IPCC

PAPER 3 (Part 2): FINANCIAL MANAGEMENT

(Theory Notes)

kanduruvinay@gmail.com

November-2009

Q .1 Explain briefly the limitations of Financial ratios. (2 Marks)

A. <u>The limitations of financial ratios are listed below:</u>

(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, debtequity 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.

(g) It is very difficult to generalise whether a particular ratio is good or bad: For example, a low current ratio may be said 'bad' from the point of view of low liquidity, but a high current ratio may not be 'good' as this may result from inefficient working capital management.

(h) Financial ratios are inter-related, not independent: Viewed in isolation one ratio may highlight efficiency. But when considered as a set of ratios they may speak differently. Such interdependence among the ratios can be taken care of through multivariate analysis.

(Note : We can write any four limitations)

Q.2 what do you understand by Business Risk and Financial Risk? (2 Marks)

A. Business Risk: 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.

Financial Risk: It is the risk borne by a shareholder when a firm uses debt in addition to equity financing in its capital structure. Generally, a firm should neither be exposed to high degree of business risk and low degree of financial risk or vice-versa, so that shareholders do not bear a higher risk.

Q.3 Differentiate between Factoring and Bills discounting. (2 Marks)

A. 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.

kanduruvinay@gmail.com

(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.

Q.4 Differentiate between Financial Management and Financial Accounting. (2 Marks)
A. Though financial management and financial accounting are closely related, still they differ inthe treatment of funds and also with regards to decision - making.
Treatment of Funds: In accounting, the measurement of funds is based on the accrual principle. The accrual based accounting data do not reflect fully the financial conditions of the organisation. An organisation which has earned profit (sales less expenses) may said to beprofitable in the accounting sense but it may not be able to meet its current obligations due to shortage of liquidity as a result of say, uncollectible receivables. Whereas, the treatment 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). Thus, cash flow based returns help financial managers to avoid insolvency and achieve desired financial goals.
Decision-making: The chief focus of an accountant is to collect data and present the data while the financial manager's primary responsibility relates to financial planning, controlling and decision-making. Thus, in a way it can be stated that financial management begins where financial accounting ends.

Q.5 Explain the two basic functions of Financial Management. (3 Marks)
A. Procurement of Funds: Funds can be obtained from different sources having different characteristics in terms of risk, cost and control. The funds raised from the issue of equity shares are the best from the risk point of view since repayment is required only at the time of liquidation. However, it is also the most costly source of finance due to dividend expectations of shareholders. On the other hand, debentures are cheaper than equity shares due to their tax advantage. However, they are usually riskier than equity shares. There are thus risk, cost and control considerations which a finance manager must consider while procuring funds. The cost of funds should be at the minimum level for that a proper balancing of risk and control factors must be carried out.
Effective Utilization of Funds: The Finance Manager has to ensure that funds are not kept idle or there is no improper use of funds. The funds are to be invested in a manner such that they generate returns higher than the cost of capital to the firm. Besides this, decisions to invest in fixed assets are to be taken only after sound analysis using capital budgeting techniques. Similarly, adequate working capital should be maintained so as to avoid the risk of insolvency.

Q.6 Explain the following terms: (3 Marks)
(a) Ploughing back of profits
(b) Desirability factor.
A. (a) Ploughing Back of Profits: Long term funds may also be provided by accumulating the profits of the company and by 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

kanduruvinay@gmail.com

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.
(b)Desirability Factor: 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 than1.
Mathematically,

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

Q.7 What do you understand by Weighted Average Cost of Capital? (3 Marks)
A. Weighted Average Cost of Capital:
The composite or overall cost of capital of a firm is the weighted average of the costs of various sources of funds. Weights are taken in proportion of each source of funds in Capital structure while making financial decisions. The weighted average cost of capital is calculated by calculating the cost of specific source of fund and multiplying the cost of each source by its proportion in capital structure. Thus, weighted average cost of capital is the weighted average after tax costs of the individual components of firm's capital structure. That is, the after tax cost of each debt and equity is calculated separately and added together to a single overall cost of capital.

<u>May-2010</u>

Q.8 ***What do you understand by Capital structure? How does it differ from Financial structure?*** **(2 Marks)**
A. 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.

