Operational Risk (e) Legal Risk (f) Regulatory Risk (g) Reputation Risk

QUESTION NO. 36 What is the purpose of Future Markets?

The purpose of futures market are as follows :

- (i) **Flexibility** : Futures markets provide flexibility to an otherwise rigid spot market because of their very concept which allows a wholistic approach to the price mechanism involved in futures contracts.
- (ii) **Quick & Low Cost Transactions** : Futures contracts can be created quickly at low cost to facilitate exchange of money for goods to be delivered at future date. Since these low cost instruments lead to a specified delivery of goods at a specified price on

a specified date, it becomes easy for finance managers to take optimal decisions in regard to production, consumption & inventory.

(iii) Price Discovery Function : The pricing of futures contracts incorporates a set of information based on which the producers and the consumers can get a fair idea of the future demand and supply position of the commodity and consequently the futures spot price. This is known as the 'price discovery' function of futures.

(iv) Advantage to Informed Individuals : Individuals who have superior information in regard to factors like commodity demand or supply, market behaviour, technology changes etc., can operate in futures markets and impart efficiency to the commodity's price determination process. This, in turn, leads to a more efficient allocation of resources.

(v) Hedging Advantage : Adverse price changes which may lead to losses. can be adequately and efficiently hedged against through futures contracts.

(vi) Speculation : Future contracts provide arbitrage opportunity to the speculators

(vii) Integrity : A key element of exchange-traded futures is that parties to the contract are not exposed to the risk of counter party default. Futures exchanges have perfected systems of margins to protect market participants.

Thus, futures markets provide economic as well as social benefits through their functions of risk management & price discovery.

QUESTION NO.37 What are the types of ORDERS in a future market?

(RTP Nov 2008)

Customers in futures and option markets are able to submit a complete range of dealing instructions to their brokers. This allows them to give precise instructions as to how their orders will be treated. Generally, following types of orders are issued:

(i) Market Order : When a trader places a buy or sell order at the price which prevails in the futures market at the time the order is given, it is called a market order.

(ii) Limit Order : If the trader specifies a particular price or the price limit within which the order should be executed, such an order is called a limit order.

(iii) Market-if-touched (MIT) Order : If an order is executed at the best available price after a trade occurs at a particular price or at a price more favourable than the specified price, it is called a Market-if-touched order.

(iv) Stop Loss Order : Stop loss orders are normally placed by specifying a range in which the order should be executed instead of giving a single price order.

(v) Good Till Cancelled (GTC) Order : In terms of National Stock Exchange (NSE) regulations, Good till cancelled orders shall be cancelled at the end of 7 calendar days from the date of entering the order.

Other type of orders include : **(vi) Guaranteed Stop.****(vii) Spread Order.****(viii) Scale Order.****(ix) Opening Order.****(x) Closing Order.****(xi) Limit or Market on Close Order.****(xii) Stop Limit Order.****(xiii) Public Limit Order.**

QUESTION NO. 38 Explain the terms 'Intrinsic Value of an Option' & the 'Time Value of an Option'? OR Distinguish between Intrinsic Value & Time Value of an option?

Option Premium is the component of two parts: Intrinsic value + Time Value of an option

Intrinsic Value ➔ Intrinsic Value is the gross profit that the option buyer would realize upon immediate exercise of the option. ➔ It is defined as the difference between the option's strike price and the stock's actual current price. ➔ Intrinsic Value is the value or profit that any given option would have if it were exercised today. ➔ It can never be negative (always equal to or greater than zero). ➔ Intrinsic Value of Call Option = Maximum of (0, Market Price - Exercise Price); Intrinsic Value of Put Option = Maximum of (0, Exercise Price - Market Price). ➔ An option which is out of the money or at the money has zero intrinsic value. ➔ **Example:** If Wipro stock is selling at Rs 105, and Call Option on Wipro stock is Rs 100, then Intrinsic Value of Wipro stock is Rs 5 (Rs 105 - 100). Again if Wipro stock is selling at Rs 105 and Put Option on Wipro is Rs 100 then Intrinsic Value will be zero (Rs 100 - Rs 105 = -5) as it cannot be negative.

Time Value of Option: ➔ Time Value of Option is the amount by which the option price exceeds the Intrinsic Value. On the expiration date, the time value of option is zero and the premium is entirely represented by the Intrinsic Value. ➔ If there is At The Money or Out Of The Money position, it means there is no intrinsic value and the entire premium is represented by the time value. ➔ Time Value is basically the risk premium that the seller requires, to provide the option buyer with the right to buy/sell the stock up to the expiration date. This component may be regarded as "insurance premium" of the option. ➔ This is also known

as extrinsic value. → Time Value decays over time. In other words, the time value of an option is directly related to how much time an option has until expiration. i.e. lesser the time, lesser is the time value. → Example: If Wipro stock's current market price is Rs. 20 Exercise Price is Rs. 100. Call Option Premium on Wipro stock is Rs 25. Then the time value of option in such case will be Rs 5 (Option Premium Rs 25 - Intrinsic Value Rs 20 = Time Value Rs 5)

QUESTION NO. 39 Distinguish between Caps and Collars?

