IPCC

FM THEORY

CA IPCC Inputs 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. It will give you momentum and will let you know which problem will take how much time in exams.
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.

Thank You………

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1. BASIC CONCEPT OF F.M

(1)

Explain the two basic functions of Financial Management.

Answer:

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 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, Fll 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 funds: 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.

(2)

Write short notes on Finance Function.

Answer:

The finance function is most important for all business enterprises. It remains a focus of all activities. It starts with the setting up of an enterprise. It is concerned with raising of funds, deciding the cheapest source of finance, utilization of funds raised, making provision for refund when money is not required in the business, deciding the most profitable investment, managing the funds raised and paying returns to the providers of funds in proportion to the risks undertaken by them. Therefore, it aims at acquiring sufficient funds, utilizing them properly, increasing the profitability of the organization and maximizing the value of the organization and ultimately the shareholder’s wealth.

(3)

Discuss the functions of a Chief Financial Officer.

Answer:

Functions of a Chief Financial Officer:

The twin aspects viz procurement and effective utilization of funds are the crucial tasks, which the CFO faces.

The Chief Finance Officer is required to look into financial implications of any decision in the firm. Thus all decisions involving management of funds comes under the purview of finance manager.

These are namely

- Estimating requirement of funds
- Decision regarding capital structure
- Investment decisions
- Dividend decision
- Cash management
- Evaluating financial performance
- Financial negotiation
- Keeping touch with stock exchange quotations & behaviour of share prices.

(4)

State the role of a Chief Financial Officer.

Answer:

The chief financial officer of an organisation plays an important role in the company's goals, policies and financial success. His responsibilities include:

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

(5)

Explain the role of Finance Manager in the changing scenario of financial management in India.

Answer:

Role of Finance Manager in the Changing Scenario of Financial Management in India:

In the modern enterprise, the finance manager occupies a key position and his role is becoming more and more pervasive and significant in solving the finance problems. The traditional role of the finance manager was confined just to raising of funds from a number of sources, but the recent development in the socio-economic and political scenario throughout the world has placed him in a central position in the business organisation.

He is now responsible for shaping the fortunes of the enterprise, and is involved in the most vital decision of allocation of capital like mergers, acquisitions, etc. He is working in a challenging environment which changes continuously.

Emergence of financial service sector and development of internet in the field of information technology has also brought new challenges before the Indian finance managers.

Development of new financial tools, techniques, instruments and products and emphasis on public sector undertaking to be self-supporting and their dependence on capital market for fund requirements have all changed the role of a finance manager. His role, especially, assumes significance in the present day context of liberalization, deregulation and globalization.

(6)
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).

(7)
Explain the 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 excepted 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, we see that investment, financing and dividend decisions are all inter-related.

(8)

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

Answer

A firm's financial management may often have the following as their objectives:
(i) The maximisation of firm's profit.
(ii) The maximisation of firm's value / wealth.

The maximisation of profit is often considered as an implied objective of a firm. To achieve the aforesaid objective various type of financing decisions may be taken. Options resulting into maximisation of profit may be selected by the firm's decision makers. They even sometime may adopt policies yielding exorbitant profits in short run which may prove to be unhealthy for the growth, survival and overall interests of the firm. The profit of the firm in this case is measured in terms of its total accounting profit available to its shareholders.

The value/wealth of a firm is defined as the market price of the firm's stock. The market price of a firm's stock represents the focal judgment of all market participants as to what the value of the particular firm is. It takes into account present and prospective future earnings per share, the timing and risk of these earnings, the dividend policy of the firm and many other factors that bear upon the market price of the stock.

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

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

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

(9)

Discuss the conflicts in Profit versus Wealth maximization principle of the firm.

Answer

Conflict in Profit versus Wealth Maximization Principle of the Firm:

Profit maximization is a short-term objective and cannot be the sole objective of a company. It is at best a limited objective. If profit is given undue importance, a number of problems can arise like the term profit is vague, profit maximisation has

to be attempted with a realisation of risks involved, it does not take into account the time pattern of returns and as an objective it is too narrow.
Whereas, on the other hand, wealth maximisation, as an objective, 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. If the company follows the goal of wealth maximisation, it means that the company will promote only those policies that will lead to an efficient allocation of resources.

(10)
Explain the limitations of profit maximization objective of Financial Management.
Answer
Limitations of Profit Maximisation Objective of Financial Management
(a) Time factor is ignored.
(b) It is vague because it is not clear whether the term relates to economic profit, accounting profit, profit after tax or before tax.
(c) The term maximization is also ambiguous.
(d) It ignores the risk factor.

(11)
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.

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2. TIME VALUE OF MONEY

(1)

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

Answer:

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 uncertainly 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 or utmost important option. 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.

3. CASH & FUNDS FLOW

(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 cap-ital	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.

4. RATIOS

(1)

Discuss any three ratios computed for investment analysis.

Answer:

Three ratios computed for investment analysis are as follows:

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

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

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

(2)

Explain the need of debt-service coverage ratio.

Answer:

Debt Service Coverage Ratio: Lenders are interested in this ratio to judge the firm's ability to pay off current interest and installments.

