Theory Notes of Cost & FM

We are happy to inform that the entire paper of IPCC/PCC- May-2012 was covered in our books.

Classes of

Group-I (Paper-3) Cost Accounting & Financial Management

By : **CA. AMIT KUMAR JHA**

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*****CHAPTER – 1*****

*****BASIC CONCEPTS*****

Ques1. 2010-Nov [6] **(b)** Write short notes on the following

(i) Essential factors for installing a Cost Accounting system

Ans. **(i) Essential Factors for installing a Cost Accounting System**

Before setting up a system of cost accounting following factors should be studied :-

(a) Objective :-
The objective of costing system, for example whether it is being introduced for fixing prices or for insisting a system of cost control

(b) Type of business :-
The areas of operation of business wherein the managements action will be most beneficial. For instance, in a concern, which is anxious to expand its operations, increases in production would require maximum attention. On the other hand for a concern, which is not able, to sell the whole of its production the selling effort would require attention. The system of costing in each case should be designed to highlight, in significant areas, factors considered important for improving the efficiency of operations in that area.

(c) General organization :-
The business, with a view of finding out the manner in which the system of cost control could be introduced without altering or extending the organization appreciably

(d) The Technical Details :-
Technical aspects of the concern and the attitude and behaviour that will be successful in winning sympathetic assistance or support of the supervisory staff and workmen

(e) Change in operations
The manner in which different variable expenses would be affected with expansion or cessation of different operations

(f) Methods of maintenance of cost records
The manner in which Cost and Financial accounts could be inter-locked into a single integral accounting system and in which results of separate sets of accounts, cost and financial, could be reconciled by means of control accounts

(g) Information
The maximum amount of information that would be sufficient and how the same should be secured without too much clerical labour, especially the possibility of collection of data on a separate printed from designed for each process; also the possibility of instruction as regards filling up of the forms in writing to ensure that these would be faithfully carried out

(h) Accuracy

How the accuracy of the data collected can be verified? Who should be made responsible for making such verification in regard to each operation and the form of certificate that he should give to indicate the verification that he has carried out?

(i) Informative and Simple

The manner in which the benefits of introducing Cost Accounting could be explained to various persons in the concern, especially those in charge of production department and awareness created for the necessity of promptitude, frequency and regularity in collection of costing data

(j) Support

Support of top management and employees are essential for installing a Cost Accounting System in any organization

Ques2. 2006 Nov. [4] (a) Distinguish between the following

(ii) Controllable costs and Uncontrollable costs

Ans. **Controllable costs and Uncontrollable costs : -** Controller costs are the costs which can be influenced by the action of the specific member of an undertaking. Controllable costs incurred in a particular responsibility centre can be influenced by the action of the executive heading that responsibility centre Uncontrollable costs are the costs which cannot be influenced by the action of a specified member of an undertaking The distinction between these two costs is a very thin line & is sometimes left to individual that we may specify a particular cost to be either controllable uncontrollable

Ques3. 2006- May [1] Answer the following

(iii) Distinguish between product cost and period cost

Ans. Product costs are associated with the purchase and sale of goods. In the production scenario, such costs are associated with the acquisition and conversation of materials and all other manufacturing inputs into finished product for sale. Hence under absorption cost, total manufacturing costs constitute inventoriable or product cost Periods costs are the costs, which are not assigned to the products but are charged as expenses against revenue of the period in which they are incurred. General Administration, marketing, sales and distribution overheads are recognized as period costs.

Ques4. 2007 – May [1] Answer the following

(ii) Briefly discuss, how the synergetic effect helps in reduction in costs.
(iv) Explain in brief the explicit cost with examples.

Ans. **(ii)** Cost reduction means "achievement of real and permanent reduction in the unit cost of goods manufactured or service rendered without impairing their suitability for the use intended or diminution in the quality of the product". Analysis of synergic effect is helpful in cost reduction **e.g.,** when two or more products are produced and managed together. In such cases the result of combined efforts are higher than sum of the results of individual products

(iv) These are also known as out of pocket costs. They refer to costs involving immediate payment of cash. Salaries, postage and telegram, printing and stationery, interest on loan etc., are some of the examples of explicit costs involving immediate cash payment

Ques5. 2007- May [4] Answer the following

(ii) What items are generally included in good uniform costing manual?

Ans. **A good uniform costing manual should contain**

1. Introduction
- **(i)** Statement of objectives
- **(ii)** Purpose of the systems
- **(iii)** Scope of the systems
- **(iv)** Need for the system

2. Organization
- (i) Organizational structure for developing and operating the system
- (ii) Stages or steps for implementing the system

3. System of Accounting
- (i) Principles of accounting to be followed
- (ii) Span of accounting period
- (iii) Classification of accounts
- (iv) Description of accounts

4. Method of Costing
- **(i)** Costing period
- **(ii)** Unit of Production
- **(iii)** Departmentisation
- **(iv)** Treatment of material cost, labour cost and OH cost,
- **(v)** Reconciliation between financial accounts and cost accounts

5. Reporting
- (i) Reporting period
- (ii) Ratio
- (iii) Levels of reporting
- (iv) Cost statements

Ques6. 2007. – Nov. [1] Answer the following

(i)Discuss briefly the relevant costs with examples

Ans. Relevant cost helps in specific management decision making. Business decisions involve planning for future and consideration of various alternative courses of action. In the planning process the costs which are affected by the decisions in hand. The cost is said to be relevant if it helps the manager in taking a right decision in furtherance of the company's objectives. Relevant cost is a future cost which causes the difference alternatives

For Example: - For sales promotion if the company extends the period of warrantee, the additional cost incurred during the extended period of warrantee

Ques7. 2008-May [1] Answer the following

(i)What are the main objectives of cost accounting?
(ii) Explain controllable and non-controllable cost with examples.

Ans. **(i)** The objectives of cost accounting are as follows

1. To ascertain & analyses costs
2. To control costs
3. To reduce costs
4. To fix the Selling Price
5. To prepare Periodic Statements
6. To Provide Information

(ii) Controllable costs and Uncontrollable costs :- Controller costs are the costs which can be influenced by the action of the specific member of an undertaking. Controllable costs incurred in a particular responsibility centre can be influenced by the action of the executive heading that responsibility centre Uncontrollable costs are the costs which cannot be influenced by the action of a specified member of an undertaking

Ques8. 2008- Nov. [1] Answer the following

(iv) State the method of costing that would be most suitable for
(a) Oil refinery
(b) Bicycle manufacturing
(c) Interior decoration
(d) Airlines company

Ans. **The suitable method of costing for the following is:-**

(a) Oil Refinery	:	Process costing
(b) Bicycle manufacturing	:	Multiple costing
(c) Interior decoration	:	Job costing but if on a larger basis then Contract costing
(d) Airlines company	:	Operating costing

Ques9. **Nov. [1]** Answer the following

(i) Define the following
(a) Imputed cost
(b) Capitalized cost

Ans. **(i) (a)** **Imputed Cost :** Imputed costs are notional costs which do not involved any cash outlay. Examples of imputed cost are Interest on capital, the payment for which is not actually made; these costs are similar to opportunity costs

(b) **Capitalized Cost:** Capitalized are costs which are initially recorded as assets and subsequently treated as expenses

Ques10. May [1] Answer the following

(i) What is Cost accounting? Enumerate its important objectives?

Ans. **Cost Accounting** is defined as "the process of accounting for cost which begins with the recording of income and expenditure or the bases on which they are calculated and ends with the preparation statements and reports for ascertaining and controlling costs".

1. Cost accounting preliminary deals with the collection and analysis of relevant cost data for interpretation and presentation for various problems of management
2. Cost accounting is the application of accounting and costing principles, methods and techniques in the ascertainment of costs and analysis of saving and / or excess as compared with previous experience or with standards
3. CIMA defines cost accounting as "the establishment of budgets, standard costs actual costs of operation, processes, activities or products & the analysis of variances, profitability or the social use of funds".

The objectives of cost accounting are as follows :-

1. **To ascertain and analyse costs :** The primary objective of cost accountings is to ascertain and analyse costs incurred on the production of various products, jobs and services etc.
2. **To control costs :** There are a number of techniques in cost accounting like standard costing and budgetary control for controlling cost
3. **To reduce costs :** By now, the objective of cost accounting has been extended to reduce costs. For cost reduction plan, products, processes, procedures, organization, and methods are continuously reviewed or scrutinized in order to improve efficiency and to reduce cost
4. **To fix the selling price :** Under cost accounting, reliable data is provided to act as a base for fixing selling prices
5. **To prepare periodic statements :** In cost accounting system, periodic cost statements (viz. monthly, quarterly) for review of operating results are prepared
6. **To provide information :** Cost accounting provides useful information for planning and control and for taking various decisions regarding increases in production, installation or replacement of a machine, making or buying of a component, continuing or closing down of a business etc.
7. **To Ascertain the profit of each activity :** The profit of any activity can be ascertained by matching cost with the revenue of that activity. The purpose under this step is to determine costing profit or loss of any activity on an objective basis
8. Decision making is defined as a process of selecting a course of action out of two or more alternative courses. For making a choice between different courses of action, it is necessary to make a comparison of the outcomes, which may be arrived under different alternatives

Ques11. Distinguish between cost units and cost centres.

Ans. **Cost Units :-** It is a unit of product, service or time (or combination of these) in relation to which costs may be ascertained or express. A batch which consists of a group of identical items and maintain its identity through one or more stages of production may also be considered as a cost unit. Cost units are usually the units of physical measurement like number, weight, area, volume, weight, area, volume, length, time and value.

Cost Centre :- It is defined as a location , person or an stress of equipment (or group of these) for which cost may be ascertained and used for the purpose of cost control. Cost centres are of two types, viz., personal and impersonal. A personal cost centre consists of a person or group of persons and an impersonal cost centre consists of a location or an item or equipment (or group of these)

Ques12. How do you deal with the following in cost account ?

(i) Packing Expenses
(ii) Fringe benefit

Ans. **Packing Expenses :-** Cost of primary packing necessary for protecting the product or for convenient handling, should become a part of the prime cost. The cost of packing to facilitate the transportation of the product from the factory to the customer should become a part of the distribution cost. If the cost of special work order or the job. The cost of fancy packing necessary to attract customers is an advertising expenditure. Hence, it is to be treated as a selling overhead.

Fringe benefit :- These are the additional payments of facilities provided to the workers apart from their salary and direct cost – allowances like house rent and city compensatory allowances. If the amount of fringe benefit is considerably large, it may be recovered as direct charge by means of a supplementary wage or labour rate; otherwise may be collected as part of production overheads

*****CHAPTER – 2 *****

*****MATERIAL COST *****

Ques1. 2006-Nov. [1] {C} (b) Discuss the use of perpetual inventory records and continuous stock verification, and its advantages

Ans. **Use of Perpetual Inventory Records**: - Under this system, a continuous of receipt and issue of materials is maintained by the stores deptt. and the information about the stock of materials is always available. In this method stock records are maintained in such a way as to make an entry in the records, the physical movement of stock on receipts and issue of materials and to indicate the balance of each item of material in the stores at any point of time In this system, the entries are made in bin cards and stores ledger as and when the receipts and issue of materials take place and the balance is ascertained after every receipt or issue of materials. The stocks as per dual records viz. bin cards and stores ledgers are reconciled on a continuous basis

Advantages:-

1. This system facilities production planning and inventory control
2. It helps in having a detailed and more reliable check on the stores
3. The stock records are more reliable and stock discrepancies are invested & immediate actions are taken

Use of Continuous Stock Taking:-

Under this system, physical stock verification is made for each item of stock on continuous basis. It is physical checking of stock on continuous basis

It is a method of verification of physical stock on a continuous basis instead of at the end of the accounting period. It is a verification conducted round the year, thus covering each item of stores twice or thrice. Variable items are checked more frequently than the stocks with lesser value

Advantages:-

1. Any discrepancies, irregularities or charges are detected at early stage & brought to the notice of management
2. It acts as a moral check on stores staff

3. It insists on upto date maintaining of stock records
4. The disruption in production caused by periodic stock taking is eliminated

Ques2. 2007-May [4] Answer the following

(i) Discuss the accounting treatment of spoilage and defectives?

Ans. Treatment of spoilage in costing :-

Normal Spoilage :- If the cost of spoiling is normal & inherent in the process or operation, then the cost of spoilage is absorbed by charging either to the specific production order or to the product overheads

Abnormal spoilage :- If the cost of abnormal spoilage arise in the process then it is charged to costing Profit & Loss A/c

It spoilt units are reused as raw materials in the same process no, separate accounting treatment is required

But if, spoilage is used for any other process or job, a proper credit should be given to relevant process A/c or job A/c

Treatment of Defective in costing :-

Normal Defective :

Charged to Good Output :- The entire cost of rectification of normal defective is charged correctly, then the rectification costs are charged to general overheads

Charged to departmental overheads :- If department responsible for such defectives is correctly identified, then rectification costs are charged to such departments

Charged to specific jobs :- If it is easily identified with specific job, the rectification costs should be charged to that job

Abnormal Defective :- The rectification cost should be charged to costing Profit & Loss A/c

Ques3. 2007-Nov. [4] Answer the following

(ii) Explain, why the Last in First out (LIFO) has an edge over First in First out (FIFO) or any other method of pricing material issues

Ans. Under LIFO method, production is charged with current market prices and hence pricing of the production is facilitated

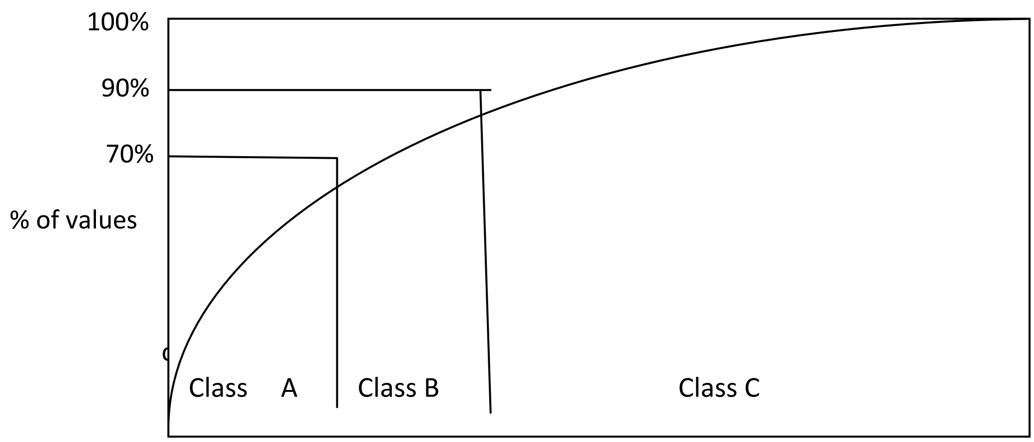
whereas in case of FIFO method, production is charged with old price (i.e.,low price under inflationary trend). In the same way, under weighted price method, the rise in prices is spread over a large number of units and therefore its effect is much reduces. The average price is always less than the current market price. However, determination of the average price requires a lot of clerical work

Therefore we prefer to use LIFO method so the product cost is near to market price

Ques4. 2008-May [4] Answer the following

(iii) Discuss ABC analysis as a technique of inventory control

Ans. ABC Analysis It is an important technique of inventory control on selective basis. Large manufacturing units have such a large number of items in their stores for which it is often not possible for the management to pay the same attention to each and every stock item. A system is therefore required by which these items are classified according to their importance & then selective control is exercised. ABC analysis or 'selective control' is a technique whereby the measure of control over an item of inventory varies directly with 'its usage value'. In other words, the high value items are controlled more than the items of low value.



