IPCC - FM Theory
Part – 1
(Covering Important Non- Practical Theories)

Expected Marks in Examinations – (8 – 12) Marks

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Question 1.

Explain two basic functions of Financial Management. *(Nov. 2002) (4 marks)*

Answer

Financial Management deals with the **procurement of funds** and effective **utilization of funds** in the business.

(i) ***Procurement of funds:***

Funds can be procured from different sources. These sources are determined depending upon the

- **risk,**
- **cost** and
- **control** aspects of various sources of funds.

Few sources of Procurement of Funds are as under:

(1) The funds can be raised by issuing **equity shares**. The funds raised are quite expensive. The issue of new shares may dilute the control of existing shareholders.

(2) **Debenture** is relatively cheaper source of funds, but involves high risk as they are to be repaid in accordance with the terms of agreement. Also interest payment has to be made under any circumstances. Thus there are risk, cost and control considerations, which must be taken into account before raising funds.

(3) Funds can also be procured from **banks and financial institutions** subject to certain restrictions.

(4) Instruments like **commercial paper, deep discount bonds, ADRs, GDRs** etc also enable to raise funds.

(5) Short term funds can be raised from **Trade Creditors, Bank Overdrafts, Cash Credits** etc.

(ii) ***Utilisation of funds:***

The funds procured should be utilised in the projects / assets which shall generate adequate income so as to fulfil the desires of the fund providers. Since all the funds are procured at a certain cost, therefore it is necessary for the finance manager to take appropriate and timely actions so that the funds do not remain idle. If these funds are not utilised in the manner so that they generate an income higher than the cost of procuring them then there is no point in running the business.

Question 2.

Discuss the functions of a Chief Financial Officer. *(May 2004) (3 marks)*

Answer

Functions of a Chief Financial Officer

The twin aspects viz procurement and effective utilization of funds are the crucial tasks, which the CFO performs. The Chief Finance Officer is required to look into financial implications of any decision in the firm. Thus all decisions involving management of funds comes under the purview of finance manager.

Finance Manager performs the following functions:

(i) ***Estimating the requirement of Funds****:* The requirement of funds is to be estimated involving the techniques of budgets and plans. The requirement of funds is to be known in terms of periodicity i.e. For long-term purposes i.e. investment in fixed assets or for short-term i.e. for working capital.

(ii) ***Decision regarding Capital Structure:*** Once the requirement of funds has been estimated, a decision regarding various sources from which these funds would be raised has to be taken. A proper balance has to be made between the loan funds and own funds.

(iii) ***Investment Decision****:* The investment of funds, in a project has to be made after careful assessment of various projects through capital budgeting techniques.

(iv) ***Dividend decision:*** The finance manager is concerned with the decision as to how much of the earned profit is to be retained and what portion is to be paid as dividend depending on the future requirement of the fund. The balance in this respect is to be maintained by the Finance Manager.

(v) ***Evaluating financial performance regularly****:* A finance manager has to constantly review the financial performance of the various units of organisation generally in terms of ROI Such a review helps the management in seeing how the funds have been utilised in various divisions and what can be done to improve it.

(vi) ***Financial negotiation****:* The finance manager plays a very important role in carrying out negotiations with the financial institutions, banks and public depositors for raising of funds on favourable terms.

(vii) ***Cash management****:* The finance manager lays down the cash management policies with a view to supply adequate funds to all units of organisation and to ensure that there is no excessive cash.

(viii) ***Keeping touch with stock exchange****:* Finance manager is required to analyse major trends in stock market and their impact on the price of the company share.

Question 3.

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

(Nov. 1999, May 2003 & Nov. 2003) (3 marks)

Answer

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

(i) The maximisation of profit.

(ii) The maximisation of wealth.

The profit maximisation can be considered as a part of the wealth maximisation strategy.

Wealth maximisation often aims at increasing the Net Worth of the shareholders in the long run. It aims at increasing the market price of the shares in the Stock Market. Further, it also targets to increase the wealth of the enterprise without jeopardising the goodwill of the enterprise in the long run.

Profit maximisation often aims at increasing the profitability of the enterprise. The focus of this approach is only on increasing profit which is considered as a short term perspective. It often leads to indulgement of un-ethical or unpropfessional system of carrying business. The profit maxisation approach may result in better profitability but does not lead to increase the net worth of the shareholders and company in long run. They even sometime may adopt policies yielding exorbitant profits in short run which may prove to be unhealthy for the growth, survival and overall interests of the firm. The profit of the firm in this case is measured in terms of its total accounting profit available to its shareholders.

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

1. The wealth maximisation objective of a firm considers all future cash flows, dividends, earning per share, risk of a decision etc. whereas profit maximisation objective does not consider the effect of its decision on the wealth of the shareholder.
2. A firm that wishes to maximise the shareholders wealth may pay regular dividends whereas a firm with the objective of profit maximisation may refrain from dividend payment to its shareholders.
3. Shareholders would prefer an increase in the firm's wealth against its generation of increasing flow of profits.
4. The market price of a share reflects the shareholders expected return, considering the long-term prospects of the firm, reflects the differences in timings of the returns, considers risk and recognizes the importance of distribution of returns.

The maximisation of a firm's value as reflected in the market price of a share is viewed as a proper goal of a firm.

Question 4.

Write short notes on Inter relationship between investment, financing and dividend decisions.

(Nov. 1999) (5 marks)

Answer:

The finance functions are divided into three major decisions, viz., investment, financing and dividend decisions. It is correct to say that these decisions are inter-related because the underlying objective of these three decisions is the same, i.e. maximisation of shareholders' wealth.

Investment decision*:* The investment of funds is to be made in such projects which generates income sufficient to satisfy the financers of the company.

Financing decision*:* Funds can be raised from various sources. Each source of funds involves different issues. The finance manager has to maintain a proper balance while procuring the funds considering the aspect of risk, cost and control. It should be ensured that the cost of capital should not exceed the return to be earned out of investment proposals.