Debt service coverage ratio = $\dfrac{\text{Earnings available for debt service}}{\text{Interest + instalment}}$

Where,

Earning for debt service = Net profit

+ Non-cash operating expenses like depreciation and other amortization.

+ Non operating adjustments like loss on sale Fixed assets.

+ Interest on Debt fund

(3)

How return on capital employed is calculated? What is its significance?
Answer
Return on Capital Employed (ROCE): It is the most important ratio of all. It is the percentage of return on funds invested in the business by its owners. In short, it indicates what returns management has made on the resources made available to them before making any distribution of those returns.

$$\text{Return on capital employed} = \frac{\text{Return}}{\text{Capital employed}} \times 100$$

Where,
Return = Net Profit
± Non-trading adjustments (but not accrual adjustments for amortization of preliminary expenses, goodwill, etc.)
+ Interest on long term debts + Provision for tax
– Interest/Dividend from non-trade investments

Capital Employed = Equity Share Capital
+ Reserve and Surplus
+ Pref. Share Capital
+ Debentures and other long term loan
– Misc. expenditure and losses
– Non-trade Investments.

Intangible assets (assets which have no physical existence like goodwill, patents and trademarks) should be included in the capital employed. But no fictitious asset should be included within capital employed.

(4)
What is quick ratio? What does it signify?
Answer
Quick Ratio: It is a much more exacting measure than the current ratio. It adjusts the current ratio to eliminate all assets that are not already in cash (or near cash form). A ratio less than one indicates low liquidity and hence is a danger sign.

$$\textbf{Quick ratio} = \frac{\text{Quick assets}}{\text{Current liabilities}}$$

Where,
Quick Assets = Current Assets – Inventory

(5)
What do you mean by Stock Turnover ratio and Gearing ratio?
Answer
Stock Turnover Ratio and Gearing Ratio
Stock Turnover Ratio helps to find out if there is too much inventory build-up. An increasing stock turnover figure or one which is much larger than the "average" for an industry may indicate poor stock management. The formula for the Stock Turnover Ratio is as follows:

Stock turnover ratio = $\frac{\text{cost of sales}}{\text{Average inventory}}$ **or** $\frac{\text{Turn over}}{\text{Average inventory}}$

Gearing Ratio indicates how much of the business is funded by borrowing. In theory, the higher the level of borrowing (gearing), the higher are the risks to a business, since the payment of interest and repayment of debts are not "optional" in the same way as dividends. However, gearing can be a financially sound part of a business's capital structure particularly if the business has strong, predictable cash flows.
The formula for the Gearing Ratio is as follows:

Gearing Ratio = $\frac{\text{Borrowings (all long term debts including normal overdraft)}}{\text{Net assets or Share holders funds}}$

(6)
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 calculation 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.
(a) 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.
(b) 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.
(c)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:** Equity Multiplier = Assets÷ Shareholders' Equity.
Calculation 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× Asset turnover × Equity multiplier

(7)

Explain the following ratios:
(i) Operating ratio
(ii) Price earnings ratio
Answer
(i) Concept of Operating Ratio

$$\textbf{Operating ratio} = \frac{\text{Cost of goods sold + operating expenses}}{\text{Net sales}} \times 100$$

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-Earnings ratio

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

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.

(8)
Explain briefly the limitations of Financial ratios.
Answer
Limitations of Financial Ratios
The limitations of financial ratios are listed below:
(a) Diversified product lines: Many businesses operate a large number of divisions in quite different industries. In such cases, ratios calculated on the basis of aggregate data cannot be used for inter-firm comparisons.
(b) Financial data are badly distorted by inflation: Historical cost values may be substantially different from true values. Such distortions of financial data are also carried in the financial ratios.
(c) Seasonal factors may also influence financial data.
(d) To give a good shape to the popularly used financial ratios (like current ratio, debt- equity ratios, etc.): The business may make some year-end adjustments. Such window dressing can change the character of financial ratios which would be different had there been no such change.
(e) Differences in accounting policies and accounting period: It can make the accounting data of two firms non-comparable as also the accounting ratios.
(f) There is no standard set of ratios against which a firm's ratios can be compared: Sometimes a firm's ratios are compared with the industry average. But if a firm desires to be above the average, then industry average becomes a low standard. On the other hand, for a below average firm, industry averages become too high a standard to achieve.

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5. COST OF CAPITAL & CAPITAL STRUCTURE

(1)

What is meant by weighted average cost of capital?

Answer

Meaning of Weighted Average Cost of Capital **(WACC):** The composite or overall cost of capital of a firm is the weighted average of the costs of the various sources of funds. Weights are taken to be in the proportion of each source of fund in the capital structure. While making financial decisions this overall or weighted cost is used. Each investment is financed from a pool of funds which represents the various sources from which funds have been raised. Any decision of investment, therefore, has to be made with reference to the overall cost of capital and not with reference to the cost of a specific source of fund used in the investment decision.

The weighted average cost of capital is calculated by:

(i) Calculating the cost of specific source of fund e.g. cost of debt, equity etc;

(ii) Multiplying the cost of each source by its proportion in capital structure; and

(iii) Adding the weighted component cost to get the firm's WACC represented by k_0.

k0 = k1 w1+ k2 w2+ ....