These are derivatives which a finance manager can use to manage his cash-flows effectively and also to reduce the risk involved in case of a major devaluation of currency.

→ **Caps** : If a company decides on a particular rate of a currency vis-a-vis the rupee over which it is not ready to take a risk, it can buy a cap at that rate. In other words Caps means setting the Upper Limits

→ **Floor** : The cost of caps is very prohibitive and can be offset by selling a 'floor' which is just the opposite of cap. In other words Floor means setting the Lower limits

→ **Collar** : a combination of caps and floors is called collar.

QUESTION NO. 40 Write a Short Notes on BOOK BUILDING ?

→ The book-building system is part of Initial Public Offer (IPO) of Indian Capital Market. It was introduced by SEBI on recommendations of Mr. Y.H. Malegam in October 1995. It is most practical, fast and efficient management of Mega Issues. Book Building involves sale of securities to the public and the institutional bidders on the basis of predetermined price range.

→ Book Building is a price discovery mechanism and is becoming increasingly popular as a method of issuing capital. The idea behind this process is to find a better price for the issue.

→ The issue price is not determined in advance. Book Building is a process wherein the issue price of a security is determined by the demand and supply forces in the capital market.

→ Book building is a process used for marketing a public offer of equity shares of a company and is a common practice in most developed countries.

→ Book building is called so because it refers to the collection of bids from investors, which is based on an indicative price range. The issue price is fixed after the bid closing date. The various bids received from the investors are recorded in a book, that is why the process is called Book Building.

→ Unlike international markets, India has a large number of retail investors who actively participate in Initial Public Offer (IPOs) by companies. Internationally, the most active investors are the mutual funds and other institutional investors, hence the entire issue is book built. But in India, 25 per cent of the issue has to be offered to the general public. Here there are two options with the company.

→ According to the first option, 25 percent of the issue has to be sold at a fixed price and 75 per cent is through book building. The other option is to split the 25 % on offer to the public (small investors) into a fixed price portion of 10 percent and a reservation in the book built portion amounting to 15 % of the issue size. The rest of the book-built portion is open to any investor.

→ Advantage

(i) The book building process helps in discovery of price & demand.

(ii) The costs of the public issue are much reduced.

(iii) The time taken for the completion of the entire process is much less than that in the normal public issue.

(iv) In book building, the demand for the share is known before the issue closes. Infact, if there is not much demand, the issue may be deferred.

(v) It inspires investors confidence leading to a large investor universe.

(vi) Issuers can choose investors by quality.

(vii) The issue price is market determined.

→ Disadvantage

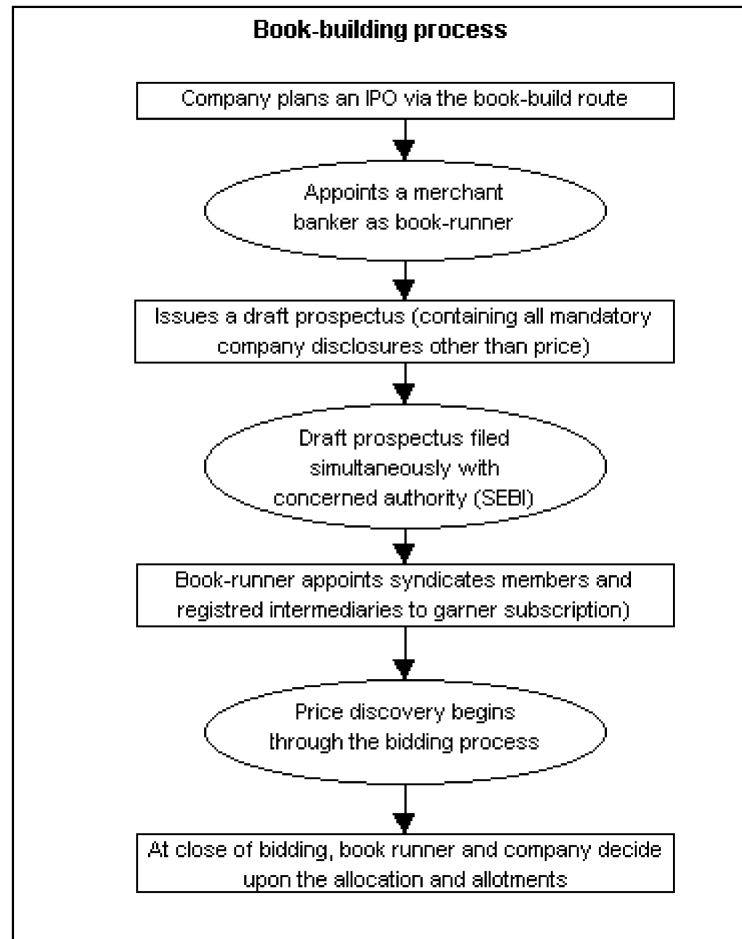
(i) There is a possibility of price rigging on listing as promoters may try to bail out syndicate members.