ABC Analysis of Inventory

This figure shows ABC analysis of inventory. Class 'A' is made of items which are either very expensive or used in massive quantities. Thus, these items though few in number contribute a high proportion of the value of inventories. Class 'B' items are not few in numbers but also they are not too many either, value wise also, they are neither very expensive not very cheap. Class 'C' contains a relatively large numbers of items, but they are either cheap items or used in very small quantities so that they do not constitute more than a negligible portion of the total inventory value

This method is known as "Always Better Control or the Alphabetic Approach". ABC concept Of classifying goods in an inventory is very commonly used for exercising effective inventory control. Under this technique the items in inventory are classified according to the value of usage

Analysis and Control :

The three categories are classified & differential control is established as under :

Category	% in total value	% in total quantity	Extent of control
A	70%	10%	Constant and strict control through budgets, ratios, stock levels, EOQ etc.
B	20%	20%	Need based selective control –periodic

			review not strict as excessive
C	10%	70%	Little control-Focus on saving associated costs

Comparative study of different class items

	Nature	A – items having high consumption value	B-items having moderate consumption value	C-items having low consumption value
1	Extent of control	Very strict control is implemented	Moderate control implemented	Loose control is implemented
2	Order frequency	Frequent ordering should be placed	Order should be placed in 3 months	Order should be placed once in 6 months or in a year
3	Lead time	Maximum efforts to reduce the lead time is undertaken	Moderate efforts to reduce lead time is undertaken	Minimum clerical efforts to reduce lead time is undertaken
4	Level of management	Must be taken care of by senior officers	Can be supervised by middle management	Can be supervised by the clerical staff
5	Review Period	Reviewed after a month or every 15 days of waste, obsolete & surplus tems	Reviewed after every 3 months of waste, obsolete & surplus items	Reviewed annually over obsolete & surplus items
6	Supply sources	There may be supply of as many source as possible for each item	There may be supply of three or more reliable sources	Three reliable sources for each item may be supplied
7	Follow-up	Maximum follow up is required	Periodic follow up is required	Follow up is required only in exceptional
8	Safety stock	Very low safety stock is needed	Low safety stock is needed	High safety stock is needed
9	Centralization	Centralized purchasing is done	Centralized & decentralized purchasing is done	Decentralized purchasing is done
10	Value Analysis	Rigorous value analysis is made	Moderate value analysis is made	Minimum value analysis is made

Advantages of ABC :-

The advantages are:-

a. **Smooth Flow :-** This method ensures that minimum investment will be made in inventories of stock of materials or stocks to be carried, without any danger of interruption of production for want of materials or stores requirement
b. **Cost Savings :-** The cost of placing orders, receiving goods & maintaining stocks is minimized
c. **Control by exception :-** Management's time is saved since attention need be paid only to some of the items rather than all the items

d. **Standardization of work :-** With the introduction of ABC system, much of the work connected with purchase can be systematized on a routine basis

Limitation of ABC:

1. In order to be fully cost effective, ABC analysis should be carried out with standardized and codification
2. The result of ABC analysis should be reviewed periodically & should be up dated

Ques5. 2009-May [4] Answer the following

(i) Discuss accounting treatment of spoilage and defectives in cost accounting

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Abnormal Defective: - The rectification cost should be charged to costing Profit & Loss A/c

Ques6. 2006- Nov [4] (b) PQR Ltd. manufactures a special product, which requires 'ZED'. The following particulars were collected for the year 2005-06

(i) Monthly demand of Zed	:	7,500 units
(ii) Cost of placing an order	:	Rs. 500
(iii) Reorder period	:	5 to 8 weeks
(iv) Cost per unit	:	Rs. 60

(v)	Carrying cost per annum	:	10%
(vi)	Normal usage	:	500 units per week
(vii)	Minimum usage	:	250 units per week
(viii)	Maximum usage	:	750 units per week

Required :

(i)Re-order quantity
(ii) Re-order level
(iii) Minimum stock level
(iv) Maximum stock level
(v) Average stock level

Ans.

(i) Re-order Quantity :-

= √(2 AS) / C   A = Annual demand of input unit for 90,000 (7500*12)

= √2 X 26,000 X 500 / 6   = √2 x 7,500 x 12 x 500 / 60 x 10%

= 2082 unit   = √9,00,00,000 / 6
= √1,50,00,000
= 3,872.98
= 3,873

(ii) Re-order level :-

Maximum re-order period x Maximum usage
= Weeks X 750 units per weeks
= 6,000 units

(iii) Minimum stock level :-

= Re-order level- (Normal user x average re-order period)
= 6000 – (500 x 6.5)
=6000 – 3250
= 2750 units

(iv) Maximum stock level :-

Re-order level + Re-order quantity – (Minimum usage x Minimum re-order period)
= 6000 + 3,873 – (250 x 5)
= 6000 + 3,873 – 1250
= 8,623 units

(v) Average stock level

= ½ (Minimum stock level + Maximum stock level)
= ½ (2750 + 8.623)
= 5,687 Units

Ques7. 2007- May [1] Answer the following

(V) The average annual consumption of a material is 18,250 units at a price of Rs. 36.50 per unit. The storage cost is 20% on an average inventory and the cost of placing an order is Rs. 50. How much quantity is to be purchased at a time

Ans. Quantity to be purchased at a time

= √(2 x 18,250 x 50) / 20% of 36.50 = √18,25,000 / 7.3

= √2,50,000 = 500 units

*****CHAPTER – 3 *****
*****EMPOLYEE COST *****

Ques1. 2008- May [4] Answer the following

(ii) Distinguish between Job Evaluation and Merit Rating

Ans. **Distinguish between Job Evaluation and Merit Rating :-**

1. Job evaluation is the ascertainment of the relative worth of jobs within a company whereas merit rating is the assessment of the relative worth of the man behind the job
2. Job evaluation and its accomplishments are meant to set up a rational wage whereas salary structure whereas, merit rating provides a scientific basis for determining fair wages for each worker based on his ability whereas and performance
3. Job evaluation simplifies wage administration by bringing uniformity in wage rates, whereas, merit rating is used to determine fair rate of pay for different workers on the basis of their performance

Ques2. 2007-May [1] Answer the following

(vi) Enumerate the various methods of Time booking

Ans. **The various methods of Time Booking are :-**

(i) Piece work card
(ii) Daily time sheet
(iii) Weekly time sheet
(iv) Clock card
(v) Time ticket
(vi) Job ticket
(vii) Combined ticket

Ques3. 2007-Nov. [4] Answer the following

(iii) Enumerate the remedial steps to be taken to minimize the labour turnover

Ans. **The following remedial steps may be adopted to minimize labour turnover :-**

1. Exit interview with each outgoing employee to ascertain the reasons for his leaving the organization

2. Job analysis and evaluation carried out even before recruitment to ascertain the requirement of each job
3. Scientific system of recruitment, placement and promotion, by fitting the right person in the right job
4. Use of committee, comprising of members from management and workers to handle issue concerning workers grievance, requirements etc.
5. Enlightened attitude of management- Mental revolution on the part of management by taking workers into confidence and acting a healthy working atmosphere, with measures such as :-
   (i)Training service rules after discussion between management and workers union
   (ii) Provisions of facilities for education, training and development of workers
   (iii) Introduction of procedures for settlement of workers grievance

Ques4. 2008- May [1] Answer the following

(ii) Discuss the treatment of over time premium in cost accounting

Ans. Accounting treatment of overtime premium depends upon the circumstances of the work

Case 1 :- If the overtime is worked on customer's instruction in order to complete the work at the earliest –then it should be directly charged to the job as a part of direct wages

Case 2 :- If the overtime is worked due to shortage of the labour or any other reason –then it is treated as a part of the labour cost and such overtime premium is appointed on the basis of total hours work on different jobs

Case 3 :- If the overtime is worked to make-up the lost time due to unavoidable reason it means it is a cost incurred for normal time and it should be treated as part of the production OH and it can be recovered from the job completed during the accounting period

Case 4 :- If the overtime is worked to make-up the time lost due to avoidable reasons i.e., abnormal idle time –then it is charged to costing Profit /Loss A/c

Case 5 :- If overtime is worked due to its management fault it should be charged to that particular department

Ques5. 2008-Nov. [3] (b) Describe briefly, how wages may be calculated under the following systems

(i) Gantt task and bonus system
(ii) Emerson's efficiency system
(iii) Rowan system
(iv) Halsey system
(v) Barth system

Ans. The various systems of wage payment have been discussed below

(i) Gantt task and bonus system :- This system, like Emerson's system, involves, measurement of efficiency. It is a combination of time and piece work system. According to this system a high standard or task is set on the basis of careful time and motion study. The worker's actual performance is compared with the standard and efficiency determined

Only time wages are paid to the worker to production below the set standards are achieved or exceeded, the payment to the concerned worker is made at a higher price rate. The piece rate fixed under this system also includes an element of bonus to the extent of 20%. The figure of bonus to such workers is calculated over the time rate of the workers

Thus, the system consists of paying a worker on time basis if he does not attain the standard and on piece basis if he does

Wages payable to workers under this plan are calculated as under

Output	Payment
(i) Output below standard **(ii)** Output at standard **(iii)** Output above standard	**(i)** Guaranteed time rate **(ii)** Time rate plus bonus of 20% (usually) of time rate **(iii)** High price rate on worker's whole output **(iv)** It is so fixed, so as to include a bonus of 20% of the time rate

(ii) Emerson's Efficiency System: - Emerson was one of Taylor's associates. He guaranteed time wages but wanted to reward efficiency. Under this system, minimum time wages are guaranteed. But beyond a certain level of efficiency, bonus in addition to minimum day wages is given

A worker who is able to attain efficiency, measured by his output equal to 2/3rd of the standard efficiency, or above, is deemed to be an efficient worker deserving encouragement. The scheme thus provides for payment of bonus at a rising scale at various levels of efficiency, ranging from 66.67% to 150%. For a performance below 66.67% only time rate wages without any bonus are paid. Above 66.67% to 100% efficiency, bonus varies between 0.01% and 20%. Above 100% efficiency, bonus of 20% of basic wages plus 1% for each 1% increase in efficiency is admissible

It can be summarized as below

Less than $66^{2/3}$ %	-	Only time wages
$66^{2/3}$ % to 100%	-	Basic (100%) + Bonus (0.01% to 20%)
100%-above	-	Basic (100%) + Bonus (20%) + 1% for each 1% increase in efficiency

This system does not pre-suppose a high degree of average performance. Wages on time basis are guaranteed

(iii) Rowan System :- In it essence, the plan is similar to the Halsey Plan Wages at the ordinary rate for actual time put in a worker are guaranteed and a bonus given, if the worker saves time out of the standard time, set for him. According to this plan, the bonus is that proportion of wages of actual time taken which time saved bears to the standard time

Formula for calculating wages under **Rowan System** :-

Time Saved / Time Allowed x Time Taken x Rate Per Hour

(iv) Halsey System :- Under this method, standard time for doing job is determined and workers are encouraged to do the job in less than the standard time. A standard is fixed for each job or process. If there is no saving on this standard time allowance, the worker is paid only his day rate. He gets his time rate even if he exceeds the standard time limit, since his day rate is guaranteed. If however, he does the job in less than the standard time, he gets a bonus equal to

50 percent of wages of time saved; the employer benefits by the other 50 percent. The scheme also is sometimes referred to as the Halsey fifty percent plan

Formula for calculating wages under **Halsey system**

= Time Taken x Time Rate + 50% of time saved x Time Rate

The Halsey Weir system is the same as the Halsey system except that the bonus paid to workers is 30% of time saved. This system is useful for capital intensive industry

(v) Barth System :- Barth System is particularly suitable for trainees and beginners and also for unskilled workers. The reason is that for low production efficiency, the earnings are higher than in the piece work system but as the efficiency increases, the rate of increase in the earnings falls

Formula for calculating the remuneration under Barth Plan :

Earning = Hourly Rate x $\sqrt{\text{Standard hours x Hours worked}}$

<u>Ques6.</u> 2009- May [4] Answer the following :

(ii) Discuss accounting treatment of idle capacity costs in cost accounting

<u>Ans.</u> Idle Capacity :- It represents the difference between practical capacity and the capacity and the capacity based on long term sales expectancy.

If the actual capacity is different from the capacity based on sales expectancy, then the idle capacity is the difference between the practical capacity and the actual capacity

Idle capacity represents a part of practical capacity which has been utilized due to regular interruptions and which may not be avoided

Idle capacity cost can be determined as

Idle capacity cost = Total capacity cost = Total OH related to plant / Normal capacity x Idle capacity

It may be normal or abnormal. The treatment can be done in the following ways :-

1. Arising due to unavoidable reasons (Normal idle capacity) :

   Generally arises due to lack of demand or due to seasonal nature of the product.

   Treatment ↓

   Production OH are absorbed into the cost of production either by the inflated OH absorption rate or the supplementary OH rate
2. Arising due to avoidable reasons (Abnormal idle capacity) :

   It may arise due to lack of proper planning control or due to lack of managements forecasting

   Treatment ↓

   The cost of such idle treatment capacity should be changed to costing Profit and Loss A/c
3. If arises due to trade depression or any other external factors :

   Then it being normal in nature

   Treatment ↓

   The cost should be charged to costing P/L A/c

<u>Ques7.</u> 2010-May [4] Answer of the following :-

(iv) Which is better plan out of Halsey 50 percent bonus scheme and Rowan bonus scheme for an efficient worker? In which situation the worker get same bonus in both schemes?

<u>Ans.</u>

- Rowan Bonus Scheme pays more bonus if the time saved is below the 50 percent of time allowed and if the time saved is more than 50 percent of time allowed then Halsey bonus scheme pays more bonus
- Normally, time saved by a worker is not more than 50 percent of time allowed
- Therefore, the Rowan bonus scheme is better for an efficient worker. When the time saved is equal to 50 percent of time allowed then both plans pays bonus to a worker

  Bonus under **Halsey Plan**

  = Standard wage rate x 50/100 x Time saved …………(i)

  Bonus under **Rowan Plan**

  = Standard wage rate x Time taken / Time allowed x Time taken ………..(ii)

  Bonus under Halsey Plan will be equal to the

  Bonus under Rowan Plan when the following condition holds good

  = Standard wage rate x 50/100 x Time saved

  = Standard wage rate x Time taken / Time allowed x Time Saved

  Or 1/2 = Time Taken / Time Allowed

  Or Time Taken = 1/2 of Time Allowed

  Hence, when the time taken is 50% of the time allowed, the bonus under Halsey and Rowan Plans is equal

<u>Ques8.</u> 2010-Nov. [7] Answer the following

(e) Discuss the three different methods of calculating labour turnover

<u>Ans.</u> **<u>Three different methods of calculating labour turnover</u> :-**

Replaced Method = $\frac{No.of\ Employee\ replaced}{Average\ number\ of\ employees\ on\ roll\ during\ the\ period}$ x 100

Separation Method = $\frac{No.of\ Employee\ seperated\ during\ the\ year}{Average\ number\ of\ employees\ on\ oll\ during\ the\ period}$ x 100

Flux Method = $\frac{No.of\ Employee\ seperated + No.of\ employee\ replaced}{Average\ number\ of\ employees\ on\ roll\ during\ the\ period}$ x 100

Or

Flux Method (with new recruitment)

= $\frac{No.of\ seperation + No.of\ replacement + No.of\ nre\ recruitments}{Avergae\ number\ of\ workers}$ x 100

<u>Ques9.</u> 2007-May [1] Answer the following

(i)Using Taylor's differential piece rate system, find the earning of A from the following particulars :

Standard time per piece	12 minutes
Normal rate per hour (in a 8 hour day)	Rs. 20
A produced	37 Units

<u>Ans.</u>

1. Standard output per day = (8 hrs. x 60 minutes) / 12 minutes = 40 units

2. Actual output = 37 units
3. Efficiency in% = 37/40 x 100 = 92.5%

   In this method, lower rate is 83% of a normal piece rate and is applicable if efficiency of worker is below 100%, then

   Earning rate per unit = 83% of 20/51 = Rs. 3.32 per units

   ∴ Earning from a product = Rs. 3.32 x 37 units = Rs. 122.84

Note: - 1. Production in one hour = 60 minute/Standard time per piece = 60/12 = 5 units

Ques10. Explain the following ratios :

(i) Operating ratio
(ii) Price earnings ratio

Ans. (i) **Concept of Operating Ratio :-**

$$\text{Operating Ratio} = \frac{\textit{Cost of goods sold + Operating expenses}}{\textit{Net sales}} \times 100$$

This is the test of the operational efficiency with which the business is being carried; the operating ratio should be low enough to leave a portion of sales to give a fair return to the investors.

