

CA IPCC Tips for exams

1. Do not leave any topic as the paper will cover the entire syllabus and almost no choices
2. Please go through the class notes first.
3. Please go through the RTP prescribed for your attempt, and your previous attempt, as sometimes the exam problem is one of the RTP questions.
4. Your answer to the problem should include as many working notes as possible.
5. Theory questions will be very simple and straight forward and please don't ignore theory and the Misc. topics. It will help in scoring and also clearing the exams.
6. Time will be a constraint so plan your time well in advance
7. Keep practicing the problems during your preparations.
8. While preparing for exam note down all the formulae in a sheet and just before entering the exam revise the formulae for an hour. It will really help you in solving problems quickly and ensure that you are not stuck mid way.
9. Try to go through the past question papers and solve them and the feel of the type of questions asked in the exams.

Best Wishes

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I-BASIC CONCEPT OF FM

Q 1. FUNCTIONS OF FINANCE MANAGER.

Answer: The finance manager occupies an important position in the organisational structure. Earlier his role was just confined to raising of funds from a number of sources. These days his functions are multidimensional. His main functions are as follows:-

- **Forecasting the financial requirement:** A financial manager has to make an estimate and forecast accordingly the financial requirements of the firm.
- **Planning:** A finance manager has to plan out how the funds will be procured and how the acquired funds will be allocated.
- **Procurement of funds:** 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.
- **Investment/Allocation of funds:** A finance manager has also to invest or allocate funds in best possible ways. In doing so a finance manager can not but ignore the principles of safety profitability and liquidity.
- **Maintaining proper liquidity:** A finance manager plays an important role in maintaining proper liquidity. He determines the need for liquid asset and then arranges them in such a way that there is no scarcity of funds.
- **Cash management:** A finance manager has also to manage the cash in an efficient 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.
- **Dividend decision:** A finance manager has also to 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.
- **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 wherever needed.
- **Financial negotiations:** 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.
- **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.

Q 2. Inter-relationship between investment, financing and dividend decisions.

Answer: The basic finance function includes:-

(i) Investment decision, (ii) Financing decision, (iii) Dividend decision.

All the above three decisions are inter-related because the ultimate aim of all these is wealth maximisation. Moreover, they influence each other in one way or the other

For e.g. Investment decision should be backed up by finance for which financing decisions are to be taken. The financing decision in turn influences and is influenced by dividend decision.

Let us examine the three decisions in relation to their inter-relationship.

Investment Decision: The funds once procured have to be allocated to the various projects. This requires proper investment decision. The investment decisions are taken after careful analysis of various projects through capital budgeting & risk analysis.

Only those proposals are accepted which yields a reasonable return on the capital employed.

Financing Decision: There are various sources of funds. A finance manager has to select the best source of finance from a large number of options available.

The financing decision regarding selection of source and internal financing depends upon the need, purpose, object and the cost involved .

The finance manager has also to maintain a proper balance between long term & short term loan. He has also to ensure a proper mix of loans fund and owner's funds which will yield maximum return to the shareholders

Dividend Decision: A finance manager has also to decide whether or not to declare dividend. If dividends are to be declared then what portion is to be paid to the shareholder and what portion is to be retained in the business.

Thus, investment, financing and dividend decisions are all inter-related.

Q 3. Differentiate between Financial Management and Financial Accounting.

Answer:

- **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.
- **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 recognised only when cash is actually received (i.e. cash inflow) and expenses are recognised on actual payment (i.e. cash outflow).

Q 4. Distinguish between the following:

(i) Profit maximisation vs Wealth maximisation objective of the firm.

(or) Two basic functions of finance management

Answer:

Profit Maximization versus Wealth Maximization Principle of the Firm

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 Maximisation is the main objective of business because:

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

Agreements in favour of profit maximisation:

- (i) When profit earning is the main aim of business the ultimate objective should be profit maximisation,
- (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 maximisation is required.
- (iv) Profit maximisation is justified on the grounds of rationality as profits act as a measure of efficiency and economic prosperity.

Arguments against profit maximisation:

- (i) It leads to exploitation of workers and consumers
- (ii) It ignores the risk factors associated with profit.
- (iii) Profit in itself is a vague concept and means differently to different people. It is a narrow concept at the cost of social and moral obligations.

Thus, profit maximisation as an objective of financial management has been considered inadequate.

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

A stock holder's wealth is shown by:

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

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

Maximum Utility → Maximum stock holder's wealth → Maximum stock price per share

Arguments in favour of wealth maximisation:

- (i) Due to wealth maximisation, 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.

Argument against wealth maximisation:

- (i) It is socially undesirable.
- (ii) It is not a descriptive idea.
- (iii) Only stock holder's wealth maximisation does not lead to firm's wealth maximisation.
- (iv) The objective of wealth maximisation is endangered when ownership and management are separated.

In spite of the arguments against wealth maximisation, it is the most appropriate objective of a firm.