Q.9 ***Explain briefly the accounts receivable systems.*** **(2 Marks)**
A. 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.10 ***Briefly discuss the concept of seed capital assistance.*** **(2 Marks)**
A. It is a scheme designed by IDBI for professionally or technically qualified entrepreneurs and/or persons possessing relevant experience, skills and entrepreneurial traits. All the projects

kanduruvinay@gmail.com

eligible for financial assistance from IDBI, directly or indirectly through refinance, are eligible under the scheme. The assistance is interest-free but carries a service charge of one percent per annum for the first five years and at an increasing rate thereafter. The project cost should not exceed Rs. 2 crores and the maximum assistance under the project will be restricted to 50 percent of the required promoter's contribution or Rs.15 lacs whichever is lower.

Q.11 Enumerate *the various forms of bank credit in financing working capital of a business organization.* ***(*2 Marks)**

***A*. Forms of Bank Credit**

The various forms of bank credit in financing the working capital of a business Organizations are:

(a) Cash credit;
(b) Bank overdraft;
(c) Bills discounting;
(d) Bill acceptance;
(e) Line of credit;
(f) Letter of credit; and
(g) Bank guarantees.

Q.12 *State the role of a Chief Financial Officer*. ***(3* Marks)**

A. Role of a Chief Financial Officer (CFO)

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

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

Q.13 *Distinguish between Funds Flow Statement and Cash Flow Statement.* ***(3* Marks)**

A. (a) Funds flow statement is based on the accrual accounting system. In case of preparation of cash flow statement all transactions affecting the cash equivalents only are taken into consideration.

(b) Funds flow statement analyses the sources and applications of funds which are long-term in nature and the net increase in long-term funds will be reflected on the working capital of the firm. The Cash flow statement will only consider the increase or decrease in current assets and current liabilities in calculating the cash flow of funds from operations.

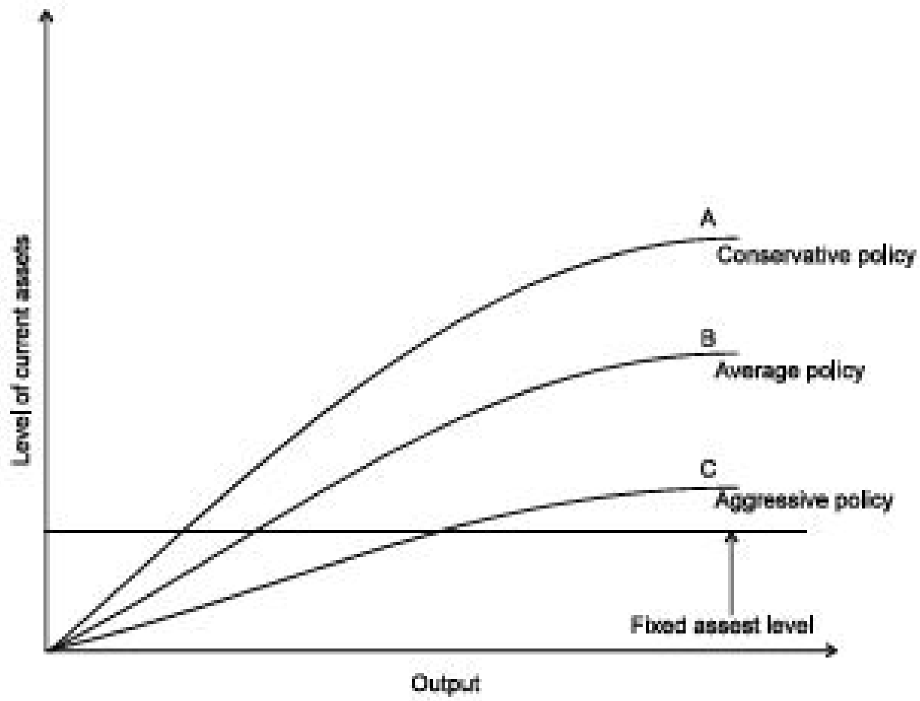
(c) Funds flow analysis is more useful for long-range financial planning. Cash flow analysis is more useful for identifying and correcting the current liquidity problems of the firm.