Where, k1, k2 are component costs and w1, w2 are weights.

(2)

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

Answer

In dividend price approach, cost of equity capital is computed by dividing the current dividend by average market price per share. This ratio expresses the cost of equity capital in relation to what yield the company should pay to attract investors.
It is computed as:
Ke=D1/P0
where
D1= Dividend per share in period 1 P0= Market price per share today
Whereas, on the other hand, the advocates of earnings price approach co-relate the earnings of the company with the market price of its share.
Accordingly, the cost of ordinary share capital would be based upon the expected rate of earnings of a company. This approach is similar to dividend price approach, only it seeks to nullify the effect of changes in dividend policy.

(3)
Explain in brief the assumptions of Modigliani-Miller theory.
Answer
Assumptions of Modigliani – Miller Theory
(a) Capital markets are perfect. All information is freely available and there is no transaction cost.
(b) All investors are rational.
(c) No existence of corporate taxes.
(d) Firms can be grouped into "Equivalent risk classes" on the basis of their business risk.
(4)
Discuss the proposition made in Modigliani and Miller approach in capital structure theory.
Answer
Three Basic Propositions made in Modigliani and Miller Approach in Capital Structure Theory
(i) The total market value of a firm and its cost of capital are independent of its capital structure. The total market value of the firm is given by capitalizing the expected stream of operating earnings at a discount rate considered appropriate for its risk class.
(ii) The cost of equity (ke) is equal to capitalization rate of pure equity stream plus a premium for financial risk. The financial risk increases with more debt content in the capital structure. As a result, ke increases in a manner to offset exactly the use of less expensive source of funds.
(iii) The cut-off rate for investment purposes is completely independent of the way in which the investment is financed. This proposition alongwith the first implies a complete separation of the investment and financing decisions of the firm.

(5)
Explain the assumptions of Net Operating Income approach (NOI) theory of capital structure.
Answer
Assumptions of Net Operating Income (NOI) Theory of Capital Structure

According to NOI approach, there is no relationship between the cost of capital and value of the firm i.e. the value of the firm is independent of the capital structure of the firm.

Assumptions

(a) The corporate income taxes do not exist.

(b) The market capitalizes the value of the firm as whole. Thus the split between debt and equity is not important.

(c) The increase in proportion of debt in capital structure leads to change in risk perception of the shareholders.

(d) The overall cost of capital (Ko) remains constant for all degrees of debt equity mix.

(6)

What do you understand by Capital structure? How does it differ from Financial structure?

Answer

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. On the other hand, 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.

(7)

List the fundamental principles governing capital structure.

Answer

Fundamental Principles Governing Capital Structure

The fundamental principles are:

(i) Cost Principle: According to this principle, an ideal pattern or capital structure is one that minimises cost of capital structure and maximises earnings per share (EPS).

(ii) Risk Principle: According to this principle, reliance is placed more on common equity for financing capital requirements than excessive use of debt. Use of more and more debt means higher commitment in form of interest payout. This would lead to erosion of shareholders value in unfavourable business situation.

(iii) Control Principle: While designing a capital structure, the finance manager may also keep in mind that existing management control and ownership remains undisturbed.

(iv) Flexibility Principle: It means that the management chooses such a combination of sources of financing which it finds easier to adjust according to changes in need of funds in future too.

(v) Other Considerations: Besides above principles, other factors such as nature of industry, timing of issue and competition in the industry should also be considered.

(8)

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.

(9)
What is optimum capital structure? Explain.
Answer
Optimum Capital Structure: 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 upto 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. Therefore, company should select its appropriate capital structure with due consideration of all factors.

(10)
Explain Principle of "Trading on equity".
Answer:
The term trading on equity means debts are contracted and loans are raised mainly on the basis of equity capital. Those who provide debt have a limited share in the firm’s earning and hence want to be protected in terms of earnings and values represented by equity capital.
Since fixed charges do not vary with firms earning before interest and tax, a magnified effect is produced on earning per share. Whether the leverage is favourable, in the sense, increase in earning per share more proportionately to the increased earning before interest and tax, depends on the profitability of investment proposal. If the rate of returns on investment exceeds their explicit cost, financial leverage is said to be positive.

(11)
Discuss the concept of Debt-Equity or EBIT-EPS indifference point, while determining the capital structure of a company.
Answer

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, a comparison can be drawn for various methods of financing by obtaining indifference point. It is a point to the EBIT level at which EPS remains unchanged irrespective of debt-equity mix. The indifference point for the capital mix (equity share capital and debt) can be determined as follows:

$$\frac{(EBIT-I_1)(1-T)}{E_1} = \frac{(EBIT-1_2)(1-T)}{E_2}$$

(12)
Difference between Business risk and Financial risk.
Answer:
Business Risk and Financial Risk

Business risk refers to the risk associated with the firm's operations. It is an unavoidable risk because of the environment in which the firm has to operate and the business risk is represented by the variability of earnings before interest and tax (EBIT). The variability in turn is influenced by revenues and expenses. Revenues and expenses are affected by demand of firm's products, variations in prices and proportion of fixed cost in total cost.