Dividend decision: The finance manager is also concerned with the decision to pay or declare dividend. He assists the top management in deciding as to what portion of the profit should be paid to the shareholders by way of dividends and what portion should be retained in the business. An optimal dividend pay-out ratio maximises shareholders' wealth. The shareholders cost of funds is dependent on the dividend policy of the company.

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

Question 5.

Discuss the major considerations in capital structure planning.

(Nov. 2003 & May 2006) (6 marks)

Answer

Major considerations in capital structure planning

There are **three major considerations**, i.e. risk, cost of capital and control, which help the finance manager in determining the proportion in which he can raise funds from various sources.

1. ***Risk:*** The finance manager attempts to design the capital structure in such a manner, so that risk of the company is on lower side. Issue of shares is considered as less risky source of finance from the company's point of view whereas issue of debentures are considered as riskier option. Lower risky source of finance has higher cost of capital and vice versa. Hence, a balance in this respect needs to be made, since the cost of fund is attached with risk associated.

2. ***Cost of Capital:*** Cost is an important consideration in capital structure decisions. It is obvious that a business should be at least capable of earning enough revenue to meet its cost of capital and finance its growth. Hence, along with a risk as a factor, the finance manager has to consider the cost aspect carefully while determining the capital structure.

3. ***Control:*** Along with cost and risk factors, the control aspect is also an important consideration in planning the capital structure. When a company issues further equity shares, it automatically dilutes the controlling interest of the present owners. Financial institutions normally stipulate that they shall have one or more directors on the Boards. Hence, when the management agrees to raise loans from financial institutions, by implication it agrees to forego a part of its control over the company. It is obvious, therefore, that decisions concerning capital structure are taken after keeping the control factor in mind.

Question 6.

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

(May 1998, May 1999) (4 marks)

Answer: *(Float here means time wastage in collection of cash)*

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

(i) ***Billing Float**:* The time between the point of sale and the mailing of the invoice is the billing float.

(ii) ***Mail Float**:* This is the time between the point of sending of the cheque by the customer and receipt of cheque by the seller. (Mailing time taken by the post offices / courier agencies)

(iii) ***Cheque processing float**:* This is the time between receipt of the cheque and the deposit of the cheque into the bank.

(iv) ***Bank processing float**:* This is the time between deposit of the cheque to the bank and crediting of funds in the bank's account. (Clearing time required by the bank)

Question 7:
Write short notes on Factoring *(Nov. 1998, Nov. 2003) (3 marks)*

Answer:

Factoring is a source of liquid finance for the company. Factoring is a process wherein the Trade Receivable (Debtors) of the company is transferred to the factor. In other words, the factor purchase the trade receivables of the company for cash and takes the responsibility of collecting the from Debtors on the due dates. With factoring, the company is relieved of the collection responsibilities and risk of bad debt. The factor then takes the responsibility of monitoring, follow-up, collection and risk-taking and provision of advance. The factor generally fixes up a limit customer-wise for the client (seller).

In factoring, accounts receivables are generally sold to a financial institution (a subsidiary of commercial bank-called “Factor”), who charges commission and bears the credit risks associated with the accounts receivables purchased by it.

Factoring offers the following advantages which makes it quite attractive to many firms.

(1) The firm can convert accounts receivables into cash without bothering about repayment.

(2) Factoring ensures a definite pattern of cash inflows.

(3) Continuous factoring virtually **eliminates the need for the credit department**.

However, factoring as a means of financing is comparatively costly source of financing since its cost of financing is higher than the normal lending rates.

Question 8:
Write notes on William J. Baumal Cash Management Model. *(May 2004) (3 marks)*

Answer:

According to William J Baumal’s Economic order quantity model optimum cash level is that level of cash where the carrying costs and transactions costs are the minimum.

The **carrying costs** refer to the cost of holding cash, namely, the interest foregone on marketable securities. (i.e. If we hold cash then we lose the chance of earning interest on the amount.)

The transaction costs refer to the cost involved in getting the marketable securities converted into cash. This happens when the firm falls short of cash and has to sell the securities resulting in clerical, brokerage, registration and other costs. *(It can also be considered as cost of depositing cash into bank. In older days, cost of depositing cash to bank were considerably high considering the distant location of the banks.)*

The optimum cash balance which should be deposited or invested (at one time) according to this model will be that point where these two costs are equal. The formula for determining optimum cash balance is :

$$\text{Optimal Cash Balance} = \sqrt{\frac{2A \times O}{C}},$$

Where

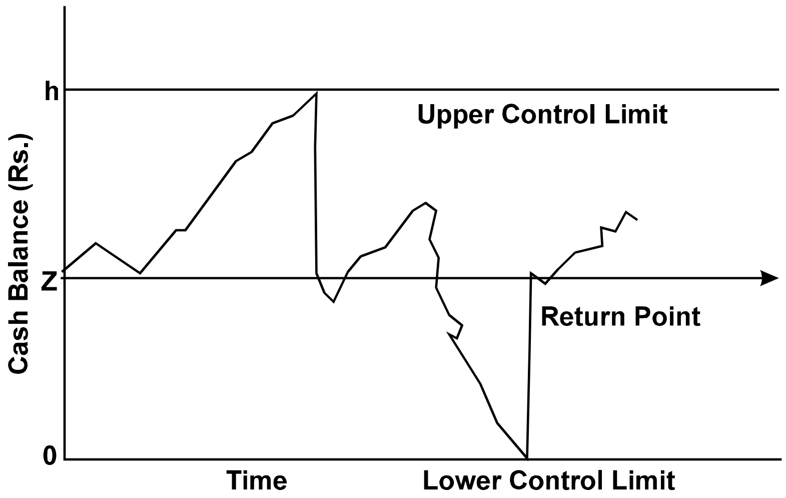
A	=	Annual (monthly) cash disbursements
O	=	Fixed cost per transaction
C	=	Opportunity cost of one rupee p.a. (or p.m)*(Similar as EOQ of Costing Subject)*

Question 9.