(ii) The book building system works very effeciently in matured market conditions. But, such conditions are not commonly found in practice.

(iii) It is appropriate for the mega issues only.

(iv) The company should be fundamentally strong & well known to the investors without it book building process will be unsuccessful.

➔ **Recent Example :** Recent example of a book building process in Indian context is the IPO of Reliance Power. The issue was made through 100 % book building process .The price band for the the book building pocesss was between Rs 405 and Rs 450 with Rs 20 discount for retail investors .



QUESTION NO. 41 What is GREEN SHOE OPTION ? or What is Green Share Option ? Explain the working mechanism ?

➔ Green Shoe Option (GSO) means an option available to the company issuing securities to the public to allocate shares in excess of the public issue and operating a post-listing price stabilising mechanism through a stabilising agent.

➔ This option acts as a safety net for the investors and is a standard global practice.

➔ The name comes from the fact that Green Shoe Company was the first entity to use this option. SEBI inserted a new Chapter No. VIII-A, with effect from August 14, 2003, in the SEBI (Disclosure and Investors Protection) Regulations, 2000 to deal with the GSO.

➔ The GSO is available to a company which is issuing equity shares through book-building mechanism for stabilising the post-listing price of the shares. The following is the mechanism of GSO :

1. The Company shall appoint one of the leading book runners as the Stabilising Agent (SA), who will be responsible for the price stabilising process.
2. 'The promoters of the company will enter into an agreement with SA to lend some of their shares to the latter, not exceeding 15% of the total issue size.

3. The borrowed shares shall be in the dematerialised form. These shares will be kept in a separate GSO Demat A/c.
 4. In case of over subscription, the allocation of these share shall be on pro-rata basis to all applicants.
 5. The money received from allotment of these shares shall also be kept in a 'GSO Bank A/c', distinct from the issue account, and the amount will be used for buying shares from the market during the stabilization period.
 6. The shares bought from the market by SA for stabilization shall be credited to GSO Demat Account.
 7. These shares shall be returned to the promoters within 2 days of closure of stabilisation process.
 8. In order to stabilise post-listing prices, the SA shall determine the timing and quantity of shares to be bought.
 9. If at the expiry of the stabilisation period, the SA does not purchase shares to the extent of over-allocated shares, then shares to the extent of shortfall will be allotted by the company to the GSO Demat A/c multiplied by the issue price. Amount left in the GSO Bank A/c (after meeting expenses of SA), shall be transferred to the Investors Protection Fund.
- In the Indian context, green shoe option has a limited connotation. SEBI guidelines governing public issues contain appropriate provisions for accepting over-subscriptions, subject to a ceiling, say 15% of the offer made to public. In certain situations, the green-shoe option can even be more than 15%.

Examples of GSO issues in India

- In April, 2004 the ICICI bank Ltd. became the first Indian company to offer GSO. The ICICI Bank Ltd. offered equity shares of Rs. 3050 crores through 100% book building process to the investors. The issue was over subscribed by 5.14 times.
- IDBI has also come up with their Flexi Bonds (Series 4 and 5) under GSO.
- More recently Infosys Technologies has also exercised GSO for its issue. This offer initially involved 5.22 million depository shares, representing 2.61 million domestic equity shares.

QUESTION NO. 42 Write a short note on Buy-Back of shares by companies? OR Briefly explain 'Buy Back of Securities' and give the management objectives of buying Back Securities?

→ In India buy back of Securities is governed by the Companies Act 1956. The Companies (Amendment) Act gives the power to the corporates to purchase its securities by virtue of Sections 77A, 77AA and 77B.

→ **Meaning** : Buyback is reverse of issue of shares by a company, where it offers to take back its shares owned by the investors at a specified prices.

→ **Objectives of Buyback** : The following are the management objectives of buying back securities :

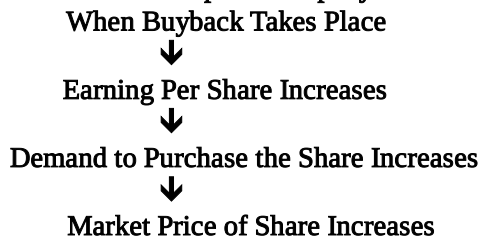
- (i) To return excess cash to shareholders, in absence of appropriate investment opportunities.
- (ii) To give a signal to the market that shares are undervalued.
- (iii) To increase promoters holding, as a percentage of total outstanding shares, without additional investment. Thus, buy back is often used as a defence mechanism against potential takeover.
- (iv) To change the capital structure.
- (v) To Increase Earning per share

→ **Resources of Buy Back** : A Company can purchase its own shares from

(i) free reserves; (ii) securities premium account; or (iii) proceeds of any shares or other specified securities. A Company cannot buyback its shares or other specified securities out of the proceeds of an earlier issue of the same kind of shares or specified securities.

→ **Advantages of Buyback** : The Advantages of Buyback of securities to investors, companies and economy are :

(i) **Revival of the Capital Market** : Buyback may flare up the market value of shares in a bearish market. This can be shown with the help of diagram given below. Buyback would also help the company to maintain the market price of its shares and to keep its stable.