(ii) **Concept of Price – Earning Ratio :-**

$$\text{Price Earning Ratio} = \frac{\textit{Market price per equity share}}{\textit{Earning per share}}$$

This ratio indicates the number of times the earnings per share is covered by its market price. It indicates the expectation of equity investors about the earnings of the firm

Ques11. Enumerate the causes of labour turnover

Ans. **Causes of Labour Turnover :-** The main causes of labour turnover in an organisation/ industry can be broadly classified under the following three heads :-

(a) Personal Causes;
(b) Unavoidable Causes ; and
(c) Avoidable Causes

Personal causes are those which induce or compel workers to leave their jobs; such cause include the following :

- Change of jobs for betterment
- Premature retirement due to ill health or old age
- Domestic problems and family responsibilities
- Discontent over the jobs and working environment

Unavoidable causes are those under which it becomes obligatory on the part of management to ask one or more of their employees to leave the organization; such causes are summed up as listed below :-

- ✓ Seasonal nature of the business;
- ✓ Shortage of raw material, power, slack market for the product etc.;
- ✓ Change in the plant location;
- ✓ Disability, making a worker unfit work;
- ✓ Disciplinary measures;
- ✓ Marriage (generally in the case of women)

Avoidable causes are those which require the attention of management on a continuous basis so as to keep the labour turnover ratio as low as possible. The main causes under this case are indicate below :-

*****CHAPTER – 4*****

*****OVERHEADS *****

Ques1. 2010-Nov. [6] (b) Write short notes on the following :

(ii) Treatment of under-absorbed and over-absorbed overheads in Cost Accounting

Ans. ***Treatment of Under-absorbed and Over-absorbed Overheads in Cost Accounting*** :-

Overheads are usually applied to production on the basis of a pre-determined rate. The actual overhead rate will rarely coincide with the pre-determined overhead rate due to different spending pattern and activity level.

Such over or under absorption as arrived at under different situations may also be termed as overhead variance. The amount of over-absorption being represented by a credit balance in the account and conversely, the amount of under absorption, being a debit balance If such balances are small, they should be transferred to costing Profit & Loss A/c where, however the different is large and due to wrong estimation, it would be desirable to adjust the cost of products manufactured, as otherwise the cost figures would convey a misleading impression. Such adjustments usually take the form of supplementary rates.

Ques2. 2008-May [1] Answer the following:

(v) Discuss the difference between allocation and apportionment of overhead

Ans. **Cost Allocation**: The term 'allocation' implies relating overheads directly to the various departments. The estimated amount of various items of manufacturing overheads should be allocated to various cost centre or departments.

Cost Apportionment: Those items of estimated overheads (like the salary of the works manager) which cannot be directly allocated to the various departments and cost centers are apportioned. Apportionment implies "the allotment of proportions of items of cost to cost centres or departments". It implies that the unallocable expenses are to be spread over the various departments or cost centres on an equitable basis.

The difference between cost allocation and apportionment are as follows :-

	Cost Allocation	Cost Apportionment
Meaning	Identifying a cost centre and charging its expenses in full	Allotment of propotions of common cost to various cost centre
Nature of expenses	Specific and identificable	General and common
Number of centre (Dept.)	One	Many
Basis	Allocate directly	Allocate Indirectly
Amount of overhead	Change in full	Change in proportionable
Assumption	Not required	Required

Ques3. 2010-May [1] Answer the following

(ii) Distinguish between Fixed overheads and Variable overheads

Ans. Fixed Overheads v/s Variable Overheads :-

Fixed overheads are not affected by any variation in the volume of activity, e.g., managerial remuneration, rent etc. These remain the same from one period to another except when they are deliberately changed. Fixed overheads are generally variable per unit of output or activity e.g., Rent, Insurance, Depreciation, Audit fees etc.

Whereas, the variable overheads that change in proportion to the change in the volume of activity or output, e.g., power consumed, consumable stores etc. The variable overheads are generally constant per unit of output or activity, e.g., direct material, direct labour, commission on sale

Ques4. 2007- May [1] Answer the following

(iv) Explain briefly the conditions when supplementary rates are used

Ans. Use of Supplementary OH Absorption Rates : This method is used when it is caused due to normal or avoidable reasons. When the amount of over and under absorbed POHEs is significant (i.e., more than 10% of total O/H incurred), supplementary rate if over absorbed amount is to be deducted. On the other hand, the supplementary rate if under absorbed amount is to be added, therefore,

Negative Supplementary Rate = Over Absorbed POHEs/ Actual value of the Base output

Positive Supplementary Rate = Under absorbed POHEs / Actual value of Base output

This method is preferred when :-

(i) There is a serious estimation errors
(ii) When there is a substantial change in the level of activities
(iii) When there is a major change in the production method
(iv) In case of contract on cost plus basis

Ques5. 2007- Nov. [1] Answer the following

(v) Explain Blanket overhead rate

(vi) Explain the cost accounting treatment of unsuccessful Research and Development

Ans. **(v)** Blanket OH Rate : Is also known as "Single" or "Plant" "wide OH absorption Rate". It is calculated as under :

Blanket rate = OH cost for the entire factory / Total quantity of the base selected

This method is used when the size of the company is small or when the burden of O/H is more or less uniform among all the production deptts. These rates are easy to compute and require clerical cost but have a very limited use. The limitation of such rates are as under

1. Such rates may give misleading results where several products are manufactured and are required to be passed through various production departments
2. As the performance of the individual deptt. cannot be assessed properly with this rate, so no satisfactory managerial control is possible
3. Such rate may render the valuation of WIP erroneous

(vi) (i) Research & Development Cost :- R & D expenditures is a differed expenditure because it is incurred not for benefitting a certain period, but for benefitting several accounting periods. Such expenditure is incurred for innovating a new product or improving the existing product or developing new methods of production

Research Cost :-

Research cost are incurred under 2 heads :-

1. Basic research cost which is incurred for improving the existing scientific and /or technical knowledge
2. Applied research cost applied research is done for the purpose of achieving some particular practical motto or objectives

Treatment in Cost A/cs :-

1. **Basic Research Cost :-** It should be treated as prod. OH for a particular period and absorb it in product cost. Because it is related to all existing products or methods or techniques of production etc.
2. **Applied Research Cost :-** It is further classified into 2 parts for the costing purpose. They are
   (i) If it is incurred for the improvement of the existing product and methods of production it should be treated as POH and absorbed accordingly
   (ii) If it is incurred for innovating new products or methods then such cost is absorbed on the basis of amortization
   If whole of such expenditure is so huge, then it should be absorbed in subsequent years in which some benefit is received by the producer.
   If applied research work becomes a failure, then such research expenditure is charged against profit in costing P & L A/c

If size of such amount is heavy, then such amount is spread over in subsequent year also.

Ques6. 2010-May [4] Answer of the following

(ii) Explain the treatment of over and under absorption of Overheads in Cost accounting

Ans. **Treatment of over and under absorption of overheads are :-**

If an enterprise uses actual rate for absorption of POHEs then the enterprise recover the actual amount incurred regarding the POH. It means no difference is there in between POHEs incurred and POHEs absorbed. Therefore, there is no over and under absorption of OHEs but this method of absorption creates a number of problems regarding costing.

Therefore, enterprises prefer to use budgeted or standard rate for absorption of POHEs but it creates another problem i.e., over and under absorption It arises due to a number of reasons which may be normal or abnormal in nature. The important ones are :-

1. Wrong estimation of POHEs
2. Unexpected changes in the level of activities
3. Change in production method
4. Uncontrollable causes (due to govt. policies, environmental changes etc.)

Out of the above mentioned causes, volume of output plays an important role because it solely depends upon the demand which is beyond the control of the enterprises.

There are varieties of methods used for over or under absorption of OHEs in accounts. However, in the corporate sector 3 important methods are widely used for accounting of over and under absorption of POHEs

(a) Use of supplementary OH absorption rates
(b) Write off to costing profit and loss A/c
(c) Carry over to the next period accounts

1. **Use of supplementary OH absorption rates :** This method is used when it is caused due to normal or avoidable reasons. When the amount of over and under absorbed POHEs is significant (i.e., more than 10% of total OH incurred), supplementary absorption rates are computed by the way of addition or deduction. This rate may be called negative supplementary rate if over absorbed amount is to be deducted. On the other hand, the supplementary rate may be called positive supplementary rate if under absorbed amount is to be added, therefore,

   Negative Supplementary Rate = Over Absorbed POHEs /Actual value of the Base output

   Positive Supplementary Rate = Under absorbed POHEs/ Actual value of Base output

   This method is preferred when :

   (i) There is a serious estimational error
   (ii) There is a substantial change in the level of activities
   (iii) There is a major change in the production method ‘
   (iv) A case of contract on cost plus basis is there

2. **Writing off to Costing Profit and Loss A/c. :** When the amount of over and under absorbed POHEs is not so significant, it may be written off to costing P/L, but, if it is significant (sizeable) and it arises due to :

   (i)Some uncontrollable and abnormal factors

(ii) Contingent estimation of output

Then such over or under absorbed POHEs may be written off to costing P/L, but, it suffer from some limitations like it cannot be adjusted in the value of WIP, unsold stock or sold unit (it means pricing policy cannot be adjusted)

3. Carry-forward to next Periods Accounts :

This method is used when :

(i)Balance amount is comparatively small

(ii) In case of new product whose output is low in initial years due to lack of demand

(iii) Normal business cycle I of more than one accounting period

Over under absorbed OH is carried over to next period in the hope that the same will automatically be adjusted or absorbed. But under this method, comparatibility of the performance is not properly feasible

Ques7. 2010- Nov. [7] Answer the following :

(a) What are the methods of re-apportionment of service department expenses over the production departments? Discuss?

Ans. **(a) Methods of re-apportionment of service department expenses over the production departments :-**

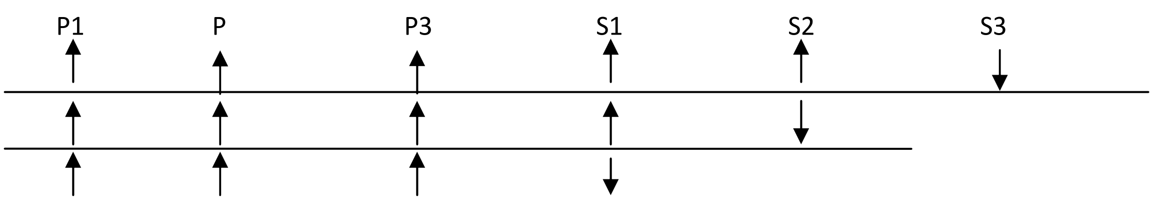
(i)Direct re-distribution method

(ii) Step method or non- reciprocal method

(iii) Reciprocal Service method

Direct re-distribution Method :- Service department costs under this method are apportioned over the production departments only, ignoring services rendered by one service department to another. Therefore, as compared to previous method, this method is more complicated because a sequence of apportionments has to be selected here. The sequence here begins with the department that maximum number of other service departments.

Production Department Service Department



Reciprocal Service Method :-

This method recognizes the fact that where there are two or more service departments they may render service to each other and, there these inter-departmental services are to be given due weight while re-distributing the expenses of service department

The methods available for dealing with reciprocal services are :

- Simultaneous equation method
- Repeated distribution method
- Trial & Error method

*****CHAPTER-5*****

*****INTEGRATED & NON- INTEGRATED ACCOUNTS *****

Ques1. 2006-Nov [5] (b) What are the essential pre-requisites of integrated accounting system?Discuss?

Ans. The success of an integrated system of accounting depends upon certain pre-requisites which should be ensured before the system is introduced. These are :-

1. Deciding the extent of integrated of the two sets of books. Some companies find it useful to integrate upto the stage of primary cost or factory cost while others prefer an integration of the entire accounting records
2. A suitable coding system must be developed to serve the purpose of both financial and cost accounts
3. To lay down the procedure for the treatment of provision for accruals prepaid expenses, other adjustments necessary for preparing interim accounts
4. Perfect co-ordination should exist between the staff responsible for financial aspects and cost aspects of the accounts. An efficient of accounting documents is to be ensured
5. Under this system, there is no need for a separate cost ledger of cause, there will be a number of subsidiary ledgers. In addition to the useful customers ledgers and the bought ledgers, there will be
   Stores ledger
   Stock ledger, &,
   Job ledger

Ques2. 2007-Nov. [4] Answer the following :

(i)Explain essential pre-requisites for integrated accounts

Ans. The success of an integrated system of accounting depends upon certain pre-requisites which should be ensured before the system is introduced. These are :-

1. Deciding the extent of integrated of the two sets of books. Some companies find it useful to integrate upto the stage of primary cost or factory cost while others prefer an integration of the entire accounting records
2. A suitable coding system must be developed to serve the purpose of both financial and cost accounts
3. To lay down the procedure for the treatment of provision for accruals prepaid expenses, other adjustments necessary for preparing interim accounts
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5. Under this system, there is no need for a separate cost ledger of cause, there will be a number of subsidiary ledgers. In addition to the useful customers ledgers and the bought ledgers, there will be
   Stores ledger
   Stock ledger, &,
   Job ledger

Ques3. 2010-May [1] Answer the following

(iv) What are the main advantages of Integrated accounts

Ans. **Main advantages of integrated accounts are as follows :**

The following are the main advantages of the integrated accounting system:

1. Since there is one set of accounts, thus there is one figure of profit. Hence, the question of reconciliation of costing profit and financial profit does not arise
2. Efforts in duplicate recording of entries & to maintain separate sets of books are saved. Thus, there is saving of time and labour
3. The operation of the system is facilitated with the use of mechanized accounting
4. Costing data are available from books of original entry and hence, no delay is caused in obtaining information
5. Combination of two sets of books and centralization of accounting function results in economy
6. Complete analysis of cost and sales is kept
7. Complete details of all receipts and payments in cash are kept
8. Complete details of all assets and liabilities are kept and this system does not use national account to represent impersonal accounts
9. Since financial books are subject to a rigorous accuracy, checking integrated accounts ensures similar checks for cost account

*****CHAPTER-6*****

*****RECONCILIATION OF COST AND ACCOUNTS*****

Ques1. 2007- May [4] Answer the following :

(iv) Enumerate the factors which cause difference in profits as shown in Financial Accounts and Cost Accounts

Ans. **Reasons For Disagreement :-**

The difference in profit or loss ascertained in cost accounts & financial account is due to the following reasons :-

1. Certain items are shown only in financial accounts and not in cost accounts

Like :

Profit or loss on sale of fixed assets
Discount on issue or redemption of shares and debentures
Receipt of interest and dividends on investments
Distribution of dividends
Donations and charities
Capital issue expenses
Cash discounts and bad debts
Preliminary expenses written off
Misc. income or expenditure not relating to business
Payment of income tax
Transfer of profits to reserves
Writing off intangible and fictitious assets like goodwill
Expenses relating to previous year

Lay off wages and retrenchment compensation

P /L relating to transactions of abnormal or non-recurring nature

2. Certain items are shown only in cost accounts and not in financial A/cs:

Like :

National rent on premises owed

Notional interest on capital

Depreciation on fully depreciation assets

3. Disagreement due to under or over absorption of overhead items :

In cost accounts, overheads are generally absorbed on the basis of a predetermined overhead rate, whereas in financial A/cs, actual expenditure on overheads is recorded, this also causes a difference between the two figures

4. Difference due to use of different methods of stock valuation

Different methods of valuation of closing stock adopted in cost and financial account will also cause a difference in the results shown by the two sets of books. In financial accounts the method generally followed is cost or market price whichever is lower, whereas in cost accounts different methods of pricing of material issues such as LIFO, FIFO, average etc., are used

5. Difference due to use f different rates of depreciation :

Use of different methods of depreciation is also responsible for the variation of profit shown by two sets of books. In financial accounts depreciation may be charged according to the provisions of Companies Act or Income tax Act (i.e., WDV method or SLM) whereas in cost accounts machine hour rate or production hour or unit method can be adopted.