Q 5. Discuss the changing scenario of Financial Management in India.

Answer: Modern financial management has come a long way from traditional corporate finance. As the economy is opening up and global resources are being tapped, the opportunities available to a finance manager have no limits. Financial management is passing through an era of experimentation and excitement as a large part of finance activities are carried out today. A few instances of these are mentioned as below:-

- Interest rate freed from regulation treasury operation therefore have to be more sophisticated as interest rates are fluctuating.
- The rupee has become fully convertible.
- Optimum debt equity mix is possible.
- Maintaining share prices is crucial. The dividend policies and bonus policies formed by finance managers have a direct bearing on the share prices.
- Share buy backs and reverse hook building.
- Raising resources globally through ADRS/GDRS
- Risk Management due to introduction of option and future trading.
- Free pricing and book building for IPOs, seasoned equity offering.
- Treasury management.

Q 6. Explain the two basic functions of Financial Management.

Answer:

The two basic aspects of Finance Manager are Procurement of funds and Effective use of these funds

1. Procurement of fund:

Procurement of funds includes:

- Identification of sources of finance
- Determination of finance mix
- Raising of funds
- Division of profit

- Retention of profit

There are various **sources of procurement** of funds such as:

Share capital, debentures, bank, financial institution, ADR, GDR, FDI, FII 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 cannot 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 require that adequate funds should be maintained to meet the working capital requirement and avoiding the blockage of funds in inventories book debts, cash etc.



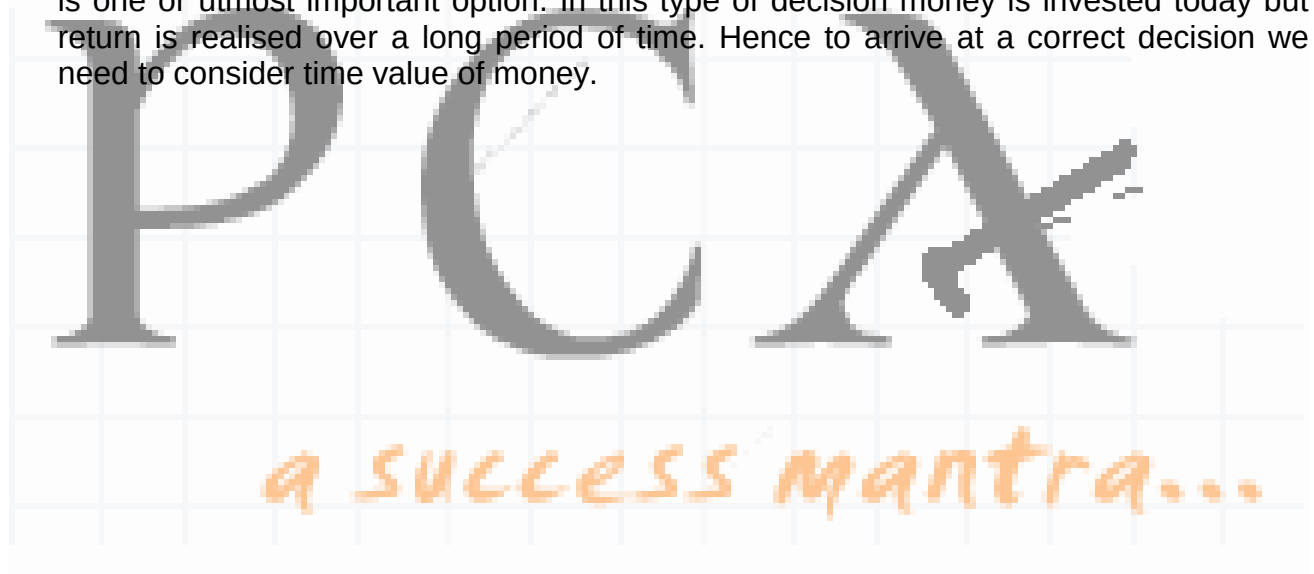
II - TIME VALUE OF MONEY

Q 1. Explain the relevance of time value of money in financial decisions.

Time value of money means that worth of a rupee received today is different from the worth of a rupee to be received tomorrow or 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 a rupee after a year due to several reasons like:-

- **Risk:-** There is uncertainty about the receipt of money in future.
- **Inflation:-** In an inflationary period, a rupee today represents a greater real purchasing power than a rupee a year later.
- **Preference for present consumption:-** Most of the persons & companies in general prefer current consumption to future consumption.
- **Investment opportunities:-** Many persons and the companies have a preference for present money as there are many opportunities of investment available for earning additional cash flow.
- **Capital Budgeting:-** While arriving at capital budgeting decisions time value of money is one of the most important options. In this type of decision money is invested today but return is realised over a long period of time. Hence to arrive at a correct decision we need to consider time value of money.



III - CASH & FUNDS FLOW

Q 1. 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	Gash 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.