Whereas, Financial risk refers to the additional risk placed on firm's shareholders as a result of debt use 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.

(13)
Discuss 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.

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

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

1_2 = Interest charges in Alternative 2

T = Tax-rate

Alternative 1= All equity finance

Alternative 2 = debt –equity finance

(14)

Write a short notes on 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 o f 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.

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6- SOURCES OF FINANCE

(1)

Explain the importance of trade credit and accruals as source of working capital. What is the cost of these sources?

Answer

Trade credit and accruals as source of working capital refers to credit facility given by suppliers of goods during the normal course of trade. It is a short term source of

finance. SSI firms in particular are heavily dependent on this source for financing their working capital needs.
The major advantages of trade credit are − easy availability, flexibility and informality.
There can be an argument that trade credit is a cost free source of finance. But it is not. It involves implicit cost. The supplier extending trade credit incurs cost in the form of opportunity cost of funds invested in trade receivables. Generally, the supplier passes on these costs to the buyer by increasing the price of the goods or alternatively by not extending cash discount facility.

(2)
Explain in brief the features of Commercial Paper.
Answer
Features of Commercial Paper (CP): A commercial paper is an unsecured money market instrument issued in the form of a promissory note. Since the CP represents an unsecured borrowing in the money market, the regulation of CP comes under the purview of the Reserve Bank of India which issued guidelines in 1990 on the basis of the recommendations of the Vaghul Working Group. These guidelines were aimed at:
(i) Enabling the highly rated corporate borrowers to diversify their sources of short term borrowings, and
(ii) To provide an additional instrument to the short term investors.
It can be issued for maturities between 7 days and a maximum upto one year from the date of issue. These can be issued in denominations of Rs.5 lakh or multiples therefore. All eligible issuers are required to get the credit rating from credit rating agencies.

(3)
Discuss the eligibility criteria for issue of commercial paper.
Answer
The companies satisfying the following conditions are eligible to issue commercial paper.
The tangible net worth of the company is Rs.5 crores or more as per audited balance sheet of the company.
The fund base working capital limit is not less than Rs.5 crores.
The company is required to obtain the necessary credit rating from the rating agencies such as CRISIL, ICRA etc.
The issuers should ensure that the credit rating at the time of applying to RBI should not be more than two months old.
The minimum current ratio should be 1.33:1 based on classification of current assets and liabilities.
For public sector companies there are no listing requirement but for companies other than public sector, the same should be listed on one or more stock exchanges.
All issue expenses shall be borne by the company issuing commercial paper

(4)

Discuss the risk-return considerations in financing of current assets.

Answer

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

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

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

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

(5)

Write notes on Seed capital assistance.

Answer:

Seed capital assistance:

The seed capital assistance has been designed by IDBI for professionally or technically qualified entrepreneurs. All the projects eligible for financial assistance from IDBI, directly or indirectly through refinance are eligible under the scheme.

The project cost should not exceed Rs. 2 crores and the maximum assistance under the project will be restricted to 50% of the required promoters contribution or Rs 15 lacs whichever is lower. The seed capital assistance is interest free but carries a security charge of one percent per annum for the first five years and an increasing rate thereafter.

(6)

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

Answer

Debt Securitisation: It is a method of recycling of funds. It is especially beneficial to financial 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 receivables.

Process of Debt Securitisation

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

(ii) The pooling function – Similar loans on receivables are clubbed together to create an underlying pool of assets. The pool is transferred in favour of Special purpose Vehicle (SPV), which acts as a trustee for investors.
(iii) The securitisation function– SPV will structure and issue securities on the basis of asset pool. The securities carry a coupon and expected maturity which can be asset-based/mortgage based. These are generally sold to investors through merchant bankers.
The process of securitization is generally without recourse i.e. investors bear the credit risk and issuer is under an obligation to pay to investors only if the cash flows are received by him from the collateral.

(7)
Explain the advantages of Debt Securitisation?
Answer
Debt securitisation is a method of recycling of funds and is especially beneficial to financial intermediaries to support lending volumes. Simply stated, under debt securitisation a group of illiquid assets say a mortgage or any asset that yields stable and regular cash flows like bank loans, consumer finance, and credit card payment are pooled together and sold to intermediary. The intermediary then
issue debt securities.
The advantages of debt securitisation to the originator are the following:
(i) The asset is shifted off the Balance Sheet, thus giving the originator recourse to off balance sheet funding.
(ii) It converts illiquid assets to liquid portfolio.
(iii) It facilitates better balance sheet management; assets are transferred off balance sheet facilitating satisfaction of capital adequacy norms.
(iv) The originator's credit rating enhances.
For the investors securitisation opens up new investment avenues. Though the investor bears the credit risk, the securities are tied up to definite assets.

(8)
Write a short notes on 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 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:
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:

1. It helps in avoiding the cost over runs.
2. Such loans are useful to implement the projects on time.

Disadvantage:

1. The rate of interest on such loans is very high.

(9)

Write a note on Venture Capital Financing & Its methods?

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.