6. Abnormal Gains & Losses :

Abnormal items not included in cost accounts also cause a difference in profit. If such items of expenses are included, cost ascertained will not be correct

Ques2. 2009-May [4] Answer the following

(iii) List the Financial expenses which are not included in cost

(iv) When is the reconciliation statements of Cost and Financial accounts not required

Ans. (iii) Financial expenses which are not included in cost accounting are as follows:

(i) Preliminary expenses

(ii) Underwriting Commissions

(iii) Discount on issue of Share

(iv) Income Tax

(v) Interest on debentures and deposit

(vi) Bonus of Employee

(vii) Pension

(viii) Gratuity

(iv) Circumstances where reconciliation statement can be avoided is as follows:

when the Cost and Financial Acocunts are integrated –there is no need to have a separate reconciliation statement between the two sets of accounts.

Integration means that the same set of accounts fulfill the requirement of both i.e, Cost and Financial Accounts

*****CHAPTER – 7*****
***** JOB COSTING & BATCH COSTING *****

Ques1. 2006- May [3] (b) Distinguish between the following :

(iii) Job Costing and Batching Costing

Ans. The main difference between job costing and process costing are as follows:-

S.No.	Basic	Job Costing	Process Costing
1.	Method	Job costing is one of the methods of costing used to ascertain cost of each job	Process costing is one of the methods of costing used to ascertain cost of a product at each process or stage of manufacture
2.	Cost determination	Cost is determined separately for each job	Cost of a product is determined by accumulating cost of each process
3.	End product	The end product of one job is the finished product and may not become raw material for other jobs	The end product of a process becomes the raw material for the next process
4.	Cost collection	The cost is collected on the basis of job order	The cost is collected by period i.e., on time basis
5.	Cost estimation	Cost is computed or estimated before the production	Costs are computed for each process at the end of each period
6.	Cost complitation	The cost of each job is complied separately by adding materials, labour and overhead period	The unit cost here is the average cost of the process for a given period
7.	WIP	There may or may not be work in progress at the end of accounting period	There is always some work in progress at the beginning as well as end of accounting period
8.	Supervision	Detailed supervision and control is needed as each job is distinct and different from others	Supervision and control is comparatively easier as the process operations are standardize

*****CHAPTER – 8 *****

*****CONTRACT COSTING *****

Ques1. 2006-Nov. [3] (b) Discuss briefly the principles to be followed while taking credit for profits on incomplete contracts

Ans. Profit on uncompleted contract is computed on the basis of Notional Profit and the percentage of work done. It is transferred to costing Profit & loss account and computed as follows :-

(1) Stage of contract – Initial (just began)
Percentage of work done - Less than 25%

Profit – Nil [as it is impossible to foresee clearly the future position]

(2) Stage of contract – In course (but not substantial)

Percentage of work done –upto or more than 25% but less than 50%

Profit - $\frac{1}{3}$ x Notional Profit x $\frac{\textbf{Cash Received}}{\textbf{Work Certified}}$

(3) Stage of contract – Substantially complete

Percentage of work done -upto or more than 50% but less than 90%

Profit = $\frac{2}{3}$ x Notional Profit x $\frac{\textbf{Cash Received}}{\textbf{Work Certified}}$

(4) Stage of contract - Almost complete

Percentage of work done – upto or more than 90% but less than 100%

Profit : Profit to be transferred to P&L A/c here is the proportion of the estimated profit.

The estimated profit is arrived at by deducting from the contract price the aggregate of estimated cost and the expenditure incurred. The proportion of estimated profit in computed by adopting any of the following formula

1. Estimated Profit x $\frac{\textbf{work Certified}}{\textbf{Contract Price}}$

2. Estimated Profit x $\frac{\textbf{work Certified}}{\textbf{Contract Price}}$ x $\frac{\textbf{Cash Received}}{\textbf{Work Certified}}$

3. Estimated Profit x $\frac{\textbf{Cost of work to date}}{\textbf{Estimated total cost}}$ x $\frac{\textbf{work Certified}}{\textbf{Contract Price}}$

4. Estimated Profit x $\frac{\textbf{Cost of work to date}}{\textbf{Estimated total cost}}$ x $\frac{\textbf{Cash Received}}{\textbf{Work Certified}}$

Note :- If Notional Profit < estimated profit then only the notional profit is transferred to Profit & Loss A/c

<u>Ques2.</u> 2007 – Nov. [1] Answer the following

(iii) Explain the importance of an Escalation Clause in contract cost

<u>Ans.</u> (iii) Escalation Clause :- Escalation clause is a stipulation in the contract that the contract price will be increased by an agreed amount or percentage if the price of raw material, wages etc., rises beyond a certain unit. The object of this clause is to safeguard the interest of both side against unfavourable change in price. While due to loss of the contractors interest is safeguard as has profit percentage not reduced. The customer's interest is safeguard as quality is ensured because due to the escalation, clause the contractor does not use materials of low quality

<u>Accounting Treatment :-</u>

<u>Step 1.</u> The increased contract price is determined with reference to the escalation clause

<u>Step 2.</u> The amount due from the customer is recorded in contract A/c by passing the following general entry

Customer's A/c Dr.
To Contract A/c

Ques3. 2008- May [1] Answer the following

(iv) What are the main advantages of cost plus contract

Ans. Advantages of Cost plus Contracts :

(i) In contracts where the probable cost of contract cannot be estimated with reasonable accuracy, cost plus contract method helps in ascertaining the contract cost by adding a percentage of profit to the total cost of contract

(ii) It is preferable in those contracts whose cost of material and labour is unsteady and is likely to change in future

(iii) It is beneficial for both contractor as well as customer. It offers a fair price to the customer and a reasonable profit to the contractor

(iv) The different costs to be included in the contract are pre-decided so that no dispute arise in future

Ques4. 2009-Nov. [1] Answer the following

(iv) Mention the main advantage of cost plus contracts

Ans. **Main advantages of Cost Plus contracts are as follows :**

- It protects the contractor from risk of fluctuation in market price of material, labour services etc.
- Contractee gets a fair price of the market
- It is useful specially when the work to be done is not definitely fixed at the time of making the estimate
- Contractee is empowered to examine the books and documents of the contractor to ascertain the veracity of the cost of the contract and hence is ensured about cost of contract

*****CHAPTER – 9*****

*****OPERATING COSITNG *****

Ques1. 2007- May [4] Answer the following

(iii) "Operation costing is defined as refinement of Process costing". Explain it.

Ans. Operation costing is used for establishing cost of services rendered or service offered for sale and no items are produced. It is also applied to the operations concerned within an organization which provides services to production departments. It is solely concerned with the determination of the cost of each operation rather than the process costing

Operation costing provides better control and facilities, the computation of unit operation cost at the end of each operation. So, it can be said that the method of operation costing is similar to output costing but not as process costing

Ques2. 2008- Nov. [1] Answer the following :

(iii) State the unit of cost for the following industries :

(a) Transport
(b) Power
(c) Hotel
(d) Hospital

Ans. **The unit of cost for various industries are as follows :**

Industry		Unit of Cost
(b)Power	:	Per kilo –watt hour (Kwh) or Horse Power (HP)
(a) Transport	:	(i) Goods –Per ton km. or per tonne km.
		(ii) Passangers –per passanger km
(c) Hotel	:	Per Room-day or Per Service –day
(d) Hospital	:	Per Patient –day or Per Bed –day or per Operation

Ques3. 2009- Nov. [4] Answer the following

(ii) Explain briefly, what do you understand by Operating Costing. How are composite units computed

Ans. Operating costing is one of the methods of costing used to ascertain the cost of generating and rendering services such as transport, hospital, canteens, electricity, transport etc.
Operating Costing aims at ascertaining the operating costs
The cost incurred to generate and render services such as hospital, canteen, electricity, transport etc. is called operating cost Operating costs (in transport costing) are classified into three broad categories:-

1. Operating and running cost
2. Standing cost
3. Maintenance cost

1. Operating and running cost :- These are the costs which are incurred for operating and running the vehicle. For eg., - cost of diesel, petrol etc. These costs are variable in nature and vary with operations in more or less same proportions

2. Standing cost :- Standing costs are the costs which are incurred irrespective of operation. For eg., - rent of garage, salary of drivers, insurance premium etc. It is fixed in nature and thus the cost goes on accumulating as the time passes

3. Maintenance cost :- Maintenance costs are the costs which are incurred to keep the vehicle in good or running condition
For eg., - Cost of repair, painting, overhauling etc. It is semi-variable in nature and is influence by both time and volume of operation

*****CHAPTER – 11 *****

*****JOINT PRODUCTS & BY PRODUCTS*****

Ques1. 2009-May [3] (b) Describe briefly, how joint costs upto the point of separation may be apportioned amongst the joint products under the following methods

(i) Average unit cost method
(ii) Contribution margin method
(iii) Market value at the point of separation
(iv) Market value after further processing
(v) Net realizable value method

Ans. Methods of apportioning joint cost among the joint products

(i) Average Unit Cost Method :

- In this method, total process cost (upto the point of separation) is divided by total units of joint products produced
- On division average cost per unit of production is obtained. The effect of application of this method is that all joint products will have uniform cost per unit

(ii) Contribution Margin Method :

- In this method joint cost are segregated into two parts –variable and fixed. The variable costs are apportioned over the joint products on the basis of units produced (average method) or physical quantities
- When the products are further processed, then all variable cost incurred be added to the variable cost determined earlier
- After that contribution is calculated by deducting variable cost from their respective sales values
- The fixed costs are then apportioned over the joint products on the basis of contribution ratios

(iii) Market value at the Time of Seperation :

- This method is used for apportioning joint costs to joint products upto the split off point
- This method is difficult to apply if the market value of the products at the point of separation are not available
- The joint cost may be apportioned in the ratio of sales values of different joint products

(iv) Net Realisable Value Method :

- Under this method joint costs is apportioned on the basis of net realizable value of the joint products

Net Realisable Value	= Sale value of joint products (at finished stage)
	(-) estimated profit margin
	(-) selling & distribution expenses, if any
	(-) post split-off cost

Ques2. 2010-Nov. [7] Answer the following :

(b) How apportionment of joint costs upto the point of separation amongst the joint products using market value at the point of separation and net realizable value method is done? Discuss?

Ans. **Apportionment of Joint Cost amongst Joint Products using:**

Market value at the point of separation

This method is used for apportionment of joint costs products upto the split off point. It is difficult to apply if the market value of the product at the point of separation is not available. It is useful method where further processing costs are incurred disproportionately.

Net realized value Method

From the sales value of the joint products (at finished stage) are deducted :-

→ Estimated profit margins
→ Selling distribution expenses, if any
→ Post split off costs

The resultant figure so obtained is known as net realized value of joint products. Joint costs are apportioned in the ratio of net realized value.

***** CHAPTER -12 *****

*****STANDARD COSTING*****

Ques1. 2006-Nov [6] (b) Under the single plan, record the journal entries giving appropriate narration, with indication of amounts of debits or credits alongside the entries, for the following transaction using the respective control A/c

(i) Material price variance (on purchase materials)
(ii) Material usage variance (on consumption)
(iii) Labour rate variance

Ans. **Under the single plan, Journal entries are:-**

(i) Material price variance (on purchase of materials)

Material Control A/c	Dr.
Material price Variance A/c	Dr. or Cr. (Bal. Fig)
To Creditor A/c	

(Being price variance during purchase of materials)

(ii) Material usages variances (on consumption)

WIP Control A/c	Dr.
Material usage variance	dr. or Cr. (Bal fig.)
To Material Control A/c	

(Being recording of usage variance at Standard cost of over/under utilized quantity)

(iii) Labour Rate Variance

Wage Control A/c	Dr.
Labour Rate Variance	Dr. or Cr. (Bal. Fig)
To Cash	

(Being entry to record wages at standard rate)

*******CHAPTER- 13 *******

*******MARGINAL COSTING*******

Ques1. 2008- May [4] Answer the following

(i)Explain and illustrate cash break even chart

Ans. A cash breakeven chart records Cash costs and revenues on the vertical axis and the level of activity on the horizontal axis. In this chart, variable cost are assumed to be payable in cash. Beside this, the fixed expenses are divided into two groups viz.

(i) Those expenses which involves cash outflow, e.g., rent, insurance, salaries etc.
(ii) Those expenses which do not involve cash outflow, e.g., depreciation, bad debts etc.

The making of the cash breakeven chart would require us to select appropriate axes. Subsequently, we will mark costs/ revenues on the Y axis whereas the level of activity shall be traced on the X axis. Lines representing (i) Cash Fixed costs, (ii) Total costs at maximum level of activity and (iii) Revenue at maximum level of activity (joined to the origin) shall be drawn next. The cash breakeven point is that point where the sales revenue line intersects the total cash cost line. Other measures like the margin of safety and profit can also be measured from the chart

Ques2. 2010-May [1] Answer the following

(iv) What do you understand by key factor? Give two examples of it?

Ans. Key factor is a factor which at a particular time or over a period limits the activities of an undertaking. It may be the level of demand for the products or service or it may be the shortage of one or more of the productive resources.

Examples of key factors are :

(a) Shortage of raw material
(b) Shortage of labour
(c) Plan capacity available
(d) Sales capacity available
(e) Cash availability

*******CHAPTER – 14*******

*******BUDGETS & BUDGETARY CONTROL *******

Ques1. 2008- Nov. [1] Answer the following

(vi) Explain briefly the concept of 'flexible budget'

Ans. Flexible Budgets show the expected results of a responsibility unless for several activity levels. It is a budget which by recognizing the difference between fixed, semi-variable and variable costs is designed to change in relation to level of activity attained. It is not rigid as it can be recasted on the basis of activity level to be achieved. It consists of services of static budgets for different levels of activity. Variance analysis through flexible budget provides useful information as each cost is analyzed according to its behaviour.

It facilitates the ascertainment of cost, fixation of selling price and submittion of quotations. Flexible budgets provide a meaningful basis of comparison of the actual performance with the budgeted targets.

Such bedgets are especially useful in estimating and controlling factory costs and operating expenses.

Flexible Budgeting may be resorted to in the following situations :

(a) New Business :

In case of new business venture, due to its typical nature, it may be difficult to forecast the demand of a product accurately.

(b) Uncertain Environment :

Where the business is dependent upon the very of nature

(c) Factor Market Conditions :

In the case of Labour intensive industry where the production of the concern is dependent upon the availability of labour

Ques2. 2009-May [1] Answer the following :

(v) Discuss the components of budgetary control system

Ans. **Components of budgetary control system :** There are a number of bases for classifying the budgets into two or more categories. But the most important and widely used bases are functional classificafication and classification according to flexibility

The policy of a business for a defined period is represented by the master budget the details of which are given in a number of individual budgets called functional budgets. The functional budgets are broadly grouped under the following heads

(a) Physical Budget :- This budget contains information in terms of physical units e.g., Sales Qty, Product Qty, Inventory, Manpower budget

(b) Cost Budgets :- Manufacturing Cost, Administration Cost, sales & distribution cost, R & D Cost

(c) Profit Budget :- A budget which enable in the ascertainment of profit, e.g., Sales budget, Profit & loss budget etc.

On the other hand, budgets may be classified into two categories on the basis of flexibility as fixed budgets and flexibility budgets.

Ques3. 2009-Nov [4] Answer the following :

(iv) List the eight functional budgets prepared by a business

Ans. A functional budget is prepared according to the various functions of the organization e.g: Sales, Production, and Administration Research & development etc.