Discuss Miller-Orr Cash Management model. *(Nov. 2005) (2 Marks)*

Answer:

Miller – Orr Cash Management Model is a model to determine the level of cash that should be maintained by the enterprise. It determines the limit of Maximum Cash and Minimum Cash that is retained by the enterprise. In this model control limits are set for cash balances. These limits may consist of 'h' as upper limit, 'z' as the return point and zero as the lower limit.



MILLER-ORR CASH MANAGEMENT MODEL

When the cash balance reaches the **upper limit**, the transfer of **cash equal to 'h – z' is invested in marketable securities account.**

When it touches the **lower limit**, the **investment in marketable securities account is divested to cash**.

During the period when **cash balance stays between higher and lower limits, no transactions** between cash and marketable securities account is made.

The high and low limits of cash balance are set up on the basis of fixed cost associated with the securities transaction, the opportunities cost of holding cash and degree of likely fluctuations in cash balances. These limits satisfy the demands for cash at the lowest possible total costs. The formula for calculation of the spread between the control limits is:

$$\text{Spread} = 3\left(\frac{3/4 \times \text{Transaction Cost} \times \text{Variance of Cashflows}}{\text{Interest rate}}\right)^{1/3}$$

And, the return point can be calculated using the formula:

$$\text{Return point} = \text{Lower limit} + \frac{\text{Spread}}{3}$$

Question 10.

Enumerate the activities which are covered by Treasury Management.

(Nov. 2002) (3 marks)

Answer:

Treasury Management is concerned about the efficient management of liquidity (Cash, Bank and Marketable Securities) in business. Main activities which are covered by Treasury Management are as follows:

(i) *Cash management:* Treasury management in a business organisation is concerned about the efficient collection and repayment of cash to both insiders and to third parties.

(ii) *Currency management:* It manages the foreign currency risk, exchange rate risks etc. It may advise on the currency to be used when invoicing overseas sales.

(iii) Funding management: Responsible for planning and sourcing firm's short, medium and long term cash needs. It participates in capital structure, forecasting of future interest and foreign currency rates decision-making process.

(iv) *Banking:* Maintains good relations with bankers and carry out initial negotiations with them for any short term loan.

(v) *Corporate finance:* It advises on aspects of corporate finance including capital structure, mergers and acquisitions.

Question 11.

Explain the importance of trade credit and accruals as source of working capital. What is the cost of these sources? *(May 2003) (2 marks)*

Answer:

Trade credit and accruals as source of working capital refers to credit facility given by suppliers of goods during the normal course of trade. It is a short term source of finance. It is considered as important source of short term finance of the enterprises specially for Small & Medium Enterprises (SME) firms and SSI units. The major advantages of trade credit are – easy availability, flexibility and informality. No documentation are required to be filed for obtaining it unlike Bank Loans.

There can be an argument that trade credit is a cost free source of finance. But, practically it involves implicit cost. The supplier extending trade credit incurs cost in the form of opportunity cost of funds invested in trade receivables. Generally, the supplier passes on these costs to the buyer by increasing the price of the goods.

Question 12.

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

(Nov. 2006) (2 marks)

Answer:

In Dividend Price Approach, cost of equity capital is computed by dividing the current dividend by average market price per share. This ratio expresses the cost of equity capital in relation to what yield the company should pay to attract investors. It is computed as:

$$K_e = \frac{D_1}{P_o}$$

Where,

D_1 = Dividend per share in period 1

P_0 = Market price per share today

Dividend Price Approach is generally followed by short term investors.

In Equity Price Approach, cost of equity capital is computed by dividing the current EPS by average market price per share. This ratio expresses the cost of equity capital in relation to what earnings the company should pay to attract investors. It is computed as:

$$K_e = \frac{E_1}{P_0}$$

Where,

E_1 = Earning per share in period 1

P_0 = Market price per share today

Dividend Price Approach is generally followed by long term investors.

Question 13.

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

(May 2004, Nov. 2004 & May 2006) (6 marks)

Answer

Debt Securitisation is a **method of recycling of funds**. Through Debt Securitisation, the illiquid Assets are readily convertible into Liquid Assets. The Advances of the financial institution are clubbed together and transferred to the Investor through Special Purpose Vehicle against Cash. After the same, the advances do not appear in the Balance Sheet of the Financial Institution. The Investor is repaid the amount as and when the original loans and advances are repaid.

The financial institution that clubs the advances and transfers the same to investor is called as **Originator.**

The Originator clubs the advances and transfers the same to investor through **Special Purpose Vehicle (SPV)**. SPV is an entity specially set up to smoothen the process of Debt Securitisation.

The entity which invests and provides cash to the originator through SPV is called as **Investor.**

<u>Process of Debt Securitisation</u>

(i) *The origination function* – A borrower seeks a loan from a finance company, bank, HDFC. The credit worthiness of borrower is evaluated and contract is entered into with repayment schedule structured over the life of the loan.

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

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

The process of securitization is generally without recourse i.e. investors bear the credit risk and issuer is under an obligation to pay to investors only if the cash flows are received by him from the collateral. The benefits to the originator are that assets are shifted off the balance sheet, thus giving the originator recourse to off-balance sheet funding.

Advantages of Debt Securitisation

Advantages of Debt Securitization: Debt securitization is a method of recycling of funds and is especially beneficial to financial intermediaries to support lending volumes. Simply stated, under debt securitization a group of illiquid assets say a mortgage or any asset that yields stable and regular cash flows like bank loans, consumer finance, credit card payment are pooled together and sold to intermediary. The intermediary then issue debt securities.

The advantages of debt securitisation to the originator are the following:

(i) The asset are shifted off the Balance Sheet, thus giving the originator recourse to off balance sheet funding.

(ii) It converts illiquid assets to liquid portfolio.