Methods of Venture Capital Financing:

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

(a) Equity financing: The venture capital undertaking requires long-term funds but is unable to provide returns in initial stage so equity capital is the best option.

(b) Conditional Loan: A conditional loan is repayable in the form of a royalty after the venture is able to generate sales. No interest is paid on such loans.

(c) Income note: It is hybrid security; the entrepreneur has to pay both interest and royalty on sales but at substantially low rates.

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

(10)

Discuss the factors that a venture capitalist should consider before financing any risky project.

Answer

Factors to be considered by a Venture Capitalist before Financing any Risky Project

(i) Quality of the management team is a very important factor to be considered. They are required to show a high level of commitment to the project.

(ii) The technical ability of the team is also vital. They should be able to develop and produce a new product / service.

(iii) Technical feasibility of the new product / service should be considered.

(iv) Since the risk involved in investing in the company is quite high, venture capitalists should ensure that the prospects for future profits compensate for the risk.

(v) A research must be carried out to ensure that there is a market for the new product.

(vi) The venture capitalist himself should have the capacity to bear risk or loss, if the project fails.
(vii) The venture capitalist should try to establish a number of exist routes.
(viii) In case of companies, venture capitalist can seek for a place on the Board of Directors to have a say on all significant matters affecting the business.

(11)
Explain the term 'Ploughing back of Profits'.
Answer:
Ploughing back of Profits:
Long-term funds may also be provided by accumulating the profits of the company and ploughing them back into business. Such funds belong to the ordinary shareholders and increase the net worth of the company. A public limited company must plough back a reasonable amount of its profits each year keeping in view the legal requirements in this regard and its own expansion plans. Such funds also entail almost no risk. Further, control of present owners is also not diluted by retaining profits.

(12)
Explain the concept of closed and open ended lease,
Answer:
In the close-ended lease, the assets gets transferred to the lessor at the end of lease, the risk of obsolescence, residual values etc. remain with the lessor being the legal owner of the assets. In the open-ended lease, the lessee has the option of purchasing the assets at the end of lease period.

(13)
Distinguish between Operating lease and financial lease.
Answer
Difference between Financial Lease and Operating Lease

S.No	Finance Lease	Operating Lease
1.	The risk and reward incident to ownership are passed on the lessee. The lesser only remains the legal owner of the asset.	The lessee is only provided the use of the asset for a certain time. Risk incident to ownership belongs only to the lessor.
2.	The lessee bears the risk of obsolescence.	The lessor bears the risk of obsolescence.
3.	The lease is non-cancellable by either party under it.	The lease is kept cancellable by the lessor.
4.	The lessor does not bear the cost of repairs, maintenance a operations.	Usually, the lessor bears the cost of repairs, maintenance a operations.
5.	The lease is usually full payout .	The lease is usually non-payout.

(14)

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.

(15)

Discuss the features of deep discount bonds.

Answer:

Deep Discount Bonds vs. Zero Coupon Bonds:

Deep Discount Bonds (DDBs) are in the form of zero interest bonds. These bonds are sold at a discounted value and on maturity face value is paid to the investors. In such bonds, there is no interest payout during lock-in period. IDBI was first to issue a Deep Discount Bonds (DDBs) in India in January 1992. The bond of a face value of Rs.1 lakh was sold for Rs.2,700 with a maturity period of 25 years.

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

(16)

Discuss the features of Secured Premium Notes (SPNs).

Answer:

Secured premium notes are issued along with detachable warrants and are redeemable after a notified period of say 4 to 7 years. This is a kind of NCD attached with warrant. It was first introduced by TISCO, which issued the SPNs to existing shareholders on right basis. Subsequently the SPNs will be repaid in some number of equal instalments. The warrant attached to SPNs gives the holder the right to apply for and get allotment of equity shares as per the conditions within the time period notified by the company.

(17)

Discuss the advantages of raising funds by issue of equity shares.

Answer

Advantages of Raising Funds by Issue of Equity Shares

(i) It is a permanent source of finance. Since such shares are not redeemable, the company has no liability for cash outflows associated with its redemption.
(ii) Equity capital increases the company's financial base and thus helps further the borrowing powers of the company.
(iii) The company is not obliged legally to pay dividends. Hence in times of uncertainties or when the company is not performing well, dividend payments can be reduced or even suspended.
(iv) The company can make further issue of share capital by making a right issue.

(18)
"Financing a business through borrowing is cheaper than using equity." Briefly explain.
Answer
"Financing a business through borrowing is cheaper than using equity"
(i) Debt capital is cheaper than equity capital from the point of its cost and interest being deductible for income tax purpose, whereas no such deduction is allowed for dividends.
(ii) Issue of new equity dilutes existing control pattern while borrowing does not result in dilution of control.
(iii) In a period of rising prices, borrowing is advantageous. The fixed monetary outgo decreases in real terms as the price level increases

(19)
Discuss the advantages of preference share capital as an instrument of raising funds?
ANSWER
Advantages of Issue of Preference Shares are:
(i) No dilution in EPS on enlarged capital base.
(ii) There is no risk of takeover as the preference shareholders do not have voting rights.
(iii) There is leveraging advantage as it bears a fixed charge.
(iv) The preference dividends are fixed and pre-decided. Preference shareholders do not participate in surplus profit as the ordinary shareholders
(v) Preference capital can be redeemed after a specified period.