(ii) **Liquidity to Dormant Shares** : Most of the shares of the companies which are held by Employees and Executives are usually dormant. By bringing in the buyback option, the company would be able to purchase those shares from the employees

& executives. And thus not only increase the liquidity in the market but also would act as an incentive to the worthy employees.

(iii) Odd Lots : Odd Lots are generally dormant in nature and buyback could act as a relief to the shareholders by way of selling those shares to the company.

(iv) Restructuring of capital base by Companies with special reference to public sector units : It is felt that buyback of shares by Public Sector Undertaking is an attractive option, for two reasons. One it gives PSUs having a bloated equity base an opportunity to restructure their capital and in process add value for the remaining shareholders.

(v) Increasing the Earnings Per Share (EPS) and at the same time providing higher prices (P/E ratio) to Investors : The shareholders' money can be maximised by optimising the current earnings on the share and at the same time increasing the market value of the shares by way of capital appreciation.

(vi) Proper Utilisation of Excess Funds : Many small and mid range companies in this country sit upon so much cash without having any idea of where to put them in. It would be better for them to return surplus cash to shareholders than go on spending simply for want of alternatives.

(vii) For ensuring price stability in share prices

(viii) For exercising control over the company

(ix) For taking tax advantages

(x) For saving the company from hostile takeover

→ **Disadvantages of Buyback** : Some of the disadvantages of Buyback are as follows :

(i) Manipulation of share prices by its promoters **(ii)** speculation **(iii)** collusive trading

→ **Conditions of Buy Back** :

(a) The buy-back is authorised by the Articles of Association of the Company;

(b) A special resolution has been passed in the general meeting of the company authorising the buy-back.

(c) The buy-back is of less than twenty-five per cent of the total paid-up capital and fee reserves of the company and that the buy-back of equity shares in any financial year shall not exceed twenty-five per cent of its total paid-up equity capital in that financial year;

(d) The ratio of the debt owed by the company is not more than twice the capital and its free reserves after such buy-back;

(e) There has been no default in any of the following :

i. in repayment of deposit or interest payable thereon, **ii.** redemption of debentures, or preference shares or **iii.** payment of dividend, if declared, to all shareholders within the stipulated time of 30 days from the date of declaration of dividend or **iv.** repayment of any term loan or interest payable thereon to any financial institution or bank;

(f) All the shares or other specified securities for buy-back are fully paid-up;

QUESTION NO. 43 Write a short note on Stock Lending Scheme-its meaning, advantages & risk involved?

→ Stock lending or borrowing of securities is not a new phenomenon for international capital market, but for India, it has recently been introduced. The stock lending began as a means to cover short sales (selling shares without possessing them). SEBI has introduced scheme for securities lending and borrowing in 6th Feb. 1997.

→ **Meaning** : The Stock Lending involves a lending institution who lends its securities to another party known as borrower who needs the security for delivery to clients or other brokers to avoid a failed delivery .

→ In stock lending, the legal title of a security is temporarily transferred from a lender to a borrower. The lender retains all the benefits of ownership, other than the voting rights. The borrower is entitled to utilise the securities as required but is liable to the lender for all benefits (e .g. dividends, interest or rights).

→ **Parties** : The main constituents or parties of the stock lending scheme are : **(a)** Lenders **(b)** Borrowers **(c)** Intermediaries

→ **Objectives of the Scheme**

(i) To improve the liquidity in the stock market. **(ii)** To facilitate the timely settlement of transaction of the securities. **(iii)** To help in correcting the imbalances in supply and demand in the stock market. **(iv)** To work as hedging strategies **(v)** To avoid delivery defaults

→ **Advantages of Stock Lending Scheme** :

From the point of view Borrowers :

(i) Borrowers use the securities lending programme to avoid settlement failures.

(ii) It creates liquidity to facilitate trading strategies for borrowers.

(iii) Securities lending gives borrowers access to lender portfolios, which provide the flexibility necessary when the borrowing is for strategic positioning and financing inventories.

(iv) Create alternative investment strategies involving Short Sales

(v) It aids in arbitrage strategies such as reverse cash and carry

From the point of view Lenders and Intermediaries :

(i) A securities lending programme is used by the lenders to maximise yields on their portfolio. Hence Securities lending provides income opportunities for security-holders . It facilitate returns on idle securities .

(ii) Securities lending is particularly attractive for large institutional holders of securities, as it is an easy way of generating income to offset custody fees and requires little time.

(iii) Creates another revenue stream for custodian and intermediaries .

From the point of view Capital Market :

It facilitates (i) timely settlement, (ii) increases the settlements, (iii) reduces market volatility , (iv) improves liquidity ,(v) Facilitate Short Selling leading to better price discovery , (vi) smooths the spot market settlement process

→Risk Involved :

For Intermediary : In case, the borrower fails to return the securities, he will be declared a defaulter and the approved intermediary will liquidate the collateral deposited with it. In the event of default of the borrower, the approved intermediary is liable for making good the loss caused to the lender.