(iii) It facilitates better balance sheet management, assets are transferred off balance sheet facilitating satisfaction of capital adequacy norms.

(iv) The originator's credit rating enhances.

For the investors securitisation opens up new investment avenues. Though the investor bears the credit risk, the securities are tied up to definite assets.

Question No. 14.

Write short Notes on Global Depository Receipts

Answer:

Global Depository Receipt (GDR) is a negotiable certificate denominated in US dollars which represents a Non-US company's publically traded local currency equity shares. GDRs are created when the local currency shares of an Indian company are delivered to Depository's local custodian Bank against which the Depository bank issues depository receipts in US dollars. The GDRs may be traded freely in the overseas market like any other dollar-expressed security either on a foreign stock exchange or in the over-the-counter market or among qualified institutional buyers.

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

Question No. 15.

Write short Notes on American Depository Receipts *(ADRs)*

(Nov. 1996, May 2003, May 2004 & May 2006*) (6 marks)*

Answer:

American Depository Receipts (ADRs): These are depository receipts issued by a company in USA and are governed by the provisions of Securities and Exchange Commission of USA. As the regulations are severe, Indian companies tap the American market through private debt placement of GDRs listed in London and Luxemberg stock exchanges.

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

Question No. 16.

Write short Notes on Bridge Finance *(Nov. 1997, 2003 & 2006) (6 marks)*

Answer:

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

Question No. 17.

Write short Notes on Packing Credit *(Nov. 1998 -6 marks)*

Answer:

Packing Credit: Packing credit is an advance made available by banks to an exporter. Any exporter, having at hand a firm export order placed with him by his foreign buyer on an irrevocable letter of credit opened in his favour, can approach a bank for availing of packing credit. An advance so taken by an exporter is required to be liquidated within 180 days from the date of its commencement by negotiation of export bills or receipt of export proceeds in an approved manner. Thus Packing Credit is essentially a short-term advance.

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

(i) *Clean Packing credit:* This is an advance made available to an exporter only on production of a firm export order or a letter of credit without exercising any charge or control over raw material or finished goods. It is a clean type of export advance. Each proposal is weighted according to particular requirements of the trade and credit worthiness of the exporter. A suitable margin has to be maintained. Also, Export Credit Guarantee Corporation (ECGC) cover should be obtained by the bank.

(ii) *Packing credit against hypothecation of goods:* Export finance is made available on certain terms and conditions where the exporter has pledgeable interest and the goods are hypothecated to the bank as security with stipulated margin. At the time of utilising the advance, the exporter is required to submit, alongwith the firm export order or letter of credit, relative stock statements and thereafter continue submitting them every fortnight and whenever there is any movement in stocks.

(iii) *Packing credit against pledge of goods:* Export finance is made available on certain terms and conditions where the exportable finished goods are pledged to the banks with approved clearing agents who will ship the same from time to time as required by the exporter. The possession of the goods so pledged lies with the bank and are kept under its lock and key.

Question No. 18.

Write short Notes on Euro Convertible Bonds.

(May 1996, 1998,May 2003, May 2004-3 marks)

Answer:

Euro Convertible Bond: Euro Convertible bonds are quasi-debt securities (unsecured) which can be converted into depository receipts or local shares. ECBs offer the investor an option to convert the bond into equity at a fixed price after the minimum lock in period. The price of equity shares at the time of conversion will have a premium element. The bonds carry a fixed rate of interest. These are bearer securities and generally the issue of such bonds may carry two options viz. call option and put option. A call option allows the company to force conversion if the market price of the shares exceed a particular percentage of the conversion price. A put option allows the investors to get his money back before maturity. In the case of ECBs, the payment of interest and the redemption of the bonds will be made by the issuer company in US dollars. ECBs issues are listed at London or Luxemberg stock exchanges.

An issuing company desirous of raising the ECBs is required to obtain prior permission of the Department of Economic Affairs, Ministry of Finance, Government of India, Companies having 3 years of good track record will only be permitted to raise funds. The condition is not applicable in the case of projects in infrastructure sector. The proceeds of ECBs would be permitted only for following purposes:

(i) Import of capital goods

(ii) Retiring foreign currency debts

(iii) Capitalising Indian joint venture abroad

(iv) 25% of total proceedings can be used for working capital and general corporate restructuring.

The impact of such issues has been to procure for the issuing companies finances at very competitive rates of interest. For the country a higher debt means a forex outgo in terms of interest.

Question No. 19.

Deep Discount Bonds vs. Zero Coupon Bonds *(May 2004) (3 marks)*

Answer:

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

IDBI was first to issue a Deep Discount Bonds (DDBs) in India in January 1992. The bond of a face value of Rs.1 lakh was sold for Rs. 2,700 with a maturity period of 25 years.

A zero coupon bond (ZCB) does not carry any interest but it is sold by the issuing company at a discount. The difference between discounted value and maturing or face value represents the interest to be earned by the investor on such bonds.

Question No. 20.

Venture capital financing *(PE-II-May 2005) (2 marks)*

Answer:

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

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

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

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

Question No. 21.

Methods of Venture Capital financing *(May 1999, Nov. 2002) (6 marks)*

Answer:

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

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

(ii) *Conditional Loan:* A conditional loan is repayable in the form of a royalty after the venture is able to generate sales. No interest is paid on such loans. In India Venture Capital Financers charge royalty ranging between 2 to 15 per cent; actual rate depends on other factors of the venture such as gestation period, cash flow patterns, riskiness and other factors of the enterprise. Some Venture Capital financers give a choice to the enterprise of paying a high rate of interest (which could be well above 20 per cent) instead of royalty on sales once it becomes commercially sound.

(iii) *Income Note:* It is a hybrid security which combines the features of both conventional loan and conditional loan. The entrepreneur has to pay both interest and royalty on sales but at substantially low rates. IDBI's Venture Capital Fund provides funding equal to 80-87.5% of the project's cost for commercial application of indigenous technology or adopting imported technology to domestic applications.