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7- INTERNATIONAL FINANCING

(1)

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:

(a) Euro Bonds
(b) Foreign Bonds
(c) Fully Hedged Bonds
(d) Medium Term Notes
(e) Floating Rate Notes
(f) External Commercial Borrowings
(g) Foreign Currency Futures
(h) Foreign Currency Option
(i) Euro Commercial Papers.

(2)

Write a short notes on Euro Convertible Bonds

Answer

Euro Convertible bonds are quasi-debt securities (unsecured) which can be converted into depository receipts or local shares. ECBs offer the investor an option to convert the bond into equity at a fixed price after the minimum lock in period.

The price of equity shares at the time of conversion will have a premium element. The bonds carry a fixed rate of interest. These are bearer securities and generally the issue of such bonds may carry two options viz. call option and put option. A call option allows the company to force conversion if the market price of the shares exceeds a particular percentage of the conversion price. A put option allows the investors to get his money back before maturity. In the case of ECBs, the payment of interest and the redemption of the bonds will be made by the issuer company in US dollars. ECBs issues are listed at London or Luxemburg stock exchanges. An issuing company desirous of raising the ECBs is required to obtain prior permission of the Department of Economic Affairs, Ministry of Finance, Government of India, Companies having 3 years of good track record will only be permitted to raise funds. The condition is not applicable in the case of projects in infrastructure sector. The proceeds of ECBs would be permitted only for following purposes:

(i) Import of capital goods
(ii) Retiring foreign currency debts
(iii) Capitalising Indian joint venture abroad
(iv) 25% of total proceedings can be used for working capital and general corporate restructuring.

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

(3)
Write a short notes on Floating Rate Bonds?
Answer
Floating Rate Bonds:
These are the bonds where the interest rate is not fixed and is allowed to float depending upon the market conditions.
These are ideal instruments which can be resorted to by the issuers to hedge themselves against the volatility in the interest rates.
They have become more popular as a money market instrument and have been successfully issued by financial institutions like IDBI, ICICI etc.

(4)
Write a short notes on Packing Credit?
Packing Credit:
Packing credit is an advance made available by banks to an exporter. Any exporter, having at hand a firm export order placed with him by his foreign buyer on an irrevocable letter of credit opened in his favour, can approach a bank for availing of packing credit. An advance so taken by an exporter is required to be liquidated within 180 days from the date of its commencement by negotiation of export bills or receipt of export proceeds in an approved manner. Thus Packing Credit is essentially a short-term advance.
Normally, banks insist upon their customers to lodge the irrevocable letters of credit opened in favour of the customer by the overseas buyers. The letter of credit and firms' sale contracts not only serve as evidence of a definite arrangement for realisation of the export proceeds but also indicate the amount of finance required by the exporter. Packing Credit, in the case of customers of long standing may also be granted against firm contracts entered into by them with overseas buyers. Packing credit may be of the following types:
(i) Clean Packing credit: This is an advance made available to an exporter only on production of a firm export order or a letter of credit without exercising any charge or control over raw material or finished goods. It is a clean type of export advance. Each proposal is weighted according to particular requirements of the trade and credit worthiness of the exporter. A suitable margin has to be maintained. Also, Export Credit Guarantee Corporation (ECGC) cover should be obtained by the bank
(ii) Packing credit against hypothecation of goods: Export finance is made available on certain terms and conditions where the exporter has pledgeable interest and the goods are hypothecated to the bank as security with stipulated margin. At the time of utilising the advance, the exporter is required to submit alongwith the firm export order or letter of credit, relative stock statements and thereafter continue submitting them every fortnight and whenever there is any movement in stocks.
(iii) Packing credit against pledge of goods: Export finance is made available on certain terms and conditions where the exportable finished goods are pledged to the banks with approved clearing agents who will ship the same from time to time as

required by the exporter. The possession of the goods so pledged lies with the bank and is kept under its lock and key.

(5)
Write short notes on the following:

(a) ADRs
(b) IDRs
(c) GDRs

Answer:

American Depository Receipts (ADRs):

American Depository Receipts (ADRs) are securities offered by non- US companies who want to list on any of the US exchanges. It is a derivative instrument.
It represents a certain number of company's shares.
These are used by depository bank against a fee income. ADRs allow US investors to buy shares of these companies without the cost of investing directly in a foreign stock exchange.
ADRs are listed on either NYSE or NASDAQ.
It facilitates integration of global capital markets.
The company can use the ADR route either to get international listing or to raise money in international capital market.