Following are the most popular functional budgets :

1. Sales budget
2. Production budget
3. Materials budget
4. Labour budget
5. Manufacturing overhead budget
6. Administrative cost budget
7. Plant utilization budget
8. Research and Development budget
9. Capital expenditure budget
10. Cash budget

FINANCIAL MANAGEMENT

***** CHAPTER –1 *****

*****SCOPE AND OBJECTIVES OF FINANCIAL MANAGEMENT*****

Ques1. 2009-Nov. [5] Answer the following:

(iv) Differentiate between Financial Management and Financial Accounting

Ans. **Differentiation between Financial Management and Financial Accounting:**

1. **Decision-making :-** The chief focus of Financial Accounting is to collect data and present the data while Financial Management's primary responsibility relates to financial planning, controlling and decision-making

2. **Treatment of funds: -** In financial Accounting, the measurement of funds is based on the accrual principle of funds, in financial management is based on cash flows.
The revenues are recognized only when cash is actually received (i.e., cash inflow) and expenses are recognized on actual payment (i.e., cash outflow)

Ques2. 2010-Nov. [5] (b) Distinguish between the following :

(i) Profit maximization vs Wealth maximization objectives of the firm

Ans. **(i)** **Profit Maximization vs Wealth Maximization objectives of the firm:-**

The primary objective of a company is to earn profit; hence the objective of financial management is also profit maximization. This implies that the finance manager has to make decisions in a manner so that the profits of the concern are maximized. Each alternative, therefore, is to be seen as to whether or not it gives maximum profit. The company may pursue profit maximization goal but that may not result into creation of shareholder value. Profit maximization is at best a limited objective. It does not take into account the time pattern of returns and it is a marrow objective.

Whereas, Wealth, maximization, on the other hand, means that the company is using its resources in a good manner. If the share value is to stay high the company has to reduce its costs and use the resources properly. Goal of wealth maximization means that the company will promote only those policies that will lead to efficient allocation of resources.

Ques3. 2006-Nov. [6] {C} (b) Discuss the conflicts in Profit versus Wealth maximization principle of the firm

Ans. Financial management is basically concerned with procurement and use of funds. In the light of these the main objectives of financial management are :-

1. Profit Maximisation
2. Wealth Maximisation

1. Profit Maximisation :-
Profit Maximization is the main objective of business because :-

(i) Profit act as a measure of efficiency and
(ii) It serves as a protection against risk

Agreements in favour of profit maximization:-

(i) When profit earning is the main aim of business the ultimate objective should be profit maximization
(ii) Future is uncertain. A firm should earn more and more profit to meet the future contingencies
(iii) The main source of finance for growth of a business is profit. Hence, profits maximization is required
(iv) Profit maximization is justified on the grounds of rationality as profits act as a measure of efficiency and economic prosperity

Agreements against profit maximization:

(i) It leads to exploitation of workers and consumers
(ii) It ignores the risk factor associated with profit
(iii) Profit in itself is a vague concept and means differently to different people
(iv) It is a narrow concept at the cost of social and moral obligations
Thus, profit maximization as an objective of financial management has been considered inadequate

2. Wealth Maximisation : Wealth maximization is considered as the appropriate objective of an enterprise. When the firms maximize the stock holder's wealth, the individual stockholder can use this wealth to maximize his individual utility. Wealth maximization is the single substitute for a stock holder's utility.

A stock holder's wealth is shown by:

Stock holder's wealth = No. of share owned x Current stock price per share

Higher the stock price per shares, the greater will be the stock holder's wealth; the greater will be the stock price per share

Maximum Utility

$\Big\downarrow$ **Refers to**

Maximum stock holder's wealth

↓ **Refers to**

Maximum stock price per share

Agreements in favour of wealth maximization:

(i) Due to wealth maximization, the short term money lenders get their payments in time.

(ii) The long time lenders too get a fixed rate of interest on their investments

(iii) The employees share in the wealth gets increased

(iv) The various resources are put to economical and efficient use

Agreement against wealth maximization:-

(i) It is socially undesirable

(ii) It is not a descriptive idea

(iii) Only stock holder's wealth maximization does not lead to firm's wealth maximization

(iv) The objective of wealth maximization is endangered when ownership and management are separated

In spite of the arguments against wealth maximization, it is the most appropriative objective of a firm

Ques4. 2007-May [8] Answer the following

(iii) What are the main responsibilities of a Chief Financial Officer of an organization

Ans. The finance manager occupies an important position in the organization structure. Earlier his role was just confined to raising of funds from a number of sources. Today his functions are multidimensional. The functions performed by todays finance managers are as below:-

(1) **Forecasting the financial requirement :** A financial manager has to make an estimate and forecast accordingly the financial requirements of the firm.

(2) **Planning :** A finance manger has to plan out how funds will be procedure and how the acquired funds will be allocated

(3) **Procurement of fund :** A finance manager has to select the best source of finance from a large number of options available. The finance manager's decisions regarding the selection of source is influenced by the need, purpose object and the cost involved

(4) **Investment / Allocation of fund :** A finance manager has also to invest or allocate funds in best possible ways. In doing so a finance manager cannot but ignore the principles of safety profitability and liquidity

(5) **Maintaining proper liquidity :** A finance manager plays an important role in maintaining proper liquidity.

He determines the need for liquid asset and then arrange them in such a way that there is no scarcity of funds

(6) **Cash Management :** A finance manager has also to manage the cash in an efficiency way. Cash is to be managed in such a way that neither there is scarcity of it nor does it remains idle earning no return on it.

(7) **Dividend decisions :** A finance manager has also decide whether or not to declare a dividend. If dividends are to be declared, then what amount is to be paid to the shareholder and what amount is to be retained in the business

(8) **Evaluation of financial performance :** A finance manager has to implement a system of financial control to evaluate the financial performance of various units and then take corrective measures whenever needed.

(9) **Financial negotiatons :** In order to procure and invest funds a finance manager has to negotiate with the various financial institutions, banks, public depositors in a meticulous way

(10) **To ensure proper use of surplus :** A finance manager has to see to the proper use of surplus fund. This is necessary for expansion and diversification plan and also for protecting the interest of share holders

Ques5. 2007- Nov. [8] Answer the following:

(ii) Explain the limitations of profit maximization objective of Financial Management

Ans. **Arguments against profit maximization:**

1. It leads to exploitation of workers and consumers
2. It ignores the risk factor associated with profit
3. Profit in itself is a vague concept and means differently to different people
4. It is a narrow concept at the cost of social and moral obligations.
   Thus, profit maximization as an objective of financial management has been considered inadequate.

Limitation of profit maximization objectives:-

1. It ignores the risk factor as well as timings of returns
2. The concept of profit maximization is vague and narrows
3. It emphasizes the short-run profitability and short-term projects
4. It may causes decrease in share price
5. It fails to consider the social responsibility of business
6. It may allow decisions to be taken at the cost of long run stability and profitability of the concern
7. The profit is only one of the many objectives of a modern firm
8. It ignores the time and risk factors

Ques6. 2009-May [5] Answer the following:

(iv) Discuss conflict in profit versus wealth maximization objective

Ans. Financial management is basically concerned with procurement and use of funds. In the light of these, the main objectives of financial management are:-

1. Profit Maximization
2. Wealth Maximization

1. **Profit Maximization** :-

Profit Maximization is the main objective of business because:-

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- **(i)** It is socially undesirable
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- **(iii)** Only stock holder's wealth maximization does not lead to firm's wealth maximization
- **(iv)** The objective of wealth maximization is endangered when ownership and management are separated

In spite of the arguments against wealth maximization, it is the most appropriative objective of a firm

Ques7. 2009-Nov. [8] Answer the following:

(i) Explain the two basic functions of Financial Management

Ans. **The two basic aspects of F.M. are:-**

1. Procurement of funds
2. Effective use of these funds

1. **Procurement of funds :-**

   Procurement of funds included:-

   - **(i)** Identification of sources of finance
   - **(ii)** Determination of finance mix
   - **(iii)** Raising of funds
   - **(iv)** Division of profit
   - **(v)** Retention of profit

There are various sources of procurement of funds such are: -

share capital, debentures, bank, financial institution, ADR,GDR,FDI,FIL etc.

Every source has an element of risk, cost and control attached with it. Whatever be the source, the cost of the fund should be at the minimum, balancing the risk and the control function.

2. **Effective use of fund: -** The funds once procured be left to remain idle. The funds are to be invested in such a way that the business yields maximum return along with maintaining its solvency.

   Thus the effective use of the funds would required that the adequate funds should be maintained to meet the working capital requirement and avoiding the blockage of funds in inventories book debts, cash etc.

Ques8. 2010-May [8] Answer the following :

(ii) State the role of a Chief Financial Officer

Ans. **Role of a Chief Financial Officer (CFO):** The chief financial officer of an organization plays an important role in the company's goals, policies and financial success. His responsibilities include

- **(a) Financial Analysis and Planning :** Determining the proper amount of funds to employ in the firm
- **(b) Investment Decisions :** The efficient allocation of funds to specific assets
- **(c) Financing and Capital Structure Decisions :** Raising funds on favourable terms as possible
- **(d)** Management of Financial Resources such as working capital
- **(e) Risk Management :** Protecting assets

*****CHAPTER – 2 *****

*****TIME VALUE OF MONEY *****

Ques1. 2008- May [5] Answer the following

(vi) Explain the relevance of time value of money in financial decisions

Ans. Time value of money means that worth of a rupee received today is different from the worth of a rupee to be received in future. The preference of money now as compared to future money is known as time preference for money.

A rupee today is more valuable than rupee after a year due to several reasons :-

- ❖ **Risk –** there is uncertainly about the receipt of money in future
- ❖ **Preference for present consumption** – Most of the persons and companies in general, Prefer current consumption over future consumption
- ❖ **Inflation** – In an inflation period a rupee today represents a greater real purchasing power than a rupee a year hence
- ❖ **Investment opportunities** – Most of the persons and companies have a preference for present money because of availabilities of opportunities of investment for earning additional cash flow

Many financial problems involve cash flow accruing at different points of time for evaluating such cash flow as explicit consideration of time value of money is required.

**** CHAPTER – 3 *****

*****FINANCIAL ANALYSIS AND PLANNING *****

Ques1. 2010-May [8] Answer the following:

(iii) Distinguish between Fund Flow Statement and Cash Flow Statement

Ans. **(iii) Distinguish between Fund Flow Statement and Cash Flow Statement**

	Basis	Cash Flow Statement	Fund Flow Statement

1.	Object	It indicates change in cash position	It indicates change in working capital
2.	Scope	Its coverage is narrow confined only to cash	Its coverage is wide confined to working capital
3.	Opening & Closing balance	It is always prepared by opening cash balance and closing cash balance	Opening & Closing cash balances are not required
4.	Adjustment	Due weightage is given to outstanding and prepaid income and expenses	No adjustment is needed for outstanding and prepaid expenses
5.	Preparation of schedule of change in working capital	No need to prepare schedule of change in working capital	It is necessary to prepare the schedule of change in working capital
6.	Increase or decrease in working capital	Not shown	Always shown
7.	Calculation	Cash generated from operation is calculated	Fund generated from operation is calculated
8.	Analysis	Essential for short term financial analysis	Essential for long term financial analysis

Ques2. 2006-Nov. [8] (a) Discuss the Financial ratios for evaluating company performance on operating efficiency and liquidity position aspects

Ans. **Financial ratios for evaluating company performance on operating efficiency and liquidity position aspects :-**

1. **Operating efficiency:** Financial Ratio Analysis helps to determine degree of efficiency and effective utilization of assets. We measure operational efficiency of an enterprise

   with the help of activity ratio. It helps to determine solvency position of an enterprise. Following are examples of activity ratio :-

   (1) Capital turnover ratio = $\frac{\textbf{Net Sales}}{\textbf{Capital employed}}$

   (2) Total asset turnover ratio = $\frac{\textbf{Net Sales}}{\textbf{Total Assets}}$

   (3) Fixed asset turnover ratio = $\frac{\textbf{Net Sales}}{\textbf{Fixed Asset}}$

2. **Liquidity positions:** Ratio analysis also helps to determine liquidity positions. A firm should be able to meet all its short turn obligations. It is current asset that yields funds in short period. Current assets should not only yield sufficient funds to meet current liabilities as they fall due but also enable the firm to carry on its day-to-day activity. If above qualities are present in an enterprise are then firm can be said to have good liquidity position. Current ratio, liquid ratio, Debt equity ratios mainly used to judge liquidity position. These ratios are particularly useful in credit analysis by banks and other suppliers of short term loans.

Ques3. 2007-May [5] Answer the following :

(ii) Explain the need of debt –service coverage ratio

Ans. **<u>Need of debt –service coverage ratio</u>:-**

- This ratio is the vital indicator to the ledger to assess the extent of ability of the borrower to service the loan in regard to timely payment of interest and repayment of principal amount
- It shows whether the business is earning sufficient profits to pay not only the interest charges, but also the installment due of the principal amount
- Debt services coverage ratio of 1 : 2 is considered ideal by the financial institutions
- This ratio will enable the lender to take correct view of the borrower's repayment capacity
- The ratio is calculated as follows :

$$= \frac{\textit{Earning available for debt service}}{\textit{Interest on loan + Installment of the principal amount}}$$

- Where earning available for debt service = Profit after tax + Depreciation + Interest on loan

Ques4. 2007- May [8] Answer the following

(ii) Diagrammatically present the DU PONT CHART to calculate return on equity

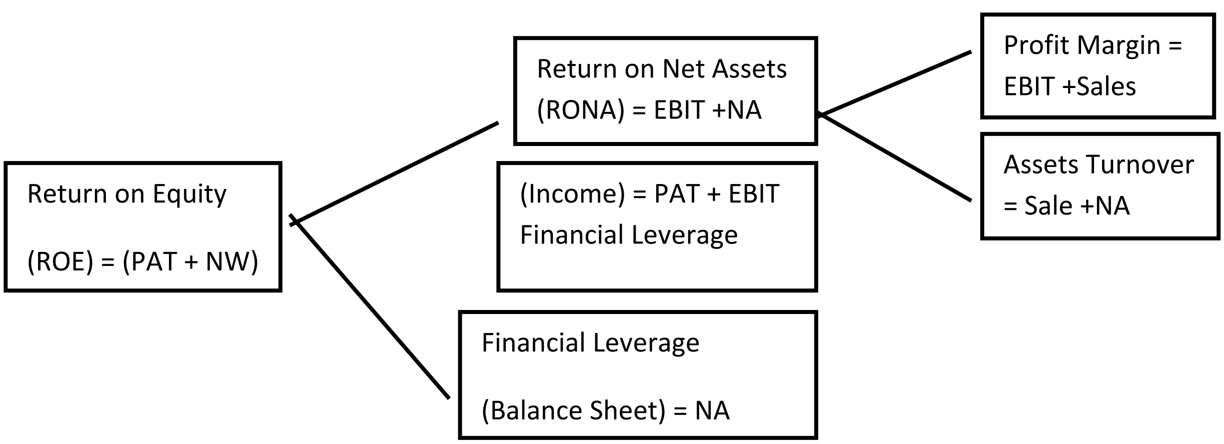
Ans. DU-Pont Chart was developed by the USA based company Du-Point

This chart is a chart of financial ratios, which analyses the Net Profit Margin in terms of asset turn out

This chart shows that the ROI is ascertained as a product of Net profit margin ratio and investment turnover ratio

There are three components in the calculation of return on equity using the traditional Du Pont model-the net profit margin, asset turnover, and the equity multiplier. By examining each input individual, the sources of a company's return on equity can be discovered and compared to its competitors

Return of Equity =(Net Profit Margin) (Asset Turnover) (Equity Multiplier)



DU – PONT

Ques5. 2008-Nov. [5] Answer the following :

(V) How is return on capital employed calculated? What is its significance?
(VI) What is quick ratio? What does it signify?