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

Question No. 22.

Seed capital assistance *(PE-II-May 2005) (3 marks)*

(i) Seed Capital Assistance: The seed capital assistance has been designed by IDBI for professionally or technically qualified entrepreneurs. All the projects eligible for financial assistance from IDBI, directly or indirectly through refinance are eligible under the scheme. The project cost should not exceed Rs. 2 crores and the maximum assistance under the project will be restricted to 50% of the required promoters contribution or Rs 15 lacs whichever is lower.

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

Question No. 23.

Commercial Paper *(PE-II-Nov. 2003) (3 marks)*

Answer:

Commercial paper (CP): To give a boost to the money market and reducing the dependence of highly rated corporate borrowers on bank finance for meeting their working capital requirement, corporate borrowers were permitted to arrange short-term borrowing by issue of commercial paper w.e.f. 1st Jan, 1990. It is being regulated by the RBI. The interest rates on such an instrument are determined by the market forces. The companies which are allowed to issue 'Commercial Paper' must have a net worth of Rs.10 crores, maximum permissible bank finance not less than Rs.25 crore and are listed on the stock exchange. In India, the cost of a C.P. will include the following components:

- Discount;
- rating charges;
- stamp duty;
- issuing ; and
- issuing paying agent (IPA) charges.

A commercial paper is a short-term issuance promissory note issued by a company negotiable by endorsement & delivery, issued at such a discount on face value as may be determined by the company.

Question No. 24.

Discuss the eligibility criteria for issue of commercial paper. *(PE-II-May2005)(3 marks)*

Answer

Eligibility criteria for issuer of commercial paper

The companies satisfying the following conditions are eligible to issue commercial paper.

- ♦ The tangible net worth of the company is Rs. 5 crores or more as per audited balance sheet of the company.
- ♦ The fund base working capital limit is not less than Rs. 5 crores.
- ♦ The company is required to obtain the necessary credit rating from the rating agencies such as CRISIL, ICRA etc.
- ♦ The issuers should ensure that the credit rating at the time of applying to RBI should not be more than two moths old.
- ♦ The minimum current ratio should be 1.33:1 based on classification of current assets and liabilities.
- ♦ For public sector companies there are no listing requirement but for companies other than public sector, the same should be listed on one or more stock exchanges.
- ♦ All issue expenses shall be borne by the company issuing commercial paper.

Question 25.

Explain, briefly, Modigliani and Miller approach on Cost of Capital

(Final May 1997)(PE-II-Nov. 2002) (10 marks)

Answer

Modigliani and Miller approach to Cost of Capital: Modigliani and Miller's argue that the total cost of capital of a particular corporation is independent of its methods and level of financing. According to them a change in the debt equity ratio does not affect the cost of capital. This is because a change in the debt equity ratio changes the risk element of the company which in turn changes the expectations of the shareholders from the particular shares of the company. Hence they contend that leverages has little effect on the overall cost of capital or on the market price.

Modigliani and Miller made the following assumptions and the derivations there from:

Assumptions:

(i) Capital markets are perfect. Information is costless and readily available to all investors, there are no transaction costs; and all securities are infinitely divisible. Investors are assumed to be rational and to behave accordingly.

(ii) The average expected future operating earnings of a firm are represented by a subjective random variable. It is assumed that the expected values of the probability distributions of all investors are the same. Implied in the MM illustration is that the expected values of the probability distributions of expected operating earnings for all future periods are the same as present operating earnings.

(iii) Firms can be categorised into "equivalent return" classes. All firms within a class have the same degree of business risk.

(iv) The absence of corporate income taxes is assumed.

Their three basic propositions are :

(i) The total market value of the firm and its cost of capital are independent of its capital structure. The total market value of a firm is given by capitalising the expected stream of operating earnings at a discount rate appropriate for its risk class.

(ii) The expected yield of a share of stock, K_e is equal to the capitalisation rate of a pure equity stream, plus a premium for financial risk equal to the difference between the pure equity capitalization rate and Kg times the ratio B/S. In other words, K_e increases in a manner to exactly offset the use of cheaper debt funds.

(iii) The cut-off rate for investment purposes is completely independent of the way in which an investment is financed. This proposition alongwith the first implies a complete separation of the investment and financing decisions of the firm.

Conclusion: The theory propounded by them is based on the prevalence of perfect market conditions which are rare to find. Corporate taxes and personal taxes are a reality and they exert appreciable influence over decision making whether to have debt or equity.

Question 26.

Discuss the relationship between the financial leverage and firms required rate of return to equity shareholders as per Modigliani and Miller Proposition II.

(PE-II-May 2003, May 2004) (3 marks)

Answer

Relationship between the financial leverage and firm's required rate of return to equity shareholders with corporate taxes is given by the following relation :

$$K_E = K_0 + \frac{D}{E}(1 - T_C)(K_O - K_d)$$

where,

K_E = required rate of return to equity shareholders

K_0 = required rate of return for an all equity firm

D = Debt amount in capital structure

E = Equity amount in capital structure

T_C = Corporate tax rate

K_d = required rate of return to lenders

Question 27.

Discuss briefly the impact of taxation on Corporate Financing. *(Final-Nov. 1996) (8 marks)*

Answer

Impact of Taxation on Corporate Financing: Tax is levied on the profits of the company. Tax is also levied on the dividends received by the shareholders in their hands though such dividends are declared out of after tax profits. Thus the corporate entity and the owners suffer tax twice in a sense. This pushes the cost of equity capital. On the other hand interest paid on the debt capital is a deductible expenditure and hence company does not pay tax on interest on debt capital. This reduces the cost of debts. Debt is a less costly source of funds and if the finance manager prudently mixes debt and equity, the weighted average cost of capital will get greatly reduced.