Indian Depository Receipts (IDRs):

The concept of the depository receipt mechanism which is used to raise funds in foreign currency has been applied in the Indian capital market through the issue of Indian Depository Receipts (IDRs).
Foreign companies can issue IDRs to raise funds from Indian market on the same lines as an Indian company uses ADRs/GDRs to raise foreign capital.
The IDRs are listed and traded in India in the same way as other Indian securities are traded

Global Depository Receipts (GDRs):

It is a negotiable certificate denominated in US dollars which represents a Non-US company's publically traded local currency equity shares.
GDRs are created when the local currency shares of an Indian company are delivered to Depository's local custodian Bank against which the Depository bank issues depository receipts in US dollars.
The GDRs may be traded freely in the overseas market like any other dollar-expressed security either on a foreign stock exchange or in the over-the-counter market or among qualified institutional buyers.
By issue of GDRs Indian companies are able to tap global equity market to raise foreign currency funds by way of equity.
It has distinct advantage over debt as there is no repayment of the principal and service costs are lower.

(6)

Write the difference between American Depository Receipts & Global Depository Receipts.

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 world wide.	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.

(7)

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

Answer:

External Commercial Borrowings are loans taken from non-resident lenders in accordance with exchange control regulations. These loans can be taken from:

♦ International banks

♦ Capital markets

♦ Multilateral financial institutions like IFC, ADB, IBRD etc.

♦ Export Credit Agencies

♦ Foreign collaborators

♦ Foreign Equity Holders.

ECBs can be accessed under automatic and approval routes depending upon the purpose and volume.

In automatic there is no need for any approval from RBI / Government while approval is required for areas such as textiles and steel sectors restructuring packages.

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8. CAPITAL BUDGETING

(1)

Do the profitability index and the NPV criterion of evaluating investment proposals lead to the same acceptance-rejection and ranking decisions? In what situations will they give conflicting results?

Answer

In the most of the situations the Net Present Value Method (NPV) and Profitability Index (PI) yield same accept or reject decision.

In general items, under PI method a project is acceptable if profitability index value is greater than 1 and rejected if it less than 1.

Under NPV method a project is acceptable if Net present value of a project is positive and rejected if it is negative.

Clearly a project offering a profitability index greater than 1 must also offer a net present value which is positive. But a conflict may arise between two methods if a choice between mutually exclusive projects has to be made.

Consider the following example:

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

According to NPV method, project A would be preferred, whereas according to profitability index method project B would be preferred. This is because Net present value gives ranking on the basis of absolute value of rupees, whereas, profitability index gives ranking on the basis of ratio. Although PI method is based on NPV, it is a better evaluation technique than NPV in a situation of capital rationing.

(2)

Distinguish between Net Present Value and Internal Rate of Return.

Answer

NPV versus IRR: NPV and IRR methods differ in the sense that the results regarding the choice of an asset under certain circumstances are mutually contradictory under two methods.

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

The net present value is expressed in financial values whereas internal rate of return (IRR) is expressed in percentage terms.
In the net present value cash flows are assumed to be re-invested at cost of capital rate. In IRR reinvestment is assumed to be made at IRR rates.

(3)
Write a short note on internal rate of return.
Answer
Internal Rate of Return: It is that rate at which discounted cash inflows are equal to the discounted cash outflows. In other words, it is the rate which discounts the cash flows to zero. It can be stated in the form of a ratio as follows:

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

This rate is to be found by trial and error method. This rate is used in the evaluation of investment proposals. In this method, the discount rate is not known but the cash outflows and cash inflows are known.
In evaluating investment proposals, internal rate of return is compared with a required rate of return, known as cut-off rate. If it is more than cut-off rate the project is treated as acceptable; otherwise project is rejected.

(4)
What do you understand by desirability factor/profitability index?
Answer
Desirability Factor/Profitability Index 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 its
profitability index value is greater than 1.
Mathematically, the desirability factor is calculated as below:

$$\frac{\text{Sum of Discounted Cash inflows}}{\text{Initial Cash outlay or Total Discounted Cash outflow (as the case may be)}}$$

(5)
Write a short note on “Cut - off Rate”.
Answer
Cut - off Rate: It is the minimum rate which the management wishes to have from any project. Usually this is based upon the cost of capital. The management gains only if a project gives return of more than the cut - off rate. Therefore, the cut - off rate can be used as the discount rate or the opportunity cost rate.

(6)
Define Modified Internal Rate of Return method.
Answer

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

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

This results in a single stream of cash inflow in the terminal year. The MIRR is obtained by assuming a single outflow in the zeroth year and the terminal cash inflow as mentioned above. The discount rate which equates the present value of the terminal cash inflow to the zeroth year outflow is called the MIRR.

(7)

Explain the 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.

(8)

Explain the concept of Multiple Internal Rate of Return.

Answer

Multiple Internal Rate of Return (MIRR)

In cases where project cash flows change signs 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).

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 IRR1 and IRR2.

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9 - WORKING CAPITAL MANAGEMENT

(1)
Discuss the factors to be taken into consideration while determining the requirement of working capital.
Answer
Factors to be taken into consideration while determining the requirement of working capital:
(i) Production Policies
(ii) Nature of the business
(iii) Credit policy
(iv) Inventory policy
(v) Abnormal factors
(vi) Market conditions
(vii) Conditions of supply
(viii) Business cycle
(ix) Growth and expansion
(x) Level of taxes
(xi) Dividend policy
(xii) Price level changes
(xiii) Operating efficiency.