For Borrower : By the time the borrower is supposed to return the securities, the prices may go up the borrower has to purchase the shares at high prices for returning the same to the lender. This may cause loss to the borrower. The borrower cannot discharge his liabilities of returning the equivalent securities through payment in cash or kind.

For the lender : The default by the intermediary may cause loss to the lender.

QUESTION NO. 44 What are the differences between Primary & Secondary Markets?

<u>Basis</u>	<u>Primary Markets</u>	<u>Secondary Markets</u>
(a) Meaning	A primary market refers to the set up which helps the industry to raise funds by issuing different types of securities.	The secondary market is market for subsequent sale/purchase and trading in the securities.
(b) Nature of Securities	It deals with new securities, i.e. securities which were not previously available, and are offered for the first time to the investors.	It is a market for old securities which have been issued already.
(c) Sale/ Purchase	Securities are acquired from issuing Companies themselves.	Securities are purchased and sold by the investors without any involvement of the companies.
(d) Nature of Financing	It provides funds to new enterprises & also for expansion and diversification of the existing one.	It does not supply additional funds to the company since the company is not involved in transaction
(e) Liquidity	It does not lend any liquidity to the securities	The secondary market provides facilities for the continuous purchase and sale of securities, thus lending liquidity and marketability to the securities.
(f) Organisational Difference	It is not rooted in any particular spot and has no geographical existence. It has neither any tangible form nor any administrative	Secondary market has physical existence in the form of stock exchange and are located in a particular geographical area having an administrative
	administrative organisational set up.	-ve organisation set up.

QUESTION NO. 45 Explain the term Insider Trading and why Insider Trading is punishable?

→Meaning : Insider trading refers to using the unpublished information about the performance or other matters of a company , in dealings with the securities of the company. or

In other words Insider Trading

- is a buying or selling or dealing in securities of a listed company,
- by a director, member of management, an employee or any other person such as internal or statutory auditor, agent, advisor, analyst, consultant etc.
- who have knowledge of material 'inside' information not available to general public
- ➔ **The dealing in securities by an insider is illegal when it is predicated upon utilization of inside information to profit at the expense of other investors who do not have access to such investment information.**
- ➔ **The word insider has wide connotation.** An outsider may be held to be an insider by virtue of his engaging himself in this practice on the strength of inside information.
- ➔ **Why Insider Trading is punishable :** Insider trading which is an unethical practice resorted by those in power in corporates has manifested not only in India but elsewhere in the world causing huge losses to common investors thus driving them away from capital market. Therefore, it is punishable. Insider trading is prohibited by the SEBI as (i) it results into unfair gains to insiders and harms the interest of other shareholders, (ii) it downgrades the image of the company, (iii) it drives away the investors from the market, and (iv) it causes unwarranted volatility in the prices of the shares of the company.
- ➔ **Regulatory Regime in India :** It was in the late 70s and thereafter that the insider trading was recognised as an undesirable practice. Sachar Committee (1979), Patel Committee (1986), Abid Hussain Committee (1989) have pointed out a need for regulation and control of Insider Trading. They all recommended that Insider Trading be made an offence punishable with civil as well as criminal penalties.
- ➔ **Current Case Of Insider Trading :** The audit committee of Infosys Technologies' board of directors has imposed a penalty of Rs 5 lakh (Rs 500,000) on Gopalakrishnan and a fine of \$2,000 on Lehman as they failed to comply with the insider trading norms of the company. The company, in perhaps the first instance in India, has fined its CEO Kris Gopalakrishnan for a technical violation of its insider trading rules.
- ➔ Indian capital markets are increasingly becoming global. In this scenario, we must develop legislative and regulatory mechanisms to protect investors and build confidence in capital markets from both domestic and international perspectives. It is very important for the regulator to check the practice of insider trading so as to maintain investor confidence.

QUESTION NO. 46 What is the difference between Capital Market and Money Market?

<u>Basics</u>	<u>Money Market</u>	<u>Capital Market</u>
(i) Tenure	It is a market for lending and borrowing of short term funds, upto one year .	Capital markets deals in long term securities for a period beyond one year.
(ii) Well defined place	It is not a well-defined market where business is done .	It is a well defined market where business is done e.g. stock exchange.
(iii) Short Term / Long Term	It deals in short term financial assets e.g. interbank call money, treasury bills, commercial paper, etc.	It deals in medium & long term financial assets e.g. equity shares, debentures etc.
(iv) Classification	There is no sub-division in money market .	Capital Market is classified between Primary Market and Secondary Market.
(v) Volume of business	The total value of transaction in money market far exceeds the capital market . According to DFHI only in call money market daily trading is Rs. 6000 crores around	Capital market lag behind the total value of transaction done in money market.
(vi) No. of instrument	The number of instruments dealt in money market are various, e.g. (a) Interbank call money (b) Notice money upto 14 days (c) Short term deposits upto 3 months (d) 91 days treasury bill (e) 182 days treasury bill (f) Commercial paper etc.	The number of instruments in capital market are shares and debentures.
(vii) Participants	The participants in money market are Bankers, RBI and Government .	The participants in capital market are general investors, brokers, merchant bankers, registrars to issue, underwriters, corporate investors, FIs & Bankers.
(viii) Liquidity	The important features of money market	Whereas Capital market are not as

	instrument is that it is liquid.	liquid as money market instrument.
(viii) Regulator	It is regulated by the guidelines of RBI	It is regulated by the guidelines of SEBI.