Depreciation is not an outgo in cash but it is deductible in computing the income subject to tax. There will be saving in tax on depreciation and such savings could be profitably employed. Thus both interest and depreciation provide tax shield and have a tendency to increase EPS. Further the unabsorbed depreciation can be carried forward indefinitely and this will be helpful for loss making concerns which start earning profits in future. The depreciation loss of one company can be carried forward for set off in another company's profits in the case of amalgamations in specified circumstances and such a provision will help growth of companies and rehabilitation of sick units. The finance manager of amalgamating company will bear this benefit for the tax shield it carries in planning the activities.

Thus the impact of tax will be felt in cost of capital, earnings per share and the cash inflows which are relevant for capital budgeting and in planning the capital structure.

Tax considerations are important as they affect the liquidity of the concerns. They are relevant in deciding the leasing of the assets, transactions of sale and lease back, and also in floating joint venture in foreign countries where tax rate and concessions may be advantageous. Tax implications will be felt in choosing the size and nature of industry and in its location as the tax laws give fillip to small units producing certain products and incentives are given for backward areas. Tax considerations in these matters are relevant for purposes of preserving and protecting internal funds.

Question 28.

Distinguish between Net Present Value and Internal Rate of Return.

(Final-May 2002) (2 marks)

Answer

NPV and IRR: NPV and IRR methods differ in the sense that the results regarding the choice of an asset under certain circumstances are mutually contradictory under two methods. In case of mutually exclusive investment projects, in certain situations, they may give contradictory results such that if the NPV method finds one proposal acceptable, IRR favours another. The different rankings given by the NPV and IRR methods could be due to size disparity problem, time disparity problem and unequal expected lives.

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

In the net present value cash flows are assumed to be re-invested at cost of capital rate. In IRR reinvestment is assumed to be made at IRR rates.

Question 29.

Do the profitability index and the NPV criterion of evaluating investment proposals lead to the same acceptance-rejection and ranking decisions? In what situations will they give conflicting results? *(Final-Nov. 1999) (6 marks)*

Answer

In the most of the situations the Net Present Value Method (NPV) and Profitability Index (PI) yield same accept or reject decision. In general items, under PI method a project is acceptable if profitability index value is greater than 1 and rejected if it less than 1. Under NPV method a project is acceptable if Net present value of a project is positive and rejected if it is negative. Clearly a project offering a profitability index greater than 1 must also offer a net present value which is positive. But a conflict may arise between two methods if a choice between mutually exclusive projects has to be made. Consider the following example:

	Project A	*Project B*
PV of Cash inflows	2,00,000	1,00,000
Initial cash outflows	1,00,000	40,000
Net present value	1,00,000	60,000
P.I	$\frac{2,00,000}{1,00,000} = 2$	$\frac{1,00,000}{40,000} = 2.5$

According to NPV method, project A would be preferred, whereas according to profitability index method project B would be preferred.

This is because Net present value gives ranking on the basis of absolute value of rupees. Whereas profitability index gives ranking on the basis of ratio. Although PI method is based on NPV, it is a better evaluation technique than NPV in a situation of capital rationing.

Question 30.

Write a short note on Internal rate of return. *(Final-May 1996) (4 marks)*

Answer

Internal Rate of Return: It is that rate at which discounted cash inflows are equal to the discounted cash outflows. In other words, it is the rate which discounts the cash flows to zero. It can be stated in the form of a ratio as follows:

$$\frac{\text{Cash inflows}}{\text{Cash Outflows}} = 1$$

This rate is to be found by trial and error method. This rate is used in the evaluation of investment proposals. In this method, the discount rate is not known but the cash outflows and cash inflows are known.

In evaluating investment proposals, Internal rate of return is compared with a required rate of return, known as cut-off rate. If it is more than cut-off rate the project is treated as acceptable; otherwise project is rejected.

Question 31.

Discuss the impact of financial leverage on shareholders wealth by using return-on-assets (ROA) and return-on-equity (ROE) analytic framework. *(PE-II-May 2003, May 2004) (3 marks)*

Answer

The impact of financial leverage on ROE is positive, if cost of debt (after-tax) is less than ROA. But it is a double-edged sword.

$$\text{ROA} = \frac{\text{NOPAT}}{\text{Sales}} \times \frac{\text{Sales}}{\text{Capital employed}}$$

$$\text{ROE} = \text{ROA} + \frac{D}{E}\,(\text{ROA} - K_d)$$

Where

NOPAT = EBIT * ($1 - T_c$)

Capital employed = Shareholders funds + Loan funds

D = Debt amount in capital structure

E = Equity capital amount in capital structure

K_d = Interest rate * ($1 - T_c$) in case of fresh loans of a company.

K_d = Yield to maturity *($1-T_c$) in case of existing loans of a company.

Question 32.

Discuss any three ratios computed for investment analysis. (PE-II--Nov.2004) (3 marks)

Answer

Three ratios computed for investment analysis are as follows;

(i) Earning per share $= \dfrac{\text{Profit after tax}}{\text{Number of equity shares outstanding}}$

(ii) Dividend yield ratio = $\dfrac{\text{Equity dividend per share} \times 100}{\text{Market price per share}}$

(iii) Return on capital employed = $\dfrac{\text{Net profit before interest and tax} \times 100}{\text{Capital employed}}$

Question 33.

Discuss the financial ratios for evaluating company performance on operating efficiency and liquidity position aspects. (PE-II-Nov. 2006) (4 marks)

Answer

Financial ratios for evaluating performance on operational efficiency and liquidity position aspects are discussed as:

Operating Efficiency: Ratio analysis throws light on the degree of efficiency in the management and utilization of its assets. The various activity ratios (such as turnover ratios) measure this kind of operational efficiency. These ratios are employed to evaluate the efficiency with which the firm manages and utilises its assets. These ratios usually indicate the frequency of sales with respect to its assets. These assets may be capital assets or working capital or average inventory. In fact, the solvency of a firm is, in the ultimate analysis, dependent upon the sales revenues generated by use of its assets – total as well as its components.