(2)
Discuss the estimation of working capital need based on operating cycle process.
Answer
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 cycle is the indicator of performance of management. The net operating cycle represents the time interval for which the firm has to negotiate 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

(3)
Enumerate the activities which are covered by Treasury Management.
Answer:
The functions of treasury department management is to ensure proper usage, storage and risk management of liquid funds so as to ensure that the organisation is able to meet its obligations, collect its receivables and also maximize the return on its investments.
Towards this end the treasury function may be divided into the following:
(i) Cash Management: The efficient collection and payment of cash both inside the organization and to third parties is the function of treasury department. Treasury normally manages surplus funds in an investment portfolio.
(ii) Currency Management: The treasury department manages the foreign currency risk exposure of the company. It advises on the currency to be used when invoicing overseas sales. It also manages any net exchange exposures in accordance with the company policy.
(iii) Fund Management: Treasury department is responsible for planning and sourcing the company's short, medium and long-term cash needs. It also participates in the decision on capital structure and forecasts future interest and foreign currency rates.
(iv) Banking: Since short-term finance can come in the form of bank loans or through the sale of commercial paper in the money market, therefore, treasury department carries out negotiations with bankers and acts as the initial point of contact with them.
(v) Corporate Finance: Treasury department is involved with both acquisition and disinvestment activities within the group. In addition, it is often responsible for investor relations.

(4)
What is factoring? Enumerate the main advantages of factoring.
Answer
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 main advantages of factoring are:

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

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

(iii) 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.

(iv) 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.

(5)

Explain the difference between the Factoring and Bill discounting

Answer

The differences between Factoring and Bills discounting are:

(a) Factoring is called as "Invoice Factoring' whereas Bills discounting is known as 'Invoice discounting."

(b) In Factoring, the parties are known as the client, factor and debtor whereas in Bills discounting, they are known as drawer, drawee and payee.

(c) Factoring is a sort of management of book debts whereas bills discounting is a sort of borrowing from commercial banks.

(d) For factoring there is no specific Act, whereas in the case of bills discounting, the Negotiable Instruments Act is applicable.

(6)

Explain the 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
(ii) Sales man's Report
(iii) Bank References
(iv) Trade References
(v) Published Financial Reports

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.

(7)
Enumerate the various forms of bank credit in financing the working capital of a business organization
Answer
Forms of Bank Credit
Some of the forms of bank credit are:
(i) Short Term Loans: In a loan account, the entire advance is disbursed at one time either in cash or by transfer to the current account of the borrower. It is a single advance and given against securities like shares, government securities, life insurance policies and fixed deposit receipts, etc.
(ii) Overdraft: Under this facility, customers are allowed to withdraw in excess of credit balance standing in their Current Account. A fixed limit is therefore granted to the borrower within which the borrower is allowed to overdraw his account.
(iii) Clean Overdrafts: Request for clean advances are entertained only from parties which are financially sound and reputed for their integrity. The bank has to rely upon the personal security of the borrowers.
(iv) Cash Credits: Cash Credit is an arrangement under which a customer is allowed an advance up to certain limit against credit granted by bank. Interest is not charged on the full amount of the advance but on the amount actually availed of by him.
(v) Advances against goods: Goods are charged to the bank either by way of pledge or by way of hypothecation. Goods include all forms of movables which are offered to the bank as security.
(vi) Bills Purchased/Discounted: These advances are allowed against the security of bills which may be clean or documentary.

Usance bills maturing at a future date or sight are discounted by the banks for approved parties. The borrower is paid the present worth and the bank collects the full amount on maturity.

(vii) Advance against documents of title to goods: A document becomes a document of title to goods when its possession is recognised by law or business custom as possession of the goods like bill of lading, dock warehouse keeper's certificate, railway receipt, etc. An advance against the pledge of such documents is an advance against the pledge of goods themselves.

(viii) Advance against supply of bills: Advances against bills for supply of goods to government or semi-government departments against firm orders after acceptance of tender fall under this category. It is this debt that is assigned to the bank by endorsement of supply bills and executing irrevocable power of attorney in favour of the banks for receiving the amount of supply bills from the Government departments.

(8)

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.

(9)

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

Answer

Different Kinds of Float with Reference to Management of Cash:

The term float is used to refer to the periods that affect cash as it moves through the different stages of the collection process.

Four kinds of float can be identified:

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

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

(iii) Cheque processing float: This is the time required for the seller to sort, record and deposit the cheque after it has been received by the company.

(iv) Bank processing float: This is the time from the deposit of the cheque to the crediting of funds in the seller's account.

(10)

Describe the three principles relating to selection of marketable securities.

Answer

Three Principles Relating to Selection of Marketable Securities

The three principles relating to selection of marketable securities are:

(i) Safety: Return and risk go hand-in-hand. As the objective in this investment is ensuring liquidity, minimum risk is the criterion of selection.

(ii) Maturity: Matching of maturity and forecasted cash needs is essential. Prices of long-term securities fluctuate more with changes in interest rates and are, therefore, riskier

(iii) Marketability: It refers to the convenience, speed and cost at which a security can be converted into cash. If the security can be sold quickly without loss of time and price, it is highly liquid or marketable.

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