Q 2. Discuss the composition of Return on Equity (ROE) using the DuPont model.

Answer:

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 measure 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:

$$\text{Equity Multiplier} = \frac{\text{Assets}}{\text{Shareholders' Equity}}$$

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.)

$$\text{Return on Equity} = \text{Net profit margin} \times \text{Asset turnover} \times \text{Equity multiplier}$$

Q 3. Explain briefly the limitations of Financial ratios.

Answer:

The limitations of RA are as below:

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

IV - COST OF CAPITAL & CAPITAL STRUCTURE

Q 1. State **three** assumptions of Modigliani and Miller approach to Cost of Capital

Answer:

The Theory: Franco Modigliani and Merton 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 :

Proposition I: The market value of the firm (V) and the cost of capital (k_0) are independent of its capital structure.

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

Assumptions:

- The investors are free to buy and sell the securities as the securities are traded in perfect market.
- The expectations of investors are same and homogenous.
- The firms can be classified into homogeneous risk class.
- The dividend payout ratio is 100%
- There are no corporate taxes.

Q 2. Discuss the major considerations in Capital structure planning.

Answer:

The major considerations in Capital Structure Planning are:

- (1) Risk (2) Cost of capital (3) Control

(1) Risk: Risk is a situation wherein the possibility of happening or non-happening of an event can be measured. With reference to capital structure planning, risk may be defined as the variability in the actual return from an investment and the estimated return as forecasted at the time of capital structure planning. While designing the capital structure the firm tries to keep the risk at minimum.

(2) Cost of Capital: The **cost of capital** is the minimum rate of return that a firm must earn on its investment to satisfy its various investor. Cost is thus, an important consideration in capital structure planning.

(3) Control: The decisions relating to capital structure are taken after keeping the **control** factor in mind. For e.g. when equity shares are issued the company automatically dilutes its controlling.

Q 3. Discuss the dividend price and earning price approach

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

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.

Q 4. OPTIMUM CAPITAL STRUCTURE

Answer:

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 maximisation 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:-

- 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.
- 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 its appropriate capital structure with due consideration of all factors

An optimal capital structure should possess the following features:

- Maximisation of profitability : by using leverage minimum cost.
- Flexibility: structure should be flexible so that company may be able to raise fund or reduce fund whenever it is required.
- Control: It should reduce the risk of dilution of control.
- Solvency : Excessive debt may threaten the solvency of the company.

Q 5. Assumptions of Net Operating Income approach (NOI)

Answer:

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_0 are constant for all leverages. As the leverage increases, k_e also increases. But the increase in k_e is such that the overall value of the firm remains same.

Conclusion: As per No. 1 approach, k_0 is constant/Therefore, there is no optimal capital structure. Instead, every capital structure is an optimal one.

Assumptions:

- the WACC remains constant for all leverage.
- k_d is always less than K_e
- k_e increases as leverage increases.
- k_d is constant
- there are no corporate taxes.

Q 6. **Weighted average cost of Capital**
Answer:

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 firm 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.

Q 7. Financial break-even and EBIT- EPS indifference analysis.

Answer:

Financial Break-even and EBIT-EPS Indifference 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 capital 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.

$$\frac{(EBIT - I_1)(1 - T)}{E_1} = \frac{(EBIT - I_2)(1 - T)}{E_2}$$

E_1

E_2

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 charges in Alternative 2

T = Tax-rate

Alternative 1= All equity finance

Alternative 2= Debt-equity finance.

V- BUSINESS RISK, FINANCIAL RISK & LEVERAGE

Q 1. Difference between Business risk and Financial risk.

Answer:

Business Risk: It refers to the risk associated with the firm's operations. It is uncertainty about the future operating income. 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.

Q 2. Leveraged lease.

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 rights 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 lessor and the financier 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.

Q 3. Operating Leverage and Financial Leverage

Operating leverage is defined as the "firm's ability to use fixed operating costs to magnify effects of changes in sales on its earnings before interest and taxes." When there is an increase or decrease in sales level the EBIT also changes.

The effect of change in sales on the level of EBIT is measured by operating leverage.

Operating leverage occurs when a firm has fixed costs which must be met regardless of volume of sales.

When the firm has fixed costs, the percentage change in profits due to change in sales level is greater than the percentage change in sales.

Whereas, **Financial leverage** is defined as "the ability of a firm to use fixed financial charges to magnify the effects of changes in EBIT/Operating profits, on the firm's earnings per share".

The **financial leverage** occurs when a firm's capital structure contains obligation of fixed financial charges e.g. interest on debentures, dividend on preference shares etc. along with owner's equity to enhance earnings of equity shareholders.

The fixed financial charges do not vary with the operating profits or EBIT.

They are fixed and are to be paid irrespective of level of operating profits or EBIT.

Q 4. Closed And Open Ended Lease

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 40,000 new car will be worth only ` 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.

VI- TYPES OF FINANCING

Q 1. Write short notes on Commercial paper.