Liquidity Position: With the help of ratio analysis, one can draw conclusions regarding liquidity position of a firm. The liquidity position of a firm would be satisfactory, if it is able to meet its current obligations when they become due. Inability to pay-off short-term liabilities affects its credibility as well as its credit rating. Continuous default on the part of the business leads to commercial bankruptcy. Eventually such commercial bankruptcy may lead to its sickness and dissolution. Liquidity ratios are current ratio, liquid ratio and cash to current liability ratio. These ratios are particularly useful in credit analysis by banks and other suppliers of short-term loans.

Question 34.

Distinguish between Cash Flow and Fund Flow statement.(PE-II-Nov.2002, May 2004) (3 marks)

Answer: The points of distinction between cash flow and funds flow statement are as below:

Cash flow statement	Funds flow statement
(i) It ascertains the changes in balance of cash in hand and bank.	(i) It ascertains the changes in financial position between two accounting periods.
(ii) It analyses the reasons for changes in balance of cash in hand and bank	(ii) It analyses the reasons for change in financial position between two balance sheets
(iii) It shows the inflows and outflows of cash.	(iii) It reveals the sources and application of finds.
(iv) It is an important tool for short term analysis.	(iv) It helps to test whether working capital has been effectively used or not.
(v) The two significant areas of analysis are cash generating efficiency and free cash flow.	

Question 35.

Discuss the risk-return considerations in financing of current assets. *(PE-II-Nov. 2004) (4 marks)*

Answer

The financing of current assets involves a trade off between risk and return. A firm can choose from short or long term sources of finance. Short term financing is less expensive than long term financing but at the same time, short term financing involves greater risk than long term financing.

Depending on the mix of short term and long term financing, the approach followed by a company may be referred as matching approach, conservative approach and aggressive approach.

In matching approach, long-term finance is used to finance fixed assets and permanent current assets and short term financing to finance temporary or variable current assets. Under the conservative plan, the firm finances its permanent assets and also a part of temporary current assets with long term financing and hence less risk of facing the problem of shortage of funds.

An aggressive policy is said to be followed by the firm when it uses more short term financing than warranted by the matching plan and finances a part of its permanent current assets with short term financing.

Question 36.

Write a short note on Pecking order theory of capital structure. (Final- Nov. 2000) (5 marks)

Answer

Pecking order Theory of Capital Structure: The pecking order theory was proposed by Donaldson in 1961. The pecking order theory suggests that firm rely for finance, as much as they can, on internally generated funds. If internally generated funds are not enough then they will move to additional debt finance then equity. This is because the issue cost of internally generated funds have the lowest issue cost and cost of new equity is the highest. Myers has suggested that the firm follows a 'modified pecking order' in their approach to financing. Myers has suggested asymmetric information as a reason for heavy reliance on internal generated funds. He demonstrates that with asymmetric information, equity shares are interpreted by the market as bad news since managers are only motivated to issue equity share when share markets are undeveloped. Further, the use of internal finance ensures that there is regular source of finance which might be in line with company's expansion programme. If additional funds are required over and above internally generated funds, then borrowings will be next alternative in this theory.

Thus, pecking order theory rests on:

(i) Stickly dividend policy,

(ii) A preference for internal funds,

(ii) An aversion to issue equity shares.

Question 37.

Explain the 'Aging Schedule' in the context of monitoring of receivables. *(Nov. 2004) (3 marks)*

Answer

Ageing Schedule : An important means to get an insight into collection pattern of debtors is the preparation of their 'Ageing Schedule'. Receivables are classified according to their age from the date of invoicing e.g. 0 – 30 days, 31 – 60 days , 61 – 90 days, 91 – 120 days and more. The ageing schedule can be compared with earlier month's figures or the corresponding month of the earlier year.

This classification helps the firm in its collection efforts and enables management to have a close control over the quality of individual accounts. The ageing schedule can be compared with other firms also.

Question 38.

Outline the methods and tools of Financial Management. *(Final-Nov. 1996) (6 marks)*

Answer

Finance Manager has to decide optimum capital structure to maximise the wealth of the shareholders. For this judicious use of financial leverage or trading on equity is important to increase the return to shareholders. In planning the capital structure, the aim is to have proper mix of debt, equity and retained earnings. EPS Analysis, PE Ratios and mathematical models are used to determine the proper debt-equity mix to derive advantages to the owners and enterprise.

In the area of investment decisions, pay back method, average rate of returns, internal rate of return, net present value, profitability index are some of the methods in evaluating capital expenditure proposals.

In the area of working capital management, certain techniques are adopted such as ABC Analysis, Economic order quantities, Cash management models, etc., to improve liquidity and to maintain adequate circulating capital.

For evaluation of firm's performance, Ratio analysis is pressed into service-with the help of ratios an investor can decide whether to invest in a firm or not. Funds flow statement, cash flow statement and projected financial statements help a lot to the finance manager in providing funds in right quantities and at right time.

Question 39.

"The information age has given a fresh perspective on the role of finance management and finance managers. With the shift in paradigm it is imperative that the role of Chief Financial Officer (CFO) changes from a controller to a facilitator." Can you describe the emergent role which is described by the speaker/author? *(Final-Nov.2000) (6 marks)*

Answer

The information age has given a fresh perspective on the role financial management and finance managers. With the shift in paradigm it is imperative that the role of Chief Finance Officer (CFO) changes from a controller to a facilitator. In the emergent role Chief Finance Officer acts as a catalyst to facilitate changes in an environment where the organisation succeeds through self managed teams. The Chief Finance Officer must transform himself to a front-end organiser and leader who spends more time in networking, analysing the external environment, making strategic decisions, managing and protecting cash flows. In due course, the role of Chief Finance Officer will shift from an operational to a strategic level. Of course on an operational level the Chief Finance Officer cannot be excused from his backend duties. The knowledge requirements for the evolution of a Chief Finance Officer will extend from being aware about capital productivity and cost of capital to human resources initiatives and competitive environment analysis. He has to develop general management skills for a wider focus encompassing all aspects of business that depend on or dictate finance.