(d) Funds flow statement tallies the funds generated from various sources with various uses to which they are put. Cash flow statement tallies difference between opening balance of cash and closing balance of cash by proceeding through sources and uses.

kanduruvinay@gmail.com

November-2010

Q.14 ***Discuss the liquidity vs. profitability issue in management of working capital.(4Marks)***
A. Working capital management entails the control and monitoring of all components of working capital i.e. cash, marketable securities, debtors, creditors etc. Finance manager has to pay particular attention to the levels of current assets and their financing. To decide the level of financing of current assets, the risk return trade off must be taken into account. The level of current assets can be measured by creating a relationship between current assets and fixed assets. A firm may follow a conservative, aggressive or moderate policy.



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

Q.15 ***Distinguish between the following:***
(i) Profit maximization vs. Wealth maximization objective of the firm. (4 Marks)
(ii) Global Depository Receipts and American Depository Receipts (4 Marks)
A. (i) Profit Maximization versus Wealth Maximization Principle of the Firm
The primary objective of a company is to earn profit; hence the objective of financial management is also profit maximisation. This implies that the finance manager has to make his decisions in a manner so that the profits of the concern are maximised.
Each alternative, therefore, is to be seen as to whether or not it gives maximum profit. The company may pursue profit maximization goal but that may not result into creation of

kanduruvinay@gmail.com

shareholder value. Profit maximization is at best a limited objective. It does not take into account the time pattern of returns and it is a narrow objective. Whereas, Wealth maximisation, on the other hand, means that the company is using its resources in a good manner. If the share value is to stay high the company has to reduce its costs and use the resources properly. Goal of wealth maximization means that the company will promote only those policies that will lead to efficient allocation of resources.

(ii) Global Depository Receipts (GDRs) and American Depository Receipts (ADRs)

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

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

Q.16 ***Discuss the estimation of working capital need based on operating cycle process.***

(4 Marks)

A. 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.

Q.17 ***Discuss financial break-even and EBIT-EPS indifference analysis.*** ***(4 Marks)***

A. 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.

kanduruvinay@gmail.com

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

Where,

EBIT = Indifference point

E1 = Number of equity shares in Alternative 1

E2 = Number of equity shares in Alternative 2

I1 = Interest charges in Alternative 1

12 = Interest charges in Alternative 2

T = Tax-rate

Alternative 1= All equity finance

Alternative 2= Debt-equity finance.

May-2011

Q.18 ***what is factoring? Enumerate the main advantages of factoring*.** **(5 Marks)**

A. 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.

Q.19 ***What is debt securitization? Explain the basic debt securitization process.*** **(4 Marks)**

A. Debt Securitisation and its Basic Process: It is a method of recyling 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 receivable.

Process of Debt securitization

(i) The Origination Function: A borrower seeks a loan from finance company, bank, etc., the credit worthiness of borrower is evaluated and contract is entered into with repayment schedule structured over the life of the loan.

kanduruvinay@gmail.com

(ii) The Pooling Function: Similar loans or receivables are clubbed together to create an underlying pool of assets. The pool is transferred in favour of special purpose vehicle (SPV), which acts as a trustee for investors.

(iii) The Securitization Function: SPV will structure and issue securities on the basis of assets pool. The securities carry a coupon and expected maturity, which can be asset based/mortgage based. These are generally sold to investors through merchant bankers. Investors are pension funds, mutual funds and insurance funds.

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

Q.20 ***Write short note on William J. Baumal Vs. Miller-Orr cash management model.***

(4 Marks)

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

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

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

Where,

C = Optimum cash balance

U = Annual (monthly) cash disbursements

P = Fixed cost per transaction

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

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

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

kanduruvinay@gmail.com

November-2011

Q.21 Distinguish between:
(i) Operating lease and financial lease, and ***(4 Marks)***
(ii) Net present value method and internal rate of return method. ***(4 Marks)***
A. (i)

S.No.	Finance Lease	Operating Lease
1	The risk and reward incident to ownership are passed on the lessee. The lessor 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 lessee is only allowed the use of asset.
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 or operations.	Usually, the lessor bears the cost of repairs, maintenance or operations.
5	The lease is usually full payout.	The lease is usually non-payout.