Ans. **(V)** Return on capital employed = $\frac{\textit{Return}}{\textit{Capital employed}}$ **x** 100

Return = Profit after tax
+ Tax
+ Interest
+ Non trading Expenses
- Non operating incomes

Capital employed = Equity share capital
+ preference share capital
+ Reserves & Surplus + P & L (Cr. Bal.) + Long term loans
+ Debentures
- Non trading investment – Fictitious Assets - P & L (Dr. Bal)

Significance of ratio "Return on capital employed":

1. Overall profitability of the business is highlighted

2. Comparison of "Return on capital employed with rate of interest debt leads to financial leverage

(VI) Quick ratio also termed as "acid test ratio" is one of the best measures of liquidity

It is worked out as follows:

Quick Ratio = $\frac{\textbf{\textit{Quick Assets}}}{\textbf{\textit{Quick Liabilities}}}$

In the above formula -

Quick Assets = Current Assets – Inventories

Quick Liabilities = Current Liabilities – Bank –Overdraft – Cash credit

Quick ratio of 1 : 1 is an ideal ratio significance :

It indicates whether the firm is in a position to pay its current liabilities within a month or immediately

Ques6. 2008-Nov. [8] Answer the following :

(iii) What do you mean by Stock Turnover ratio and Gearing ratio

Ans. Inventory / Stock turnover ratio

It establishes the relationship between the cost of goods sold during the year and average inventory held during the year It is calculated as follows :

Inventory / Stock turnover Ratio = $\frac{\textbf{\textit{Sales / Turnover}}}{\textbf{\textit{Average / Inventory}}}$

In above formula :

Average inventory = $\frac{\textbf{\textit{Opening Stock+Closing Stock}}}{\textbf{2}}$

This ratio indicates that how fast inventory is sold.

A high ratio is good from the view point of liquidity and a low ratio would indicate that inventory is not sold and remains in godown for a long time

Note :- Turnover is generally taken as cost of goods sold

Gearing Ratio :-

It is also called as " Capital Gearing Ratio". It shows the proportion of fixed interest (dividend) bearing capital to funds belonging to equity share-holders funds. This ratio indicate how much of the business is funded by borrowing **It**

is calculated as follows : Capital Gearing Ratio = Preference Capital + $\frac{\textit{Debentures+Long term loans}}{\textit{Equity share capital+Reserves}}$ and surplus- losses

This ratio helps to judge the long term solvency position of a firm

Ques7. 2009-May [5] Answer the following

(iii) How is Debt service coverage ratio calculated? What is its significance?

Ans. **Debt service coverage ratio and its significance :-**

- This ratio is the vital indicator to the lender to assess the extent of ability of the borrower to service the loan in regard to timely payment of interest and repayment of principal amount
- It shows whether the business is earning sufficient profits to pay not only the interest charges, but also the installment due of the principal amount
- Debt service coverage ratio 1 : 2 is considered ideal by the financial institutions
- This ratio will enable the lender to take correct view of the borrower's repayment capacity
- The ratio is calculated as follows :

$$= \frac{\textit{Earning available for debt service*}}{\textit{Interest on loan+Installment of the principal amount}}$$

  - Where earning available for debt service = Profit after tax + Depreciation + Interest on Loan

Ques8. 2009-May [8] Answer the following :

(iv) Discuss the composition of Return on Equity (ROE) using the Du Pont model

Ans. **Composition of Return on Equity using the DuPont Model**

There are three components in the computation of return on equity using the traditional DuPont model- the net profit margin, asset turnover, and the equity multiplier. By examining each input individually, the sources of a company's return on equity can be discovered and compared to its competitors

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

Net profit margin = Net Income + Revenue

Net profit margin is a safety cushion; the lower the margin, lesser the room for error

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

Asset Turnover = Revenue + Assets

The asset turnover ratio tends to be inversely related to the net profit margin; i.e., the higher the net profit margin, the lower the asset turnover

(iii) **Equity Multiplier :** It is possible for a company with terrible sales and margins to take on excessive debt and artificially increase its return on equity. The equity multiplier, a measure of financial leverage, allows the investor to see what portion of the return on equity is the result of debt. The equity multiplier is calculated as follows :

Computation of Return on Equity

To calculate the return on equity using the DuPont model, simply multiply the three components (net profit margin, asset turnover, and equity multiplier).
Return on Equity = Net profit margin x Asset turnover x Equity multiplier

Ques9. 2009-Nov. [5] Answer the following :

(i) Explain briefly the limitations of Financial ratios

Ans. **The limitations of RA are as below :-**

1. **Concept of Ideal Ratio :** The concept of ideal ratio is vague and there is no uniformity as to what an ideal ratio is
2. **Thin line of difference between good and bad ratio :** The line of difference between good and bad ratio is so thin that they are hardly separable
3. **Financial ratios are not independent :** The FR's cannot be considered in isolation. They are inner related but not independent. Thus, decision taken on the basis of one ratio may not be correct.
4. **Misleading :** Various firms may follow different accounting policies. In such case ratio companies of may be misleading
5. **Impact of Seasonal Factor :** Seasonal factor brings boom or recession. Ratios may indicate different results during different periods
6. **Impact of Inflation :** Under the impact of inflation, the ratios might not present a true picture
7. **Product line diversification :** Due to product line diversification, the overall position of the firm may differ from position of individual product line

*****CHAPTER -4 *****

*****FINANCING DECISIONS – COST OF CAPITAL & STRUCTURE*****

Ques1. 2006 – Nov. [9] (a) Discuss the dividend-price approach, and earnings price approach to estimate cost of Equity Capital

Ans. **Dividend price approach :** This approach emphasizes on dividend expected by an investor from a particular share to determines its cost. Cost of ordinary share is calculated on the basis of the present values of the expected future stream of dividend; where as

Earning price approach : Under this approach cost of ordinary share capital would be based on expected ratio of earning of a company. This approach is similar to dividend price approach, only it seeks to nullify the effect of changes in dividend policy.

Ques2. 2007- May [5] Answer the following :

(V) Explain in brief the assumption of Modigliani –Miller theory

Ans. **The Theory :** Franco Modigliani and Meron H Miller developed a hypothesis which is actually an extension of net operating income approach. "According to the theory, in absence of corporate tax, cost of capital and the market value of equity share is independent to the changes in capital structure or degree of leverage."

Explanation :-

The M-M hypothesis gave two propositions, which are as follows:

Propositions I :- The market value of the firm (V) and the cost of capital (ko) are independent of its structure

Propositions II :- The firm cost of equity increase to offset the use by cheaper debt capital. In other words, the firms use of debt increases its cost of equity as well

Assumptions :-

1. The investors are free to buy and sell the securities is the securities are traded in perfect market
2. The expectations of investors are same and homogeneous
3. The firms can be classified into homogenous
4. The dividend pay out ratio is 100%
5. There are no corporate taxes

Ques3. 2007- Nov [5] Answer the following :

(iii) What is optimum Capital structure? Explain

Ans. Capital structure is optimum when the value of the firm is maximum and cost of capital (debits & equity) is minimum and so market price per share is maximum. Which leads to the maximization of the value of the firm. Optimum Capital Structure deals with the issue of right mix of debt and equity in the long-term capital structure of a firm. According to this :-

1. If a company takes on debt, the value of the firm increases upon a certain point. Beyond that value of the firm will start to decrease
2. If the company is unable to pay the debt within the specified period then it will affect the goodwill of the company in the market

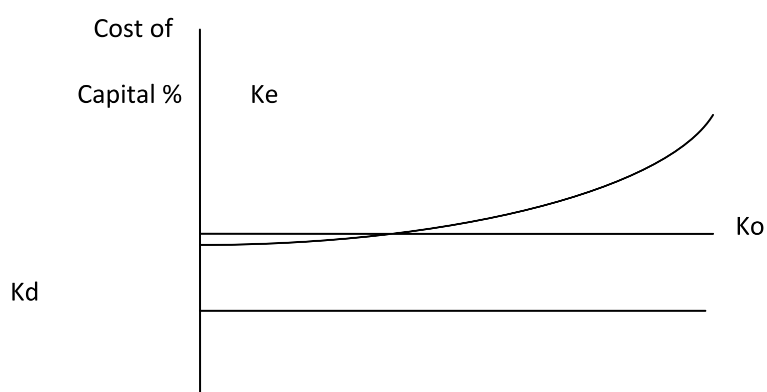
Hence, company should select it appropriate capital structure with due consideration of all factors

Ques4. 2007- Nov. [8] Answer the following :

(i) Explain the assumption of Net Operating Income approach (NOI) theory of capital structure.

Ans. **The Theory :** According to the net operating income approach, the market value of the firm depends upon the net operating profit or EBIT and the WACC. The financing mix or capital structure is irrelevant and does not affect the value of the firm **Explanation :** The market value of the firm is not affected by the capital structure changes. For a given value of EBIT, the value of firm remains same irrespective of the capital composition It however depends upon the WACC

Graphical Representation : .



Net operational Income Approach:
According to the figure,
K_d & K_o are constant for all leverages. As the leverage increases, **K_e** is such that overall value of the firm remains same
Conclusion : As per No. 1 approach, **K_o** is constant. Therefore, there is no optimum capital structure. Instead, every capital structure is an optimum one

Assumption :
1. The WACC remains constant for all leverage
2. **K_d** is always less than **K_e**
3. **K_e** increases as leverage increases
4. **K_d** is constant
5. There are no corporate taxes

Ques5. 2008- Nov. [5] Answer the following :

(iii) Discuss the concept of "Optimum Capital Structure".

Ans. Capital Structure is optimum when the value of the firm is maximum and Cost of capital (debts & equity) is minimum and so market price per share is maximum. Which leads to the maximization of the value of the firm

An optimal capital structure should possess the following features:

1. **Maximization of profitability :** by using leverage minimum cost
2. **Flexibility :** structure should be flexible so that company may be able to raise fund or reduce fund whenever it is required
3. **Control :** It should reduced the risk of dilution of control
4. **Solvency :** Expenses debt may threat the solvency of the company

Ques6. 2009-May [5] Answer the following

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

Ans. **Concept of Debt-Equity or EBIT-EPS Indifference Point while Determining the Capital Structure of a Company**

The determination of optimum level of debt in the capital structure of a company is a formidable task and is a major policy decision. It ensures that the firm is able to service its debt as well as contain its interest cost. Determination of optimum level of debt involves equalizing between return and risk. EBIT –EPS analysis is a widely used tool to determine level of debt in a firm. Through this analysis, comparison can be drawn for various methods of financing by obtaining indifference point. It is point to the EBIT level at which EPS remain unchanged irrespective of debt level equity mix. For example indifference point for the capital mix (equity share capital and debt) can be determined as follows :

$$\frac{(EBIT-I1)(1-T)}{E1} = \frac{(EBIT-I2)(1-T)}{E2}$$

Where,

EBIT = Indifference point

E_1 = Number of equity shares in Alternative 1

E_2 = Number of equity shares in Alternative 2

I_1 = Interest charged in Alternative 1

I_2 = Interest charged in Alternative 2

T = Tax-rate

Alternative 1 = All equity finance

Alternative 2 = Debt-equity finance

Ques7. 2009- Nov. [8] Answer the following

(iii) What do you want understand by Weighted average cost of Capital?

Ans. **Computation of overall cost of capital of a firm involves :**

1. Computation of weighted average cost of capital
2. Computation of cost of specific source of finance

1. **Computation of Weighted Average Cost of Capital (WACC) :** Weighted average cost of capital is the average cost of the costs of various sources of financing. Weighted average cost of capital is also known as composite cost of capital, overall cost of capital or average cost of capital. Once the specific cost of individual sources of finance is determined, we can compute the weighted average costs of capital by putting weights to the specific costs of capital in proportion to the various sources of firem to the total. The weights may be given either by using the book value of the source or market value of the sources.

WACC = (Proportion of Equity x Cost of Equity) + (Proportion of Preference + Cost of Preference) + (Proportion of Debt x Cost of Debt)

For the above formula, we consider some assumptions in order to simplify & make it calculative. These are :

(i) **We consider only three types of capital :** Equity non-convertible & non-cancellable preference shares and non-convertible & non-cancellable debts so, we have to ignore other forms of capital, because cost of these forms of capital is very difficult to calculate due to its complexities. Generally, such types of financing covers a minor part only, so it should be excluded as it cannot make any material difference

(ii) **Debts include :** Long term debts as well as short terms debts (i.e., working capital loan, commercial papers etc.)

(iii) **Non-interest** : Bearing liabilities such as trade creditors are not included in the calculation of WACC. This is done to ensure the consistency in reality. Such type of securities have cost but such costs are indirectly reflected in the price paid by the co. at the time of getting the goods & services

Ques8. 2010-May [5] Answer the following :

(i) What do you understand by capital structure? How does it differ from Financial structure?

Ans. **Meaning of Capital Structure and its Differentiation from Financial Structure :** Capital Structure refers to the combination of debt and equity which a company uses to finance its long-term operations. It is the permanent financing of the company representing long-term sources of capital i.e., owner's equity and long-term debts but excludes current liabilities whereas, Financial Structure is the entire left-hand side of the balance sheet which represents all the long-term and short-term sources of capital. Thus, capital structure is only a part of financial structure.

Ques9. 2010-Nov. [7] Answer the following :

(d) Discuss financial break-even and EBIT-EPS indifferent analysis

Ans. **Financial Break-even and EBIT-EPS Indifferent Analysis :-**

Financial break-even point is the minimum level of EBIT needed to satisfy all the fixed financial charges i.e., interest and preference dividend. It denotes the level of EBIT for which firm's EPS equals zero. If the EBIT is less than the financial breakeven point, then the EPS will be negative but if the expected level of EBIT is more than the breakeven point, then more fixed costs financing instruments can be taken in the capital structure, otherwise, equity would be preferred

EBIT-EPS analysis is a vital tool for designing the optimal structure of a firm. The objective of this analysis is to find the EBIT level that will equate EPS regardless of the financing plan chosen

$$\frac{(EBIT-I1)(1-T)}{E1} = \frac{(EBIT-I2)(1-T)}{E2}$$

Where,

EBIT = Indifference point

E_1 = Number of equity shares in Alternative 1

E_2 = Number of equity shares in Alternative 2

I_1 = Interest charges in Alternative 1

I_2 = Interest in Alternative 2

T = Tax –rate

Alternative 1 = All equity finance

Alternative 2 = Debt –equity finance

*****CHAPTER-5*****

*****BUSINESS RISK, FINANCIAL RISK & LEVERAGE*****

Ques1. 2007- May [8] Answer the following :

(i) Differentiate between Business risk and Financial risk

Ans.

Business Risk	Financial Risk
It refers to the risk associated with the firm's operations. It is uncertainly about the future operating income. That is, how well can the operating income be predicted? It can be measured by standard deviation of basic earning power ratio	It refers to the additional risk placed on firm's shareholders as a result of debts used in financing. Companies that issue more debt instruments would have higher financial risk than companies financed mostly by equity. Financial risk can be measured by ratios such as firm's financial leverage multiplier, total debt to assets ratio etc.

Ques2. 2009- Nov. [5] Answer the following :

(ii) What do you understand by Business Risk and Financial Risk?

Ans. **Business Risk :** It refers to the risk associated with the firm's operations. It is uncertainly about the future operating income. That is, how well can the operating income be predicted? It can be measured by standard deviation of basic earning power ratio.

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

*****CHAPTER – 6*****

*****TYPES OF FINANCING*****

Ques1. 2008- Nov. [5] Answer the following :

(i) Write a short note on "Deep Discount Bounds".

Ans. **Deep Discount Bonds :** Deep discount bonds are a form of zero interest bonds. These bonds are sold at a discounted value and an maturity face value is paid to the investors. In such bonds, there is no interest payout during lock in period. When such bonds are sold in the stock market, the difference realized between face value and market price is the capital gain IDBI was the first to issue deep discount bonds in India in January, 1992

Ques2. 2007- May [5] Answer the following :

(iii) Explain the term 'Ploughing back of Profits'.

Ans. **Meaning :** Ploughing back of profit is an internal sources of finance. It is a phenomenon under which the company does not distribute all the profit earned but retains a part of it, which is re-invested in the business for its development. It is thus known as Retained Earning.

Ques3. 2007- May [8] Answer the following :

(iv) Explain in brief the features of Commercial Paper.