Question 40.

Discuss the need for social cost benefit analysis. (PE-II-May 2003 & Nov. 2006) (4 marks)

Answer

Several hundred crores of rupees are committed every year to various public projects. Analysis of such projects has to be done with reference to social costs and benefits. Since they cannot be expected to yield an adequate commercial return on the funds employed, at least during the short run.

Social cost benefit analysis is important for the private corporations also who have a moral responsibility to undertake socially desirable projects.

The need for social cost benefit analysis arises due to the following:

(i) The market prices used to measure costs & benefits in project analysis, may not represent social values due to market imperfections.

(ii) Monetary cost benefit analysis fails to consider the external positive & negative effects of a project.

(iii) Taxes & subsidies are transfer payments & hence irrelevant in national economic profitability analysis.

(iv) The redistribution benefits because of project needs to be captured.

(v) The merit wants are important appraisal criteria for social cost benefit analysis.

Question 41.

Decision tree analysis is helpful in managerial decisions." Explain with an example.
(PE-II-May 2005) (5 marks)

Answer

Significance of Decision Tree Analysis: it is generally observed that the present investment decision may have several implications for future investments decisions. Such complex investment decisions involve a sequence of decisions over time. It is also argued that since present choices modify future alternatives, industrial activity can not be reduced to a single decision and must be viewed as a sequence of decisions extending from the present time into the future. These sequential decisions are taken on the bases of decision tree analysis. While constructing and using decision tree, some important steps to be considered are as follows:

(i) Investment proposal should be properly defined.

(ii) Decision alternatives should be clearly clarified.

(iii) The decision tree should be properly graphed indicating the decision points, chances, events and other data.

(iv) The results should be analysed and the best alternative should be selected.

Question 42.

Briefly explain the meaning and importance of 'Credit-rating'. (Final-May 2002) (4 marks)

Answer

Credit-rating essentially reflects the probability of timely repayment of principal and interest by a borrower company. It indicates the risk involved in a debt instrument as well its qualities. Higher the credit rating, greater is the probability that the borrower will make timely payment of principal and interest and vice-versa.

It has assumed an important place in the modern and developed financial markets. It is a boon to the companies as well as investors. It facilitates the company in raising funds in the capital market and helps the investor to select their risk-return trade off. By indicating creditworthiness of a borrower, it helps the investor in arriving at a correct and rational decision about making investments.

Credit rating system plays a vital role in investor protection. Fair and good credit ratings motivate the public to invest their savings.

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, it is an indicator expressing the underlying credit quality of a (debt) issue programme. The investor is fully informed about the company as any effect of changes in business/economic conditions on the company is evaluated and published regularly by the rating agencies. The corporate borrowers can raise funds at a cheaper rate with good rating. It minimizes the role of the 'name recognition' and less known companies can also approach the market on the basis of their rating. The fund ratings are useful to the banks and other financial institutions while deciding lending and investment strategies.

Question 43.

Write short notes on the following:

(a) Impact of inflation on working capital. (Final-May 1996) (4 marks)

(d) Effect of inflation on inventory management (Final-May 2001, Nov. 2001) (4 marks)

Answer

(a) Impact of Inflation on Working Capital: The impact of inflation on working capital is direct. For the same quantity of sales, the value of sundry debtors, closing stock etc. increases as a result of inflation. The valuation of closing stock progressively on higher amounts would result in the company not being able to maintain its operating capability unless it finds extra funds to maintain the same stock level. The higher valuation results in acute shortage of funds as it triggers profit related cash outflows in respect of income tax, dividends and bonus. Unless proper planning is done, the business is likely to face a condition known as "technical insolvency".

(d) Effect on Inflation on Inventory Management: The main objective of inventory management is to determine and maintain the optimum level of investment in inventories. For inventory management a moderate inflation rate say 3% can be ignored but if inflation rate is higher it becomes important to take into consideration the effect of inflation on inventory management. The effect of inflation on goods which the firm stock is relatively constant can be dealt easily, one simply deducts the expected annual rate of inflation from the carrying cost percentage and uses this modified version in the EOQ model to compute the optimum stock. The reason for making this deduction is that inflation causes the value of the inventory to raise, thus offsetting somewhat the effects of depreciation and other carrying cost factors. Since carrying cost will now be smaller, the calculated EOQ and hence the average inventory will increase. However, if rate of inflation is higher the interest rates will also be higher, and this will cause carrying cost to increase and thus lower the EOQ and average inventories.

Thus, there is no evidence as to whether inflation raises or lowers the optimal level of inventories of firms in the aggregate. It should still be thoroughly considered, however, for it will raise the individual firm's optimal holdings if the rate of inflation for its own inventories is above average and is greater than the effects of inflation on interest rates and vice-versa.

Question 44.

Write Short Notes on Recent changes in Maximum Permissible Bank Finance (MPBF).

(PE-II-Nov. 2003) (3 marks)

Maximum Permissible Bank Finance (MPBF): The maximum permissible limit for bank finance as recommended and suggested by study groups of RBI was 75% of working capital gap shown as below:

Current assets	100
Less: Non-interest bearing current liabilities	40
Working capital gap	60
Financing from long term-sources 25% of either CA or working capital gap	15
MPBF	45

The RBI vide its credit policy scrapped the concept of MPBF. The salient features of new credit system were:

- For borrowers with requirements of upto Rs.25 lakhs credit limit will be computed after detailed discussions with the borrower, without going into detailed evaluation.
- For borrowers with requirements above Rs.25 lakhs, but upto Rs.5 crore, credit limit can be offered upto 20% of the projected gross sales of the borrower.

For large borrowers not falling in the above categories, the cash budget systems may be used to identify the working capital needs.