Answer:

Commercial Paper: A commercial paper is an instrument meant for financing working capital requirement. It represents short term unsecured promissory notes issued by firms which enjoy a fairly high credit rating. Such a promissory note is negotiable by endorsement and delivery and is issued at a discount on face value.

The features of a commercial paper are:

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

Q 2. Write notes on

(i) Venture capital financing

(ii) Seed capital assistance

Answer:

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

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

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

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

(ii) Seed capital assistance:- The seed capital assistance scheme is designed by the IDBI for professionally or technically qualified entrepreneur.

- The project cost should not exceed 2 crores. The maximum assistance under this scheme will be :-
 (a) 50% of the promoters required contribution, or
 (b) 15 lacs, whichever is lower.
- The assistance is initially interest free but carries a service charge of 1% p.a. for the 1st five years and at increasing rate thereafter.
- The repayment schedule is fixed depending upon the repaying capacity of the unit with an initial moratorium of upto 5 years

Q 3. Write short notes on the following:

(i) Debt Securitization (OR)

What Is debt Securitization? Explain the basic debt securitization process.

(ii) Bridge Finance.

Answer:

(i) Debt Securitization:- Debt securitization is a method of recycling of funds. It is a process whereby loans and other receivables are underwritten and sold in form of asset. It is thus a process of transforming the assets of a lending institution into negotiable instrument for generation of funds.

Process of debt securitization: The process of debt securitization is as follows:-

1. The loans are segregated into relatively homogeneous pools.
2. The basis of pool is the type of credit, maturity pattern, interest rate, risk etc.
3. The asset pools are then transferred to a trustee.
4. The trustee then issues securities which are purchased by investors
5. Such securities (asset pool) are sold on the undertaking without recourse to seller.

Function of debt securitization:

It is a method of recycling of funds. It is especially beneficial to financial intermediaries to support the lending volumes. The basic debt securitization process can be classified in the following three functions:

1. The origination function: Whenever a bank, financial institution, leasing company, Hire Purchase Company, credit card company, housing finance company etc. lends money (whether directly or indirectly) to a borrower, there comes into existence an asset in the books of bank. This creation of financial asset is called the origination function.

2. The pooling function: Similar loans or receivables are clubbed together to create an underlying pool of assets. This pool is transferred in favour of a SPV (Special Purpose Vehicle), which acts as a trustee for the investor. This pooling of assets is SPV's portfolio is called the pooling function.

3. The securitization function: Once the assets are transferred, SPV issue its securities (Called Pass through certificates) to the investor. This issue of securities is called the securitization function.

In this way we see that conversion of debts to securities is known as debt securitization.

Following are the various parties involved in the process of asset securitization:

1. Originator is an entity that owns the financial assets proposed to be securitized and initiates the process of securitization in respect of such assets.
2. Special Purpose Entity (SPE) is an entity which acquires the financial assets under securitization and normally holds them till maturity. SPE is an independent entity, usually constituted as a trust though it may be constituted in other forms, for example, as a limited company formed with small capital for the specific purpose of funding the transaction by issue of PTCs or debt securities. The purpose of forming SPE is insolvency remote.
3. Investor is the person who finances the acquisition of the securitized assets or of beneficial interest therein by subscribing to PTCs and /or debt securities issued by an SPE. The investors interest in this type of securities are generally institutional investors like mutual funds, insurance companies etc.

Advantages of debt securitization:

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 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.

(ii) Bridge Finance: - Bridge finance is a short-term loan taken by a firm from commercial banks to disperse loans sanctioned by financial institutions.

Importance or Need for Bridge finance: Bridge finance as the name suggests bridges the time gap between the date of sanctioning of a term loan and its disbursement. The reason for such delay is due to procedure formalities. Such delays result in cost overrun of the project. Thus, to avoid such cost over runs, firms approach commercial banks for short term loans for a period for which delay may occur. Characteristics of Bridge Finance:

1. It is short-term loan.
2. It bridges the gap between the date of sanctioning the loan and the final disbursement of loan.

3. The rate of interest on such loan is usually high.
4. These loans are usually repaid as and when term loans are disbursed.

Advantage: It helps in avoiding the cost over runs and Such loans are useful to implement the projects on time.

Disadvantage: The rate of interest on such loans is very high.

Q 4. Write a short note on "Deep Discount Bonds".

Answer:

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 investor such bonds, there is no interest payout during lock in period. When such bonds are sold in the stock market, the difference realised between face value and market price is the capital gain IDBI was the first to issue deep discount bonds in India in January 1992.

Q 5. Write a note on Venture Capital Financing.