Ans. **The features of a commercial paper are :**

1. It is a short term instrument for financing the working capital requirement
2. It represents a promissory note, which is negotiable by endorsement and delivery
3. It is a certificate, which acts as an evidence for unsecured corporate debt of short term maturity
4. The maturity period of commercial paper usually ranges between 90 to 360 days
5. It is issued at a discount and is redeemed at face value
6. It is issued directly by the firm to the investors or through banks
7. Under it, the issuer promises to pay the buyer some fixed amount on some future date
8. No asset is pledged against the promise

Ques4. 2007- Nov. [5] Answer the following :

(i) Explain the concept of leveraged lease
(ii) Discuss the features of deep discount bond

Ans. **Concept of leveraged lease :-**

(i) Under a leverage lease transaction, the leasing company (called the equity participation) and a lender (called the loan participant) jointly fund the investment in the asset to be leased to the lessee.
In this form of lease agreement, the lessor undertakes to finance only a part of the money required to purchase the asset. The major part of the finance is arranged with a financier to whom the title deeds for the asset as well as the lease retails are assigned. There are usually three parties involved, the lessor, the lessee and the financier. The lease agreement is between the lessee and lessor as in any other case. But it is supplemented by another separate agreement between the lesseer and the financer who agrees to provide a major part say 80% of the money required. Such lease agreement which will enable the lessor to undertake an expand volume of lease business with a limited amount of capital and hence it is named leverage leasing.

Features of deep discount bond :-

(ii) A deep discount bond does not carry any coupon rate but is issued at a steep discount over its face value. It is also known as 'zero interest (coupon) bond' or just a zero.
In India, IDBI has first time issued Deep Discount Bond in 1996. Which has a face value of Rs. 2, 00,000 and a maturity period of 25 years. The bonds were issued at Rs. 5300.
The unique benefit of DOB is the elimination of investment risk. It allows an investor to lock in the yield to maturity or keep on withdrawing from the scheme periodically after five years by returning the certificate.

Advantages: The main advantages of DOB is that the difference between the sale price and original cost of acquisition will be treated as capital gain, if the investor sells the bonds on stock exchange. The DDB is safe, solid and liquid instrument.

Investors can take advantage of these new instruments in balancing their mix of securities to minimize risks and maximize returns.

Disadvantages:

The main disadvantages of deep discount bonds is that they entail a huge payment at maturity

- The issuer may experience difficulty in arranging for such a large payment and hence investors may be exposed to higher risk

Ques5. 2007- Nov. [8] Answer the following:

(iii) Explain the methods of venture capital financing

Ans. Ventures capital refers to financial investment in a high risky project with the objective of earning a high rate of return

Thus, venture capital financing means financing of high risk projects promoted by new, inexperienced entrepreneurs who have excellent business ideas, but does not have a financial backing.

Features of Venture Capital Financing:

1. Equity participation by the venture capitalist
2. It is a long term financing for a period between 5 to 10 years
3. The venture capitalist not only invest but also participate in the management of the venture capital undertaking

Methods of Ventures Capital Financing:

1. Equity financing : Usually venture capital financing takes form of equity financing as equity financing is a long term financing
2. Income Note : It is a type of financing in which the entrepreneur has to pay both interest and royalty on sales but at a low rate

Process of Ventures Capital Financing: A Venture Capitalist (the financer) invests in equity or debt of a venture capital undertaking (entrepreneurs).

Invests

Venture Caitalist	→	Venture Capital Undertaking

Venture Capital assistance

Ques6. 2008- May [5] Answer the following :

(ii) Discuss the features of Secured Premium Notes (SPNs)
(iv) Explain the concept of closed and open ended lease
(v) Discuss the advantages of preferences share capital as an instrument of raising funds

Ans. **(ii)** Secured premium Notes is issued along with a detachable warrant and is redeemable after a notified period of say A to 7 or 8 years. The conversion of detachable warrant into equity shares will have to be done within time period notified by the company.

In simple language SPN is a zero interest bond, issued at par, redeemable gradually at a premium and a warrant is also attached with. SPN was issued during August, 1992 by TISCO Ltd. following were the features of SPN: Face value of the one note was Rs. 300 and this were issued at par It was redeemable in four equal installment of Rs. 150 each 6 totaling Rs. 600 at the end of 4th to 7th year
Out of each repayment of Rs. 150, Rs. 75 was to be considered as repayment of principal and Rs. 75 was to be considered as capital gain. There was a warrant attached with this SPN, which entitles every SPN holder to get one equity share of the company at a price of Rs. 100 each at the end of first year.

(iv) Close ended lease In the closed ended lease, the asset gets transferred to the lessor at the end, and the risk of obsolescence, residual value etc, remain with the lessor being the legal owner of the asset. It is also known as "true lease", "walkaway lease" or net lease". Because the lessee has no obligation to purchase the leased asset upon lease expiration, that person does not have to worry about whether the asset will depreciate more than expected throughout the course of the lease. So, it is argued that the closed-end leases are better for the average person.
Open ended lease in the open ended lease, the lease has the option of purchasing the asset at the end of lease. It is also known as "finance lease".
For example, suppose your lease payments are based on the assumption that a RS. 40,000 new car will be worth only Rs. 20,000 at the end of your lease agreement. If the car turns out to be worth only $ 8,000, you must compensate the lessor (the company who leased the car to you) for the lost $ 12,000 since your lease payment was calculated on the basis of the car having a salvage value of $ 20,000
(V) Meaning : As the name suggests, Preference shares are the shares which enjoys certain preferential rights over the equity shareholders in regard to :

1. Payment of dividend at a fixed rate
2. Repayment of capital on the winding up of the company

<u>**Characteristics**</u> :

(1) Claims on Income : The preference shares have prior claim on income (dividend) over equity shares. The rate of dividend is fixed irrespective of the profit earned

(2) Claim on Asset : In the event of winding up, the preference shareholders have a right to claim settlement from the asset

(3) Redeemable and convertible : The preference shares are redeemable and can be converted to equity shares even

(4) Controls : Under ordinary conditions the preference shares do not have voting rights, however they can vote on resolutions which are directly attached to their rights

(5) Hybrid forms of financing : Preference shares possess dual characteristics that of debt and equity. It is a debt because it carries a fixed rate of dividend and a priority over equity shares holders
It is equity because the dividend is payable only out of distributable profit and is not deductible as an expense while determining tax liability

<u>**Advantage**</u> :

(1) It provides a long term capital to the company
(2) There is no dilution of EPS
(3) As it bears a fixed charges, there is a leveraging advantage
(4) It can be redeemed after a specified time period
(5) It does not carry voting rights hence, there is no dilution of control

(6) It enhance the credit worthiness of the company

Ques7. 2008- May [8] Answer the following :

(i) Explain the concept of Debt securitization

Ans. Debt securitization is a method of recycling of funds. It is a process whereby loans and other receivables are under written and sold in form of asset. It is thus a process of transforming the assets of a lending institution into negotiable instrument for generating of funds.

Functions of debt securitization :-

1. **The origination function :-** The credit worthiness of borrower is assessed
2. **The pooling function :-** The loans/ credits of similar types are dubbed or pooled together
3. **The transferring function :-** The asset pool is then transferred to a trustee
4. **Securitization function :-** The trustee then issues securities on the basis of asset pools.
   In this way we see that conversation of debts to securities is known as debt securities

Advantages of debt securities :-

1. It converts the debt into securities
2. It converts the illiquid asset into liquid ones
3. The assets are shifted from the balance sheet, giving the borrower an opportunity of off balance sheet funding
4. It thus helps in better balance sheet management
5. It enhances the borrower's credit rating
6. It opens up new investment avenues
7. The securities are tied up in definite asset

Ques8. 2005- Nov. [5] Answer the following

(ii) What is the meant 'Venture Capital Financing'?

Ans. Ventures capital refers to financial investment in a high risky project with the objective of earning a high rate of return

Thus, venture capital financing means financing of high risk projects promoted by new, inexperienced entrepreneurs who have excellent business ideas, but does not have a financial backing.

Features of Venture Capital Financing :

1. Equity participation by the venture capitalist
2. It is a long term financing for a period between 5 to 10 years
3. The venture capitalist not only invest but also participate in the management of the venture capital undertaking

Methods of Ventures Capital Financing :

1. Equity financing : Usually venture capital financing takes form of equity financing as equity financing is a long term financing
2. Income Note : It is a type of financing in which the entrepreneur has to pay both interest and royalty on sales but at a low rate

Process of Ventures Capital Financing : A Venture Capitalist (the financer) invests in equity or debt of a venture capital undertaking (entrepreneurs).

Invests

Venture Capitalist → Venture Capital Undertaking

Venture Capital assistance

Ques9. 2009- May [5] Answer the following :

(vi) Discuss the benefits to the originator of Debt Securitization

Ans. Benefits to the Originator of Debt Securitization

The benefit to the originator of debt securitization are as follows :-

(a) The assets are shifted off the balance sheet, thus giving the originator recourse to off balance sheet funding
(b) It converts illiquid assets to liquid portfolio
(c) It facilitates better balance sheet management as assets are transferred off balance sheet facilitating satisfaction of capital adequacy norms
(d) The originator's credit rating enhances

Ques10. 2009- Nov. [8] (ii) Explain the following terms :

(a) Ploughing back of profits

Ans. **Meaning :** Ploughing back of profit is an internal source of finance.

It is a phenomenon under which the company does not distribute all the profit earned but retains a part of it, which is re-invested in the business for its development

It is thus known as Retained Earning

Characteristics :

1. It is a technique of self-financing
2. It is a source of finance which contributes towards the fixed as well as working capital needs of the company
3. Under this phenomenon, a part of the total profit is transferred to various reserves such as general reserve, reserve for repair and renewal, secret reserves etc.
4. The funds so created entails almost no risk and the control of the owners is also not diluted

Advantages :

1. **Economical method of financing :-** Since the company des not depend upon external sources ploughing back of profit or retained earning acts as an economical methods of financing
2. **Helps the company to follow stable dividend policy :-** The retained earning helps the company to pay dividend regularly. This enhances the credit worthiness of the company
3. **It acts as a shock absorbent :-** A company with large reserves can withstand the shocks of trade cycle and the uncertainty of market with ease
4. **Flexible financial structure :-** It allows the financial structure to remain flexible
5. **Self-dependent :-** It makes the company self dependent. It need not depend on outsiders for its financial needs

Disadvantages :

1. **Over Capitalization :-** Excessive ploughing back of profit may lead to over capitalization
2. **Misuse of retained earning :-** The retained earning may be investing in non-profitable areas
3. **Uncontrollable growth :-** With the help of retained earning, the company may expand to an extent beyond control
4. **Dissatisfaction among shareholders :-** Excessive retention of profit may lead to high dissatisfaction among shareholders

Ques11. 2010- May [5] Answer the following?

(iii) Briefly discuss the concept of speed capital assistance

Ans. **Concept of Speed Capital Assistance:-**

- This scheme is designed by IDBI for professionally or technically qualified entrepreneurs and /or persons possessing relevant experience, skills and entrepreneurial traits
- All the projects eligible for financial assistance from IDBI, directly or indirectly through refinance are eligible under the scheme
- The assistance is interest-free but carries a service charge of one percent per annum for the first five years and at an increasing rate thereafter
- The project cost should not exceed Rs. 2 crores and the maximum assistance under the project will be restricted to 50 percent of the required promoter's contribution of Rs. 15 lacs whichever is lower

Ques12. What is debt securitization? Explain the basic debt securitization process?

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

Process of Debt Securitization

(i) **The Original Function :-** A borrower seeks a loan from finance company, bank, etc., 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 or 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 Securitization Function :-** SPV will structure and issue securities on the basis of assets pool. The securities carry a coupon and expected maturity, which can be asset based /mortgage based. These are generally sold to investors through merchant bankers. Investors are pension funds, mutual funds and insurance funds.

The process of securitization is without resource i.e., investors bear the credit risk or risk of default. Credit enhancement facilities like insurance, letter of credit and guarantees are provided.

*****CHAPTER – 7 *****

*****INTERNATIONAL FINANCING *****

Ques1. 2010- Nov. [5] (b) Distinguish between the following :

(ii) Global Depository Receipts and American Depository Receipts

Ans. **Global Depository Receipts (GDRs) and American Depository Receipts (ADRs) :-**

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

Whereas, American Depository Receipts, on the other hand, are basically negotiable certificates denominated in US dollars that represent a non-US company's publicly traded local currency equity shares. These are created when the local currency shares of Indian Company are delivered to the depository's local custodian bank, against which the depository bank issues Depository Receipts in US dollars. These are deposited in a custodial account in the US. Such receipts have to be issued in accordance with the provisions stipulated by the SEC.

Que2. 2007- Nov. [5] Answer the following :

(vi) Explain the concept of Indian depository receipts.

Ans. The department of Company Affairs (DCA) has notified the Companies (Issue of Indian Depository Receipts) Rules, 2004 (the IDR Rules). These rules pave the way for foreign companies to raise funds in India by means of issue of depository receipts against their underlying equity shares Although the concept of IDRs was mooted by the DCA as early as in 1997, when the Companies Bill 1997 introduced this concept for the first time, it did not find place in the actual amendments introduced in the Companies Act 1956, in 1999 The concept of an IDR can be understood as a mirror image of the familiar ADRs/GDRs transferable. The actual shares underlying the IDRs would be held by an Overseas Custodian which shall authorize the Indian Depository to issue the IDRs The Overseas Custodian is required to be a foreign bank having a place of business in India and needs approval from the Finance Ministry for acting as a custodian while the India Depository needs to be registered with SEBI

Ques3. 2008- May [8] Answer the following :

(iii) Explain briefly the features of External Commercial Borrowings (ECB)

Ans. **External Commercial Borrowings (ECB) :** ECBs refer to commercial loans (in the form of bank loans, buyers credit, suppliers credit, securitized instruments (e.g., floating rate notes and fixed rate bonds) availed from non resident lenders with minimum average maturity of 3 years. Borrowers can raise ECBs through internationally recognized sources like (i) international banks, (ii) international capital markets (iii) multilateral financing institutions such as the IFC, ADB etc, (iv) export credit agencies (v) suppliers of equipment, (vi) foreign collaborators and (vii) foreign equity holders

External Commercial Borrowings can be accessed under two routes viz. (i) Automatic route (ii) Approval route. Under the Automatic route there is no need to take the RBI / Government approval whereas such approval is necessary under the Approval route. Company's registered under the Companies Act and NGOs engaged in micro finance activities are eligible for the Automatic Route where as Financial Institutions and Banks dealing exclusively in infrastructure or export finance and the ones which had participated in the textile and steel sector restructuring packages as approved by the government are required to take the Approval Route

Ques4. 2008- Nov [5] Answer the following :

(iv) Name the various financial instruments dealt with in the international market

Ans. Some of the various financial instruments dealt with in the international market are discussed below :-

1. **Euror Issue :-** An Euror issue is a issue listed on a foreign stock exchange. It is an instrument which raises foreign currency in the international market, through the issue of :
   (i) Depository Receipts –ADR & GDR
   (ii) Foreign Currency convertible bonds
2. **Euro Bonds :-** Euro bonds are long term loans raised by entities enjoying an excellent credit rating These bonds are issued for a period ranging between 3 to 20 years
3. **Foreign Bonds :-** Foreign Bonds are debt instrument denominate in a currency which is foreign to the borrower and is sold in the country of that currency
4. **Fully Hedged Bonds :**- Fully hedged bonds are the foreign bonds devoid of the risk of currency fluctuation

   It eliminates the risk by selling the entire streams of principal and interest payment in forward market
5. **Floating Rate Note :-** The floating Rate Notes provide foreign currency at a rate lower than foreign loans. They are issued for a period upto 7 years
   The interest rates are adjusted to reflect the prevailing exchange rate
6. **Euro Commercial Paper :-** Euro commercial papers are promissory notes with a maturity period of less than one year. These are unsecured instruments issued by a corporate body. The main investors are banks insurance companies, fund managers etc.
7. **Foreign Currency Option :**- Foreign currency option is a right to buy or sell a sum of foreign currency at a predetermined rate on a future date
8. **Foreign Currency Futures :**- A foreign currency future is a right to by or sell a sum of foreign currency at a fixed exchange rate on a specific future date.