(ii) Difference between Net Present Value (NPV) Method and Internal Rate of Return (IRR) Method

1. The results of NPV and IRR methods regarding the choice of an asset under certain circumstances are mutually contradictory under two methods.
2. The NPV is expressed in financial values whereas IRR is expressed in percentage terms.
3. In the NPV, cash flows are assumed to be reinvested at cost of capital rate whereas in IRR, reinvestment is assumed to be made at IRR rates.
4. Under IRR method, a project is selected when IRR is greater than cut-off date, whereas, under NPV method, a project is accepted with positive NPV.

Q.22 ***(a) Elucidate the responsibilities of Chief Financial Officer.*** ***(4 Marks)***
(b) Explain the relevance of time value of money. ***(4 Marks)***
(c) Discuss ABC analysis as a system of inventory control ***(4 Marks)***
(d) Explain the following:
(i) Bridge finance ***(2 Marks)***
(ii) Essentials of budget ***(2 Marks)***

A. <u>(a) Main Responsibilities of Chief Financial Officer (CFO)</u>

The main responsibilities of Chief Financial Officer (CFO) are as follows:

1 Financial analysis and planning.
2. Investment decisions - Efficient utilization of funds to specific assets/projects.
3. Capital structure decisions.
4. Management of short-term financial resources (working capital).

kanduruvinay@gmail.com

5. Risk management.

(b) Relevance of Time Value of Money in Financial Decisions

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

1. Risk: There is uncertainty about the receipt of money in future.

2. Preference for Present Consumption: Most of the person and companies in general, prefer current consumption over future consumption.

3. Inflation: In an inflationary period a rupee today represents a greater real purchasing power than a rupee after a year.

4. Investment Opportunities: Most of the persons and companies have a preference for present money because of availabilities of opportunities of investment for earning additional cash flow.

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

(c) ABC analysis exercises discriminating control over different items of stores classified on the basis of investment involved.

'**A**' category items consists of only a small proportion i.e. approximately 10% of total items of stores but needs huge investment. Say about 70% of inventory vogue, because of their high prices or heavy requirement.

'B' category items are relatively 20% of the total items of stoles. The proportion of investments requires is also approximately 20% of total inventory investment.

'C' category items do not require much investment. It may be about 10% total inventory value but they are nearly 70% of the total items of stores.

(d) (i) Bridge Finance

It refers to loans taken by a company normally from commercial banks for a short period because of pending disbursement of loans sanctioned by financial institutions.

(ii) Essentials of budget

· It is prepared in advance and is based on a future plan of actions
· It relates to a future period and is based on objectives to be attained.
· It is a statement expressed in monetary and/or physical units prepared for the Implementation of policy formulated by management.

May-2012

Q.23 ***Discuss factors that a venture capitalist should consider before financing any risky project.*** ***(4 Marks)***

A. (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.

kanduruvinay@gmail.com

(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.
(Note: We can answer any four of the above factors)

Q.24 ***What is Net Operating income theory of capital structure? Explain the assumptions on which the NOI theory is based.*** ***(4 Marks)***
A. According to this approach, there is no relationship between the cost of capital and value of the firm. The value of the firm is independent of the capital structure of the firm.
Assumptions of NOI Approach
(a) There are no taxes.
(b) The market capitalizes the value of the firm as a 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 i.e. increase in cost of equity (Ke). The increase in cost of equity is such as completely offset the benefits of using cheaper debt.
(d) The overall cost of capital remains same for all degrees of debt equity mix.

Q.25 ***"The profit maximization is not an operationally feasible criterion." Comment on it.*** ***(4 Marks)***
A. The above statement is true because Profit maximisation can be a short-term objective for any organisation and cannot be its sole objective. Profit maximization fails to serve as an operational criterion for maximizing the owner's economic welfare. It fails to provide an operationally feasible measure for ranking alternative courses of action in terms of their economic efficiency. It suffers from the following limitations:
(i) Vague term: The definition of the term profit is ambiguous. Does it mean short term or long term profit? Does it refer to profit before or after tax? Total profit or profit per share? **(ii) Timing of Return:** The profit maximization objective does not make distinction between returns received in different time periods. It gives no consideration to the time value of money, and values benefits received today and benefits received after a period as the same.
(iii) It ignores the risk factor.
(iv) The term maximization is also vague.