Answer:

Venture capital refers to financial investment in a highly 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:

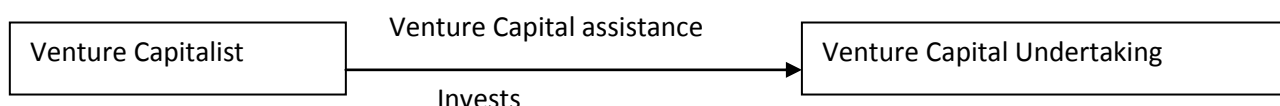
1. Equity participation by the venture capitalist.
2. It is a long term financing for a period between 5 to 10 years
3. The venture capitalist not only invest but also participate in the management of the venture capital undertaking.

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



Q 6. Discuss the eligibility criteria for issue of commercial paper.

Answer:

Eligibility criteria issue of commercial paper:-

The issue of commercial paper is subject to the nature and conditions stipulated by RBI from time to time. The broad condition are:

(1) Listing: The issuing company should be listed in atleast one recognised stock exchange. However, relaxation from this rule is given to closely held companies & public sector companies.

(2) Credit Rating: The issuing company should obtain the necessary credit rating from agencies like ICRA, CRISIL etc. Application to RBI for approval should be made within 2 months of obtaining the rating.

(3) Standard Asset: In addition to credit rating, the issuing company should be classified as "standard assets" by bankers/lending financial institutions.

(4) Net worth: The issues should have a minimum tangible net worth of 5 crores as per recent audited balance sheet, **where Net worth = Paid up capital + Free reserves - Accumulated losses & fictitious assets**

(5) Working capital: The fund based WC limit should be maximum of 5 crores

(6) Current Ratio: The minimum current ratio should be 1.33:1

(7) Issue Expenses: All issue expenses like dealers fee, credit rating, agency fee etc. shall be borne by the issue company.

Q 7. Explain the term 'Ploughing back of Profits'.

Answer:

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 does 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 Capitalisation:** Excessive ploughing back of profit may lead to over capitalisation.
- 2. Misuse of retained earning:** The retained earning may be misused by 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

Q 8. Explain the concept of leveraged lease.

Answer:

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 lesser and the financier 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.

Q 9. Discuss the features of deep discount bonds.

Answer:

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 2,00,000 and a maturity period of 25 years The bonds were issued at 5300.

The unique benefit of DDB 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 advantage of DDB 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 minimise risks and maximise returns.

Disadvantages:

- The main disadvantage 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.

Q 10. Discuss the features of Secured Premium Notes (SPNs).

Answer:

Secured premium Notes is issued along with a detachable warrant and is redeemable after a notified period of say 4 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 one note was 300 and this were issued at par
- It was redeemable in four equal installments of 150 each 6 totaling 600) at the end of 4th to 7th year.
- Out of each repayment of 150, 75 was to be considered as repayment of principal and 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 100 each at the end of first year.

Q 11. Discuss the advantages of preference share capital as an instrument of raising funds.

Meaning: As the name suggests, Preference shares are the shares which enjoys certain preferential rights over the equity shareholders in regards to:-

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

Characteristics:

(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.

Advantage:

- It provides a long term capital to the company.
- There is no dilution of EPS.
- As it bears a fixed charge, there is a leveraging advantage
- It can be redeemed after a specified time period.
- It does not carry voting rights hence, there is no dilution of control.
- It enhance the credit worthiness of the company.

Q 12. Discuss the benefits to the originator of Debt Securitization

Answer:

Benefits to the Originator of Debit Securitization

The benefits to the originator of debt securitization are as follows:

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

VII - INTERNATIONAL FINANCING

Q 1. Euro Convertible Bonds

Euro Convertible Bonds: It is a Euro Bond with the characteristics of convertibility attached to it. It gives the bond holders an option to convert them into equity shares at premium. These bonds carry a fixed rate of interest and may include a call option of a put option. Under call option, the issuing company has the option to buy or call the bonds prior to maturity date for its redemption. Under a Put Option the holder has the option to Put/sell his bonds to the issuing company at a predetermined date & price.

Q 2. Write short notes on the following:

(a) American Depository Receipts vs. Global Depository Receipts. (IMP)

Basis of Difference	GDR	ADR
1. Meaning	The depository receipts in the world market is called GDR.	The depository receipts in the US market is called ADR
2. Voting Right	GDR's do not have voting rights.	ADR's may be with or without voting rights.
3. Scope	GDR's are traded worldwide.	ADR's are traded only in US.
4. Preference	GDR's are more preferred due to their easy operation.	ADR's provide certain stringent rules to be followed which makes them less preferred.
5. Cost involved	The cost involved in operation of GDR is less than that of ADR.	The cost involved in operation of ADR is comparatively high due to formalities to be fulfilled under US GAAP & SEC.

Q 3. American Depository Receipts

Answer:

American depository receipt:- 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 USA. An ADR is generally created by the deposit of the securities of an outsider company with a custodian bank in the country of incorporation of issuing company. The custodian bank informs the depository in USA 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.