   It is an alternative to forward contract for hedging of exchange risk.

Ques5. 2009- May [5] Answer the following :

(ii) Discuss the concept of American Depository Receipts

Ans. **American depository receipts: -** Deposit receipt issued by an Indian company in USA is known as American depository receipt (ADRs). Such receipt have to be issued in accordance with the provisions stipulated by the security and exchange commission of U.S.A. An ADR is generally created by the deposit of the securities of a outsider company with a custodian bank in the country of incorporation of issuing company. The custodian bank informs the depository in U.S.A. that the

ADRs can be issued. ADRs are dollar denominated and are traded in the same way as are security of U.S. Company.

ADRs can be traded either by trading existing ADRs or purchasing the shares in the issuer's home market and having new ADRs created, based upon availability and market conditions. When trading in existing ADRs, the trade is executed on the secondary market on the New York Stock Exchange through Depository Trust Company (DTC) without involvement from foreign brokers or custodians.

*****CHAPTER- 8 *****

*****CAPITAL CUDGETING & INVESTMENT DECISIONS *****

Ques1. 2006- Nov [7] (b) Discuss the need for social cost benefit analysis

Ans. **Need for social Cost Benefit Analysis :-**

1. The market price which is used to measure cost & benefit in a project does not represent social values due to imperfections in market
2. Monetary cost & benefit analysis fails to consider the external positive and negative effects of a project
3. Taxes and subsidies are transfer payments and therefore are not relevant in national economic profitability analysis
4. The SCBA is essential for measuring the redistribution effect of benefit of a project, as benefit going to economically weaker section is more important than one going to economically fairer section
5. Merit wants are important appraisal criteria for SCBA

Ques2. 2007- May [5] Answer the following :

(i) Define Modified Internal Rate of Return method

Ans. In order to cope up various limitations of the conventional Internal Rate of Return, Modified Internal Rate of Return was developed

Limitations of the conventional IRR are,

(i)It eliminates multiple IRR are
(ii) It addresses to rein issue and produces results, which are consistent with the Net Present Value (NPV) method

Under this method, all cash flows (except initial investment), are brought to the terminal value using an appropriate discount rate (generally the cost of capital)

MIRR results in a single stream of cash inflow in the terminal year

It is obtained by assuming a single outflow in the zeroth year and the terminal cash inflow.

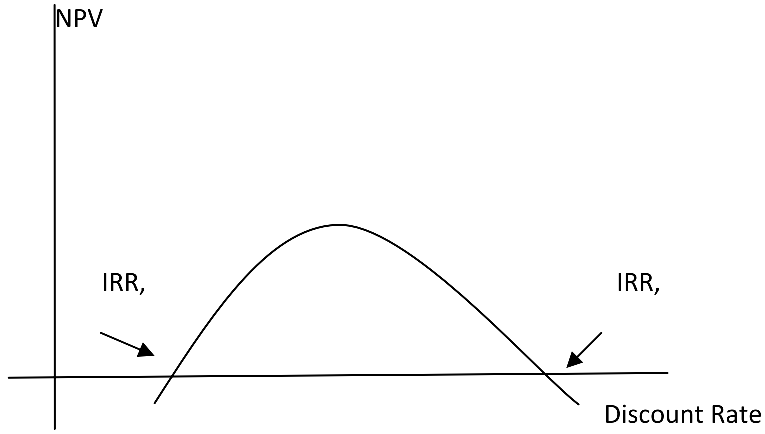
The discount rate which equates the PV of the terminal cash inflow to the zeroth year outflow is known as MIRR

Ques3. 2008- Nov. [8] Answer the following

(iii) Explain the concept of multiple Internal rate of Return

Ans. **Multiple Internal Rate of Return :**

In cases where project cash flows change sings or reverse during the life of a project for example, an initial cash outflow is followed by cash inflows and subsequently followed by a major cash outflow, there may be more than one internal rate of return (IRR)



The following graph of discount rate versus net present value (NPV) may be used as an illustration:

In such situations if the cost of capital is less than the two IRRs, a decision can be made easily, however, otherwise the IRR decision rule may turn out to be misleading as the project should only be invested if the cost of capital is between IRR^1 and IRR^2 . to understand the concept of multiple IRRs it is necessary to understand the implicit re-investment assumption in both NPV and IRR techniques

Some of the advantages of MIRR are :-

1. This method makes use of concept of time value of money
2. All the Cash flows in the project are considered

Some of the limitations of MIRR are :-

1. Calculation process is tedious
2. The IRP approach creates a peculiar situation if we compare two projects with different inflow / outflow patterns
3. In case of mutually exclusive projects decisions based only on IRR may not be correct

Ques4. 2009- May [8] Answer the following :

(iv) Explain the concept of discounted payback period

Ans. **Concept of discounted Payback Period :-**

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

- ➢Discounted payback period considers present value of cash flows, discounted at company's cost of capital to estimate breakeven period i.e., it is that period in which future discounted cash flows equal the initial outflow
- ➢The shorter the period, better it is. It also ignores post discounted payback period cash flows.
- ➢It takes care of the time value of money

Ques5. 2009- Nov. [8] **(ii)** Explain the following terms :

(b) Desirability factor

Ans. In certain cases we have to compare a number of proposals each involving different amount of cash inflows. One of the method of comparing such proposals is to work out, what is known as the 'Desirability Factor' or 'Profitability Index'. In general terms, a project is acceptable if the Profitability Index is greater than 1.

Mathematically,

$$\text{Desirability Factor} = \frac{\textit{Sum of Discounted Cash inflows}}{\textit{Initial Cash Outlay or Total Discounted Cashoutflows}}$$

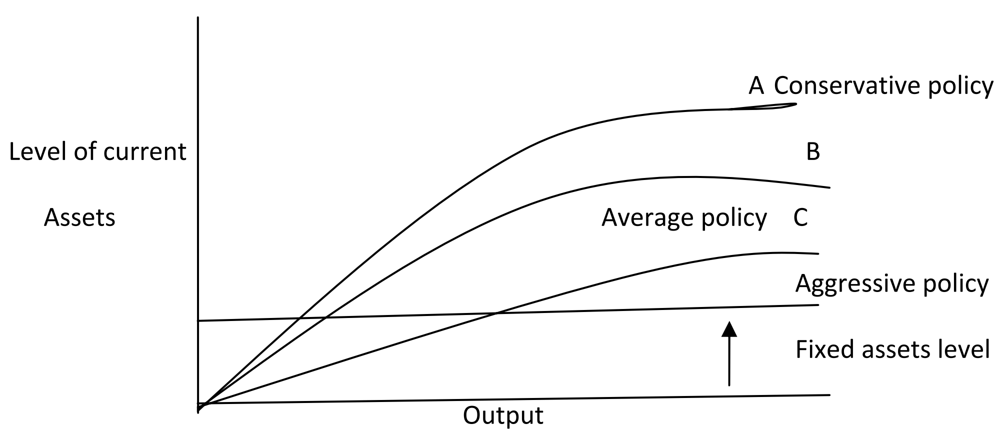
*****CHAPTER – 9 *****

*****MEANING, CONCEPT & POLICIES OF WORKING CAPITAL*****

Ques1. 2010- Nov. [3] (b) (ii) Discuss the liquidity vs. profitability issue in management of working capital

Ans. **Liquidity vs. Profitability Issue in Management of Working Capital :-**

Working capital management entails the control and monitoring of all components of working capital i.e., cash, marketable securities, debtors, creditors etc. Finance manager has to pay particular attention to the levels of current assets and their financing. To decide the level of financing of current assets, the risk return trade off must be taken into account. The level of current assets can be measured by creating a relationship between current assets and fixed assets. A firm may follow a conservative, aggressive or moderate policy.



A conservative policy means lower return and risk while an aggressive policy produces higher return and risk. The two important aims of the working capital management are probability and solvency. A liquid firm has less risk of insolvency. A liquid firm has less risk of insolvency i.e., it will hardly experience a cash shortage or a stock out situation. However, there is a cost associated with maintaining a sound liquidity position. So, to have a higher profitability the firm may have to sacrifice solvency and maintain a relative low level of current assets.

Ques2. 2010 – Nov. [7] Answer the following :

(c) Discuss the estimation of working capital need based on operating cycle process

Ans. **Estimation of Working Capital Need Based on Operating Cycle :-**

One of the methods for forecasting working capital requirement is based on the concept of operating cycle. The determination of operating capital cycle helps in the forecast, control and management of working capital. The length of operating cycles is the indicator of performance of management. The net operating cycle represents the time interval for which the firm has to negotiable for Working Capital from its Bankers. It enables to determine accurately the amount of working capital needed for the continuous operation of business activities. The duration of working capital cycle may vary depending on the nature of the business.

In the form of an equation, the operating cycle process can be expressed as follows :

Operating Cycle = R + W + F + D – C

Where,

R = Raw material storage period

W = Work-in –progress holding period

F = Finished goods storage period

D = Debtors collection period

C = Credit period availed

*****CHAPTER – 10 *****

*****TREASURY & CASH MANAGEMENT *****

Ques1. 2009- May [5] Answer the following

(i) Write a short note on functions of Treasury department

Or

2008 – May [8] Answer the following

(ii) Explain briefly the functions of Treasury Department

Ans. Treasury Department conducts efficient management of liquidity and financial risk is business. Earlier it was viewed as a peripheral activity conducted by back-office, but today it plays a very role is corporate management

The major functions of treasury department are as follows :

1. **Setting up of corporate financial objective :**
   - **(i)** Financial and treasury policies
   - **(ii)** Financial and treasury systems
   - **(iii)** Financial aims and strategies
2. **Corporate Finance :**
   - **(i)** Equity capital management
   - **(ii)** Project finance
   - **(iii)** Joint ventures
   - **(iv)** Business acquisition
   - **(v)** Business sales
   - **(vi)** Equity capital management
3. **Liquidity Management :**
   - **(i)** Working capital management
   - **(ii)** Money management
   - **(iii)** Money transmission management
   - **(iv)** Banking relationship management
4. **Funding Management :**
   - **(i)** Sources of fund
   - **(ii)** Funding policies
   - **(iii)** Types of funds
   - **(iv)** Funding procedures
5. **Currency Management :**
   - **(i)** Exposure policies and procedures
   - **(ii)** Exchange regulations
   - **(iii)** Exchange dealings
6. **Other :**
   - **(i)** Risk management
   - **(ii)** Insurance management
   - **(iii)** Corporate management
   - **(iv)** Pension fund investment management

Ques2. Write short note on William J. Baumal Vs. Miller –Orr cash management model?

Ans. **William J Baumal vs Miller- Orr Cash Management Model :-** According to William J Baumal's Economic order quantity model optimum cash level of cash where the carrying costs and transactions costs and transactions costs are the minimum. The carrying costs refer to the cost of holding cash, namely, the interest foregone on marketable securities. The transaction costs refer to the cost involved in getting the marketable securities converted into cash. This happens when the firm falls short of cash and has to sell the securities resulting in clerical, brokerage, registration and other costs.

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

$$C = \sqrt{\frac{2U \; x \; P}{S}},$$

Where,

C = Optimum cash balance

U = Annual (monthly) cash disbursements

P = Fixed cost per transaction

S = Opportunity cost of one rupee p.a. (or p.m.)

Miller-Orr cash management model is a net cash flow stochastic model. This model is designed to determine the time and size of transfers between an investment account and cash account. In this model control limits are set for cash balances. These limits may consist of has upper limit, z as the return point, and zero as the lower limit

When the cash balances reach the upper limit, the transfer of cash equal to h-z is invested in marketable securities account. When it touches the lower limit, a transfer from marketable securities account to cash is made. During the period when cash balance stays between (h,z) and (z,o) i.e., high and low limits no transactions between cash and marketable securities account is made. The high and low limits of cash balance are set up on the basis of fixed cost associated with the securities transactions, the opportunity cost of holding cash and the degree of likely fluctuations in cash balances. These limits satisfy the demands for cash at the lowest possible total costs.

*****CHAPTER -12 *****

*****MANAGEMENT OF RECEIVABLES*****

Ques1. 2008 – May [5] Answer the following :

(vi) Explain the principles of "Trading on equity".

Ans. The term 'equity' refers to the ownership or 'stock' of a company and 'trading' means 'taking advantages of'. Hence, the term 'trading on equity' means taking advantage of equity share capital to borrow funds on reasonable basis. It refers to the additional profit which equity shares make at the expenses of other forms to securities. This concept is based on the theory that there is a difference among the rates of return on the various types of securities issued by the company. When the Return on Investment (ROI) is more than the interest rate then financial leverage works in favour of equity shareholder and Return on Equity (ROE) will be even more than ROI

The policy of treading on equity is followed by a company for the following three purpose:-

(i) To retain full control over the business
(ii) To increase the rate of dividend on equity shares
(iii) To achieved control on more financial resources by taking maximum loan / debt on the basis of minimum owned or equity share capital

For Example the Capital employed is Rs. 2, 00,000, debt equity ratio is 1:1, interest rate is 10% and EBIT is Rs. 30,000. Here ROI is 15% (30,000 / 2, 00,000) which is more than interest rate of 10%. This excess return of 15% (15-10) will go to equity shareholders and (ROE) will be 20% (20,000 / 1, 00,000)
This excess return earned by equity shareholder due to favourable financial leverage position is termed as trading on equity

Ques2. 2010- May [5] Answer the following :

(ii) Explain briefly the accounts receivable systems

Ans. **Accounts Receivable Systems :-**

- Manual systems of recording the transactions and managing receivables are cumbersome and costly
- The automated receivable management systems automatically update all the accounting records affected by a transaction
- This system allows the application and tracking of receivables and collections to store important information for an unlimited number of customers and transactions, and accommodate efficient processing of customer payments and adjustments

*****CHAPTER -13 *****

*****FINANCING OF WORKING CAPITAL*****

Ques1. 2009- Nov. [5] Answer the following :

(iv) Differentiate between Factoring and Bills discounting

Ans. **Differentiation between Factoring and Bills discounting**

S.No.	Basic of Difference	Factoring	Bill Discounting
1.	Meaning	It is management of book debt	It is borrowing from commercial bank
2.	Parties	Factors, clients, debtors	Drawer, drawee and payee
3.	Also known as	Invoice Factoring	Invoice Discounting
4.	Applicable Act	No specific Act	Negotiable Instruments Act

Ques2. 2010- May [5] Answer the following :

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

Ans. **Forms of Bank Credit :-** The various forms of bank credit in financing the working capital of a business organization are :-

(a) Cash credit ;
(b) Bank overdraft;

(c) Bills discounting;
(d) Bill acceptance;
(e) Line of credit;
(f) Letter of credit; and
(g) Bank guarantees

Ques3. What is factoring? Enumerate the main advantages of factoring?

Ans. **Concept of Factoring and its Main Advantages:-** Factoring involves provision of specialized services relating to credit investigation, sales ledger management purchase and collection of debts, credit protection as well as provision of finance against receivables and risk bearing. 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 .

Advantages of Factoring :-

- The firm can convert accounts receivables into cash without bothering about repayment
- Factoring ensures definite pattern of cash inflows
- Continuous factoring virtually eliminates the need for the credit department. Factoring is gaining popularity as useful source of financing short-term funds requirement of business enterprises because of the inherent advantage of flexibility it affords to the borrowing firm. The seller firm may continue to finance its receivables on a more or less automatic basis. If sales expand or contract it can vary the financing proportionally.
- Unlike an unsecured loan, compensating balances are not required in this case. Another advantage consists of relieving the borrowing firm of substantially credit and collection costs and from a considerable part of cash management.

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Law, Ethics & Communication

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Batch-I	M/W/F	11.00 to 2.00 PM	1st August 2012	48 Lectures
Batch-II	T/T/S	3.30 to 6.30 PM	2nd August 2012	48 Lectures

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