Q.26 ***Explain the important ratios that would be used in each of the following situations:***
(i) A bank is approached by a company for a loan of ` 50 lakh for working capital purposes. ***(1 Mark)***
(ii) A long term creditor interested in determining whether his claim is adequately secured. ***(1 Mark)***
(iii) A shareholder who is examining his portfolio and who is to decide whetherr he should hold or sell his holding in the company. ***(1 Mark)***
(iv) A finance manager interested to know the effectiveness with which a firm uses its available resources. ***(1 Mark)***
A. (i) Liquidity Ratios- Here Liquidity or short-term solvency ratios would be used by the bank to check the ability of the company to pay its short-term liabilities. A bank may use Current ratio and Quick ratio to judge short terms solvency of the firm.
(ii) Capital Structure/Leverage Ratios- Here the long-term creditor would use the capital

kanduruvinay@gmail.com

structure/leverage ratios to ensure the long term stability and structure of the firm. A long term creditors interested in the determining whether his claim is adequately secured may use Debt-service coverage and interest coverage ratio.

(iii) Profitability Ratios- The shareholder would use the profitability ratios to measure the profitability or the operational efficiency of the firm to see the final results of business operations. A shareholder may use return on equity, earning per share and dividend per share.

(iv) Activity Ratios- The finance manager would use these ratios to evaluate the efficiency with which the firm manages and utilises its assets. Some important ratios are (a) Capital turnover ratio (b) Current and fixed assets turnover ratio (c) Stock, Debtors and Creditors turnover ratio.

Q.27 ***Write short notes on the following:***
(i) Deep Discount Bonds ***(2 Marks)***
(ii) Angle of Incidence ***(2 Marks)***

A. (i) Short Note on Deep Discount Bonds

Deep Discount Bonds is a 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 the first to issue a deep discount bond in India in January, 1992. The investor could hold the bond for 26 years or seek redemption at the end of every five years with a specified maturity value.

(ii) Angle of incidence

This angle is formed by the intersection of sales line and total cost line at the breakeven point. This angle shows the rate at which profits are being earned once the break-even point has been reached. The wider the angle the greater is the rate of earning profits. A large angle of incidence with a high margin of safety indicates extremely favourable position.

Q.28 ***Discuss basic assumptions of Cost Volume Profit analysis.*** ***(4 Marks)***

A. (i) Changes in the levels of revenues and costs arise only because of changes in the number of products (or service) units produced and sold.
(ii) Total cost can be separated into two components: Fixed and variable
(iii) Graphically, the behaviour of total revenues and total cost are linear in relation to output level within a relevant range.
(iv) Selling price, variable cost per unit and total fixed costs are known and constant.
(v) All revenues and costs can be added, sub traded and compared without taking into account the time value of money.

November-2012

Q.29 ***List the fundamental principles governing capital structure.*** ***(4 Marks)***

A. **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.

kanduruvinay@gmail.com

(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.
(Note: *We can answer any four of the above principles.***)**

Q.30 ***Discuss the conflicts in profit verses wealth maximization principle of the firm.***
(4 Marks)

A. **(a) Conflict in Profit versus Wealth Maximization Principle of the Firm**
Profit maximisation 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.

Q.31 ***State the considerations on which capital expenditure budget is prepared. (4 Marks)***
A. **The preparation of Capital Expenditure Budget is based on the following considerations:**
1. Overhead on production facilities of certain departments as indicated by the plant utilisation budget.
2. Future development plans to increase output by expansion of plant facilities.
3. Replacement requests from the concerned departments
4. Factors like sales potential to absorb the increased output, possibility of price reductions, increased costs of advertising and sales promotion to absorb increased output, etc.