QUESTION NO. 47 Write a short note on :**INTER-BANK PARTICIPATION CERTIFICATE (IBPC)**

→ **Meaning :** A IBPC is a deed of transfer through which a bank, sells or transfers to a third party (transferee) a part or all of a loan made its clients (borrowers). In other words The Inter Bank Participation Certificates are short term instruments to even out the short term liquidity within the Banking system particularly when there are imbalances affecting the maturity mix of assets in Banking Book.

→ **Why it is called so ? :** It is called a participation certificate because through it, the PC holder participates in a bank loan, and so also in the interest, the security of the loan, and risk of default on a proportionate basis.

→ **Objective:** The primary objective is to provide some degree of flexibility in the credit portfolio of banks & to smoothen the consortium arrangements.

→ **Who can Issue & Subscribe:** The IBPC can be issued by scheduled commercial bank and can be subscribed by any commercial bank.

→ **Issued against underlying Advance :** The IBPC is issued against an underlying advance, classified standard during the currency of the participation. the aggregate amount of participation should be covered by the outstanding balance in account.

→ **Types :** The participation can be issued in two types, viz. with and without risk to the lender.

While the participation without risk can be issued for a period not exceeding 90 days. Participation is with risk can be issued for a period between 91 days and 180 days. Under 'with risk participation', the issuing bank will reduce the amount of participation from the advances outstanding and participating bank will show the participation as part of its advances. Banks are permitted to issue IBPC under 'with risk' nomenclature classified under Health Code-I status and the aggregate amount of such participation in any account should not exceed 40% of outstanding amount at the time of issue. Under without risk participation, the issuing bank will show the participation as borrowing from banks and participating bank will show it as advances to bank.

→ **Benefits :** The scheme is beneficial both to the issuing and participating banks. **The issuing bank** can secure funds against advances without actually diluting its asset-mix. A **bank** having the highest loans to total asset ratio and liquidity bind can square the situation by issuing IBPCs. **To the lender**, it provides an opportunity to deploy the short term surplus funds in a secured and profitable manner. The IBPC with risk can also be used for capital adequacy management.

→ **Interest Rate:** The interest rate on IBPC is freely determined in the market. The certificates are neither transferable nor prematurely redeemable by the issuing bank.

→ **Current Scenario :** Despite its advantages, the IBPC scheme has not become a popular money market instrument one of the reason for this may be the prohibition against transferability as the participants are not allowed to transfer the certificates. Secondly due to the absence of a ceiling on the interest rate the borrower bank has to pay the issuing bank a rate higher than that agreed with the borrower.

QUESTION NO. 48 Explain the terms ESOS and ESPS with reference to the SEBI guidelines for The Employees Stock Option Plans (ESOPs).**ESOS**

1. **Meaning :** Employee Stock Option Scheme means a scheme under which the company grants options to employees

2. **Auditors Certificate :** Auditors Certificate to be placed at each AGM stating that the scheme has been implemented as per the guidelines and in accordance with the special resolution passed

3. **Transferability :** It is not transferable

4. **Consequences of failure :** The amount payable may be forfeited. If the option are not vested due to non-fulfillment

ESPS

Employee Stock Purchase Scheme means a scheme under which the company offers shares to employees as a part of public issue.

No such Certificate is required

It is transferable after lock in period

Not applicable

of condition relating to vesting of option then the amount may be refunded to the employees

5. Lock in period : Minimum period of 1 year shall be there between the grant and vesting of options. Company is free to specify the lock in period for the shares issued pursuant to exercise of option

One year from the date of allotment. If the ESPS is part of public issue and the shares are issued to employees at the same price as in the public issue, the shares issued to employees pursuant to ESPS shall not be subject to any lock in.

QUESTION NO. 49 Write a short note on :

A. Financial Intermediation

→ **Meaning :**

It involves financial institutions acquiring funds from the public by issuing their own instruments and then using the funds to buy primary securities.

It is a sort of indirect financing in which savers deposit funds with financial institutions rather than directly buying bonds and the financial institutions, in turn, lend to the ultimate borrowers.

Efficient financial intermediation is the key necessity for economic growth and development.

→ **Benefit:**

(i) Financial intermediaries are in a better position than individuals to bear and spread the risks of primary security ownership.

(ii) Because of their large size, intermediaries can diversify their portfolios and minimize the risk involved in holding any security. (iii) They

-employ skilled portfolio managers

-possess expertise in evaluation of borrower credit characteristics and

-take advantage of economies in large scale buying and selling.

→ **Example :** A good example of a financial intermediary is a **mutual fund**, which pools the financial resources of a number of people and invests in a basket of securities. Financial intermediation is the routing of savings to investments through financial intermediaries. It is a process through which an economy's savings are transformed into capital investments.