Q 4. Debt Securitization and Bridge Finance

Debt Securitization: Debt securitization is a method of recycling of funds. It is a process whereby loans and other receivables are underwritten and sold in form of asset. It is thus a process of transforming the assets of a lending institution into negotiable instrument for generation of funds. Process of debt securitization:

The process of debt securitization is as follows:-

1. The loans are segregated into relatively homogeneous pools.
2. The basis of pool is the type of credit, maturity pattern, interest rate, risk etc.
3. The asset pools are then transferred to a trustee.
4. The trustee then issues securities which are purchased by investors
5. Such securities (asset pool) are sold on the undertaking without recourse to seller.

Bridge Finance:

Bridge finance is a short-term loan taken by a firm from commercial banks to disperse loans sanctioned by financial institutions.

Importance or Need for Bridge finance: Bridge finance as the name suggests bridge the time gap between the date of sanctioning of a term loan and its disbursement. The reason for such delay is due to procedure formalities. Such delays result in cost over run of the project. Thus, to avoid such cost over runs, firms approach commercial banks for short term loans for a period for which delay may occur.

Characteristics of Bridge Finance:

- It is short-term loan.
- It bridges the gap between the date of sanctioning the loan and the final disbursement of loan.
- The rate of interest on such loan is usually high.
- These loans are usually repaid as and when term loans are disbursed.

Q 5. Global Depository Receipts and American Depository Receipts.

Answer:

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.
- **American Depository Receipts**, whereas 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.

Q 6. Explain the concept of Indian depository receipts.

Answer:

The MCA 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 MCA 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/GD In an IDR, foreign companies issue shares to an Indian Depository, which would, in turn, issue Depository Receipts to investors in India.

The Depository Receipts would be listed on stock exchanges in India and would be freely transferable. The actual shares underlying the ID would be held by an Overseas Custodian, which shall authorise the Indian Depository to issue the ID

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.

Q 7. Explain briefly the features of External Commercial Borrowings. (ECB)

Answer:

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 recognised sources like (i) international banks, (ii) international capital markets (iii) multilateral financial institutions such as the IFC, ADB etc, (iv) export credit agencies (v) suppliers of equipment, (vi) foreign collaborators and (vii) foreign equity holders

External Commercial Borrowings can be accessed under two routes via

(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 i 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.

Q 8. Name the various financial instruments dealt with in the international market.

Answer:

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

1. Euro Issue : An Euro 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 denominated 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.

VIII - CAPITAL BUDGETING & INVESTMENT DECISIONS

Q 1. Net Present value and Internal Rate of Return

Answer:

NPV and IRR Method differ in the following ways :

(1) Under NPV, projects with positive NPV are accepted.

Under IRR, projects whose IRR is more than the cost of project are accepted.

(2) NPV measures both quality and scale of investment.

IRR measures only quality of investment.

(3) NPV provides an absolute measure in quantitative terms.

IRR Provides a relative measure in percentage.

(4) Under NPV, cash flows are re-invested at the rate of cost of capital.

Under IRR, cash flows are re-invested at the rate of IRR.

Q 2. Social Cost Benefit Analysis

Answer:

Need for Social Cost Benefit Analysis:

- The market price which is used to measure cost & benefit in a project does not represent social values due to imperfections in market.
- Monetary cost & benefit analysis fails to consider the external positive and negative effects of a project.
- Taxes and subsidies are transfer payments and therefore are not relevant in national economic profitability analysis.
- 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.
- Merit wants are important appraisal criteria for **SCBA**.

Q 3. Concept of discounted payback period.

Answer: 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.

Q 4. Desirability factor.

Answer:

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

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



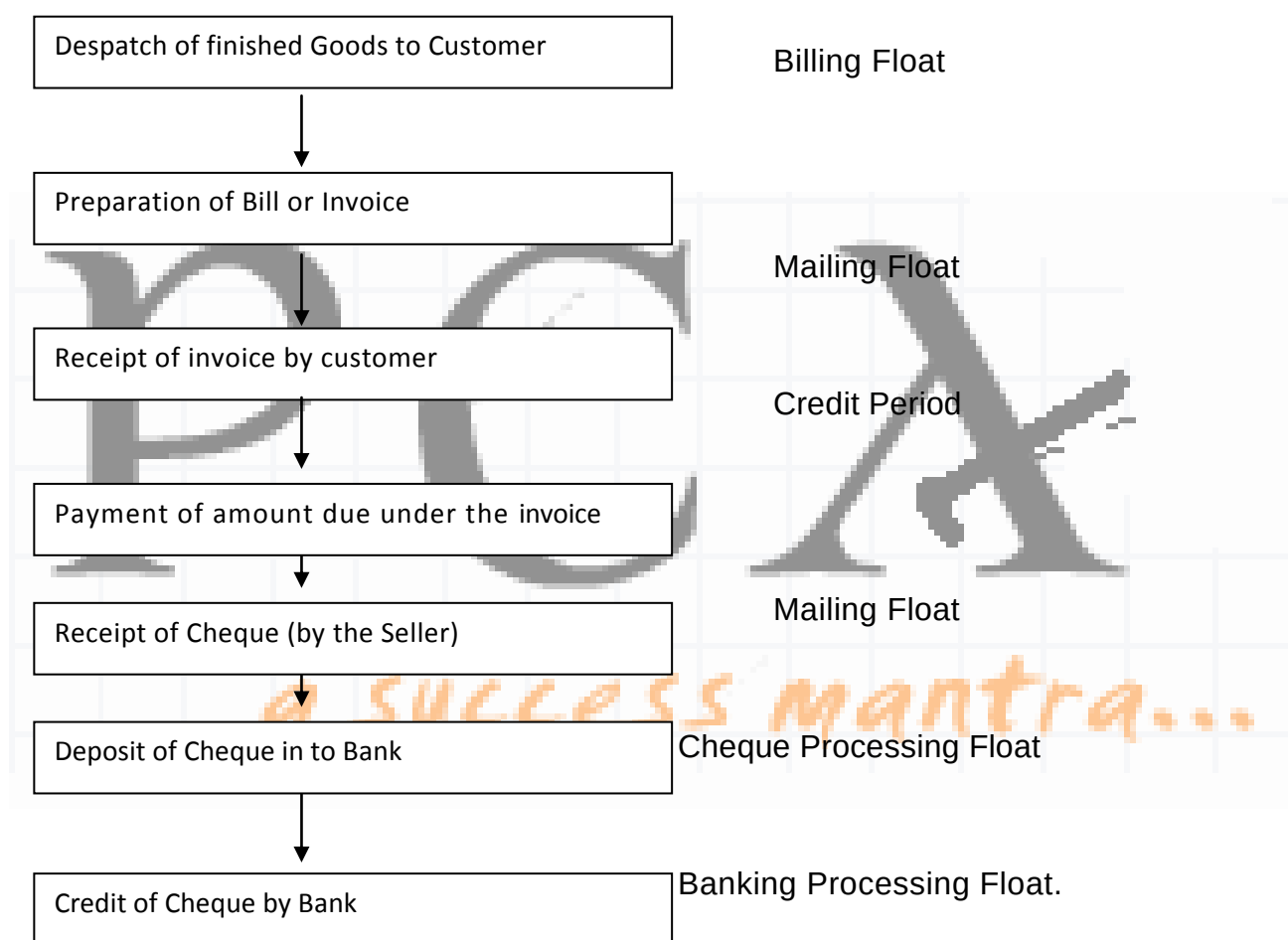
IX - TREASURY & CASH MANAGEMENT

Q 1. Different kinds of float with reference to management of cash

Answer:

The term 'float' denotes a delay or lag between two events.

When a firm receives a cheque, there is usually a time gap between the time the cheque is written and when it is cleared. This time gap is known as 'Float.' In the context of cash management the term float is usually used for the following delays:



Measures are adopted to Reduce various Floats in management of Cash:

Float

- Billing float
- Mailing float (Invoice from seller to customer)
- Mailing float (Cheque from customer) Cheque processing float, Banking processing float

Measures

- Immediate preparation of bill right on the very date of dispatch of finished goods.
- Sending the invoice by faster means.

- Concentration Banking & Lock Box System

Q 2. Enumerate the activities which are covered by Treasury Management.

Answer:

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 vital role in 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 relationships and arrangements.
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 transaction.

Q 3. Forms of Bank Credit

The bank credit will generally be in the following forms:

- **Cash Credit:** This facility will be given by the banker to the customers by giving certain amount of credit facility on continuous basis. The borrower will not be allowed to exceed the limits sanctioned by the bank.

- **Bank Overdraft:** It is a short-term borrowing facility made available to the companies in case of urgent need of funds. The banks will impose limits on the amount they can lend. When the borrowed funds are no longer required they can quickly and easily be repaid. The banks issue overdrafts with a right to call them in at short notice.
- **Bills Discounting:** The company which sells goods on credit, will normally draw a bill on the buyer who will accept it and sends it to the seller of goods. The seller, in turn discounts the bill with his banker. The banker will generally earmark the discounting bill limit.
- **Bills Acceptance:** To obtain finance under this type of arrangement a company draws a bill of exchange on bank. The bank accepts the bill thereby promising to pay out the amount of the bill at some specified future date.
- **Line of Credit:** Line of Credit is a commitment by a bank to lend a certain amount of funds on demand specifying the maximum amount.
- **Letter of Credit:** It is an arrangement by which the issuing bank on the instructions of a customer or on its own behalf undertakes to pay or accept or negotiate or authorizes another bank to do so against stipulated documents subject to compliance with specified terms and conditions.
- **Bank Guarantees:** Bank guarantee is one of the facilities that the commercial banks extend on behalf of their clients in favour of third parties who will be the beneficiaries of the guarantees.

PCA

A SUCCESS MANTRA...

X -MANAGEMENT OF RECEIVABLES

Q 1. Factoring.