→ **Three Different Groups Of People :** In this process, three different groups of people are involved

Savers/ Suppliers of Funds : The savers/suppliers of funds would like to maximize the return while minimizing the risks.

Those Who Need Money for Productive Investment : Those in need of money would like to have it as cheaply as possible and with as few conditions attached as possible.

The Financial Intermediaries : The financial intermediaries provide their services to both the groups of people for their own (financial intermediaries) profits.

→ **Types of Financial Intermediations :** There are two types of Financial Intermediations : (i) Traditional Financial Intermediation; and (ii) Contemporary Financial Intermediation.

B. External Commercial Borrowings

→ The foreign currency borrowings raised by the Indian corporates from confirmed banking sources outside India are called "External Commercial Borrowings" (ECBs).

→ These Foreign Currency borrowings can be raised within ECB Policy guidelines of Govt. of India/ Reserve Bank of India applicable from time to time.

→ External Commercial Borrowings (ECB) are defined to include

1. commercial bank loans 2. buyer's credit 3. supplier's credit 4. securitised instruments such as floating rate notes, fixed rate bonds 5. credit from official export credit agencies etc

→ Multilateral financial institutions like IFC, ADB, AFIC, CDC are providing such facilities.

→ **Benefits :** The ECBs route is beneficial to the Indian corporates on account of following :-

1. It provides the foreign currency funds which may not be available in India.

2. The cost of funds at times works out to be cheaper as compared to the cost of rupee funds.

3. The availability of the funds from the International market is huge as compared to domestic market and corporates can raise large amount of funds depending on the risk perception of the International market.

4. ECBs provided an additional source of funds to the Indian companies, allowing them to supplement domestically

available resources and to take advantage of lower international interest rates.

5. While the ECB policy provides flexibility in borrowing consistent with maintenance of prudential limits for total external borrowings, its guiding principles are to keep borrowing maturities long, costs low and encourage infrastructure/core and export sector financing which are crucial for overall growth of the economy.

→ **End-use :**

(a) ECBs are to be utilised for foreign exchange costs of capital goods and services (on FOB and CIF basis). Proceeds should be utilized at the earliest and corporates should comply with RBI's guidelines on parking ECBs outside till actual imports. RBI would be monitoring ECB proceeds parked outside. However, in the case of infrastructure projects in the power, telecommunications and railway sectors, ECB can be utilised for project - related rupee expenditure. License fee payments would be an approved use of ECB in the telecom sector.

(b) ECB proceeds may also be utilised for project - related rupee expenditure, as outlined above. Proceeds must be brought into the country immediately. However, under no circumstances, ECB proceeds will be utilised for :

(i) investment in the stock market (ii) speculation in real estate

(c) ECB may be raised to acquire ships/vessels from Indian shipyards

→ **ECB cap :** With a view to manage the country's external debt prudently, the Finance Ministry sets an annual cap on the total ECBs that Indian corporates can access in a year. There have been reports that the Government plans to hike the cap on ECB currently fixed at \$18 billion to about \$22 billion.

→ The government has been streamlining/liberalising ECB procedures from time to time to enable Indian corporates have greater access to international financial markets.

→ **Recent Example :** About 812 companies have raised about \$20.24 billion through ECBs in the April 2006-February 2007 period. That would be equivalent to about Rs 88,000 crore. The top fundraiser was Reliance Industries, which raised \$700 million, followed by Reliance Communication, which raised \$500 million. Units in SEZ are permitted to use ECBs under a special window.

C. Reverse Mortgage

→ **Meaning :** A reverse mortgage is a periodic or lump sum loan against the mortgage of a residence. A reverse mortgage, therefore help converting the house equity into cash. Reverse mortgage helps the 'house rich' but 'cash poor' people to have regular cash inflows till they are alive.

→ **Indian Scenario :** In the Union Budget 2007-08, the Finance Minister proposed in Budget Speech a proposal to introduce 'Reverse Mortgages' as a measure of social security to senior citizens.

→ **Objective :** To address the financial needs of senior citizens owning self occupied property (house), for leading a decent life.

→ **Process :** In the reverse mortgage, senior citizens (borrowers), who own a house property, but do not have regular income, can mortgage the same with the lender (a scheduled bank or a housing finance company). In return, the lender makes periodic payment to the borrowers during their lifetime. In spite of mortgaging the house property, the borrower can continue to stay in it during his entire life span and continue to receive regular flows of income from the lender as well.

→ The concept of reverse mortgage, although new in India, is very popular in countries like the United States. Recently, National Housing Bank (NHB), a subsidiary of the Reserve Bank of India (RBI), released draft norms of reverse mortgage

→ **Benefits of a Reverse Mortgage:**

(i) The borrower remains the occupier as well as the owner of the house during his/her life time. There is no risk of being 'vacated'

(ii) The house property will not necessarily go to the lender. The heirs can repay the loan to keep the property. Else, they will get the residual amount from the sale of the property by the lender.

(iii) The 'dormant' wealth of the owner can be converted into a regular source of inflow.