(i) Factoring: Factoring is an arrangement between a firm and a financial institution under which the firm called the borrower receives advances against its receivables from the financial institution called the factor. In factoring, receivables are generally sold to the factor, who charges commission and bears the credit risk associated with the receivables. It is not just a single service but involves provisions of specialised services relating to:

1. credit investigation
2. sales ledger management
3. purchase of debts
4. collection of debts
5. credit protection
6. Provision of finance against receivables and risk bearing, etc.

The borrower selects various combinations of these functions and makes arrangement with the factor accordingly. The operation of factoring is very simple and operates in the following way:

1. The borrower enters into an agreement with the factor on suitable terms and conditions.
2. The factor then selects the account of the customer that would be handled by it.
3. The borrower sells his account receivable to the factor.
4. The factor provide advance against the account receivables after deducting its commission and fees.
5. The borrower forwards collection from the customers to the factor and settles the advances received along with interest on advances.
6. If provided in the agreement, the factor provides for the following allied services.
 - (i) Credit investigation.
 - (ii) Collection of debt.
 - (iii) Sales ledger management.
 - (iv) Credit protection.
 - (v) Provision of finance against receivables.

Note: The operation of factoring in India is with recourse i.e. in case of default by the customer the risk is borne by borrower and not the factor

The benefits of factoring are as follows:

1. The receivables gets easily converted into cash.
2. It ensures a definite pattern of cash inflows from credit sales.
3. It eliminates the need for the credit and collection department and in this way reduces the cost.
4. It provides flexibility to the borrower as he is ensured of the debt return.
5. Unlike an unsecured loan, compensating balances are not required in this case.
 1. Factoring may be considered as a sign of financial weakness.
 2. The cost of factoring sometimes tends to be higher than the cost of other forms of short term borrowing.
 3. While evaluating the credit worthiness of a customer by a factor, it may over look the sales growth aspect.

Q 2. Importance of 'Credit-rating'.

Answer:

After drawing up the credit policy, a firm has to evaluate the credit worthiness of the individual customer and also the possibility of bad debt. Credit analysis determines the degree of risk associated with the capacity of the customer to borrow and his ability and willingness to pay. For this, firm has to ascertain the credit rating of prospective customers

Credit Rating: Credit rating is to rate the various debtors who seek credit facility.

Credit rating implies taking decisions regarding individual debtors so as to ascertain the quantum of credit and the credit period.

This would further involve:-

1. Collection of information about the debtor.
2. Decision Tree analysis of credit granting.

Collection of information about the debtor:

The various sources of information are:-

(i) Past Records: Past records of existing customers prove to be a valuable source of information to find out the credit risk involved,

(ii) Sales man's Report: Very often the firms depend and decide the credit worthiness of a customer on the basis of the sales man's report. The sales man ascertains the potential of the customers and reports accordingly,

(iii) Bank References: Sometimes the banks provide the required information about the customer and decision is taken after analysing such information,

(iv) Trade References: Information about the customer is also collected from the persons referred by the customer himself. Such persons giving relevant information about the customer are the trade references.

(v) Credit Bureau Reports: Useful and authentic credit information is also provided by credit bureaus of specific industries.

(vi) Published Financial Reports: The financials reports i.e. balance sheet, profit & loss A/c and others when examined can give valuable information about credit worthiness of a customer.

(vii) List of Government Suppliers: If a customer's name appears in the list of Government approved suppliers in agencies like DGS & D or any other reputed agency, it proves the credit worthiness of the customer.

(viii) Decision tree analysis of credit granting: Once all the credit information about the customer (both existing and prospective) is gathered, it has to be thoroughly analysed to arrive at a decision relating to:

- (a) Whether or not to grant credit.
- (b) If credit is to be granted, then on what terms and conditions.

The five 'C's of credit which provide a framework for evaluating a customer are:

- Character.
- Capacity.
- Capital.
- Collateral.
- Condition.

Q 3. Principles of "Trading on equity".

Answer:

The term 'equity' refers to the ownership or 'stock' of a company and 'trading' means

'taking advantage 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 expense 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 trading 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 achieve 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 ` 2,00,000, debt equity ratio is 1:1, interest rate is 10% and EBIT is ` 30,000. Here ROI is 15% ` (30000 / 200000) which is more than interest rate of 10%. This excess return of 5% (15-10) will go to equity shareholders and (ROE) will be 20% (20000/100000).

This excess return earned by equity shareholder due to favourable financial-leverage position is termed as trading on equity.

Q 4. Accounts receivable systems.

Answer:

- 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.

Q 5. Factoring and Bills discounting

Basis of Difference	Factoring	Bill Discounting
Meaning	It is management of book Bank debt	It is borrowing from commercial
Parties	Factors, clients, debtors	Drawer, drawee and payee
Also known as	Invoice Factoring	Invoice Discounting
Applicable Act	No specific Act	Negotiable Instruments Act