(iv) Proceeds from reverse mortgages are tax-free. Proceeds could be used for: In-home care, Home repairs & improvements, paying off an existing mortgage, Education of grandchildren, Hospital & health care costs, paying off taxes and credit card debt, buying a second home and Travel.

(v) No loan repayment or payments as long as you live in your home.

(vi) Reverse mortgage is a measure of social security and is a boon for the retiring people .

D. Credit Cards As A Part Of Consumer Finance

→ **Meaning** : Credit cards are primarily seen as a means of convenience in meeting ones expenses. A person who holds a credit card need not pay in cash at the time of every expenditure. Instead, he can deposit a lump sum in the bank or the agencies of which he holds the credit card, to meet the expenditures. Credit Cards are a good substitute for cash and the resultant safety and convenience, the competition in this business has made credit cards a source of short-term finance also for individuals.

→ **Parties Involved In Credit Card Transaction** : Every transaction on a credit card involves three parties : (1) The credit card issuer (2) The credit cardholder and (3) The party to whom the cardholder is supposed to pay, say the merchant outlet (MO). Examples of MO are : a departmental store, hotel, railways, airlines etc.

→ **Advantages & Disadvantages:**

Advantages :

- (i) They allow you to make purchases on credit without carrying around a lot of cash. This allows you a lot of flexibility.
- (ii) They allow accurate record-keeping by consolidating purchases into a single statement.
- (iii) They allow convenient remote purchasing - ordering/shopping online or by phone. They allow you to pay for large purchases in small, monthly installments.
- (iv) Under certain circumstances, they allow you to withhold payment for merchandise which proves defective.
- (v) They are cheaper for short-term borrowing - interest is only paid on the remaining debt, not the full loan amount.
- (vi) Many cards offer additional benefits such as additional insurance cover on purchases, cash back, air miles and discounts on holidays.
- (vii) Beside this, the credit-card may also extend the benefit of roll over credit, supplementary cards and travel assistance.
- (viii) Credit cards enable a person to track and document all his expenses
- (ix) It is safer to carry Credit Cards rather than cash as it provides 100% safety of cash against theft

Disadvantages:

- (i) You may become an impulsive buyer and tend to overspend because of the ease of using credit cards. Cards can encourage the purchasing of goods and services you cannot really afford.
- (ii) Credit cards are a relatively expensive way of obtaining credit if you don't use them carefully, especially because of the high interest rates and other costs.
- (iii) Lost or stolen cards may result in some unwanted expense and inconvenience.
- (iv) The use of a large number of credit cards can get you even further into debt.
- (v) Using a credit card, especially remotely, introduces an element of risk as the card details may fall into the wrong hands resulting in fraudulent purchases on the card. Fraudulent or unauthorized charges may take months to dispute, investigate, and resolve.

QUESTION NO.50 State the difference between Factoring and Bill Discounting ?

<u>Basis</u>	<u>Factoring</u>	<u>Bill Discounting</u>
Parties:	In this case, the Parties are: Client, Factor and Debtor	In this case, the parties are: Drawer, Drawee & Payee.
Nature:	It is management of Book debts / Receivables	It is borrowing from commercial banks.
Grace Period :	Grace time is not given	Grace time of 3 days is given
Risk of Bad Debt :	Bad debts may be borne by factor in case of extra commission as agreed	No such provision. The risk of bad debts is still retained by the business.
Act :	There is no specific Act	There is Negotiable Instrument Act.
Service Offered :	It finances and manages the receivables of the client	It does not offer any non-financial services
Basis of Financing :	In factoring the basis of financing is turnover.	Whereas in bill discounting it is the security provision as well as the requirement of finance which determine the amount of financing.
Income To Financier :	Factor earns "Interest" for the financing service, and Commission for other services rendered	Banker earns " Discounting Charges" on the transaction.

QUESTION NO. 51 Write a short note on Shareholder Value Analysis (SVA) ?

➔ **Meaning** : SVA is an approach to Financial Management developed in 1980s. This approach focuses on the creation of economic value for shareholders, as measured by share price performance and flow of funds. SVA is used as a way of linking management strategy and decisions to the creation of value for shareholders.

➔ **Value Drivers** : The factors, called 'value drivers' are identified which will influence the shareholder's value. They may be : growth in sales, improvement in profit margin, capital investment decisions, capital structure decisions etc. The management is required to pay attention to such value drivers while taking investment & finance decisions.

➔ **Benefits** :

(i) SVA helps the management to concentrate on activities which create value to the shareholders rather than on short-term profitability.

(ii) SVA helps to strengthen the competitive position of the firm, by focussing on wealth creation .

(iii) They provide an objective and consistent framework of evaluation and decision making across all functions, departments and units of the company

➔ The shareholders value analysis got recognition only after 1986, when Prof. Rappaport of USA published his book Creating Shareholder Value. As per the concept of Shareholder Value Analysis (SVA), all business activity should aim to maximize the value of company's equity shares in the long run. As per SVA, the primary responsibility of management (not only of the finance manager) is to create value for the shareholders. All the decisions of the management should have only one target and that is value creation for the shareholders.