Q.32 ***Distinguish between business risk and financial risk.*** ***(4 Marks)***
A. 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.

kanduruvinay@gmail.com

Q.33 ***What are the forms of bank credit?*** ***(4 Marks)***

A. 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.

(Note: *We can answer any four of the above forms of bank credit.***)**

Q.34 ***"Financing a business through borrowing is cheaper than using equity." Briefly explain.*** ***(4 Marks)***

A. (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.

kanduruvinay@gmail.com

May-2013

Q.35 Answer the following, supporting the same with reasoning/working notes:

(a) "Debtors Turnover is a measure of Debt Service capacity of a firm". Do you agree with this statement? Explain.

(b) Ratio Analysis can be used to study liquidity, turnover, profitability, etc. of a firm. What does Debt-Equity Ratio help to study?

(c) "Equity capital does not carry any cost." Do you agree with this statement? Explain.

(d) "In a closed-ended lease, the lessee has the option of purchasing the asset at the end of the lease period." Do you agree with this statement? Explain.

(e) What are Certificates of Deposits? Explain in brief.

A. **(a)** No, the statement is incorrect. Interest Coverage Ratio is the measure of Debt Service capacity of a firm while debtor's turnover ratio throws light on the collection and credit policies of the firm.

(b) Debt-Equity Ratio is an indicator of leverage of a firm. A high ratio means less protection for creditors while a low ratio indicates a wider safety cushion.

(c) No, the statement is incorrect. The cost of ordinary shares is usually the highest. This is due to the fact that such shareholders expect a higher rate of return (as their risk is the highest) on their investment as compared to other suppliers of long-term funds.

(d) No, the statement is incorrect. In fact, in the open-ended lease, the lessee has the option of purchasing the asset at the end of the lease period while in the closeended lease, the assets get transferred to the lessor at the end of lease, the risk of obsolescence, residual value etc., remain with the lessor being the legal owner of the asset.

(e) The certificate of deposit is a document of title similar to a time deposit receipt issued by a bank except that there is no prescribed interest rate on such funds. The main advantage of CD is that banker is not required to encash the deposit before maturity period and the investor is assured of liquidity because he can sell the CD in secondary market.

Q.36 Differentiate ***between the following:***

(a) Deep Discount Bonds and Zero Coupon Bonds

(b) Investment Decision and Financing Decision

(c) Operating Leverage and Financial Leverage.

A. (a) Deep Discount Bonds and 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 ` 2,700 with a maturity period of 25 years.

On the other hand, 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.

(b) Investment Decision and Financing Decision: The investment of long term funds is made after a careful assessment of the various projects through capital budgeting

kanduruvinay@gmail.com

and uncertainty analysis. However, only that investment proposal is to be accepted which is expected to yield at least so much return as is adequate to meet its cost of financing. This have an influence on the profitability of the company and ultimately on its wealth. Such types of decisions are known as investment decisions.
On the other hand, Financing Decisions relate to raising of funds from various sources. Each source of funds involves different issues. The finance manager has to maintain a proper balance between long-term and short-term funds. With the total volume of long-term funds, he has to ensure a proper mix of loan funds and owner's funds. The optimum financing mix will increase return to equity shareholders and thus maximise their wealth.
(c) 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% change in profits due to change in sales level is greater than the % 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.

November-2013

Q.37 ***What is Virtual Banking? State its advantages.*** ***(4 Marks)***
A. Virtual banking refers to the provision of banking and related services through the use of information technology without direct recourse to the bank by the customer.
The **advantages of virtual banking** services are as follows:
- Lower cost of handling a transaction.
- The increased speed of response to customer requirements.
- The lower cost of operating branch network along with reduced staff costs leads to cost efficiency.
- Virtual banking allows the possibility of improved and a range of services being made available to the customer rapidly, accurately and at his convenience.

(Note: *We can answer any two of the above advantages)*

Q.38 What is Over capitalisation? State its causes and consequences ***(4 Marks)***
A. It is a situation where a firm has more capital than it needs or in other words assets are worth less than its issued share capital, and earnings are insufficient to pay dividend and interest.
Causes of Over Capitalization
Over-capitalisation arises due to following reasons:
(i) Raising more money through issue of shares or debentures than company can employ profitably.

kanduruvinay@gmail.com

(ii) Borrowing huge amount at higher rate than rate at which company can earn.
(iii) Excessive payment for the acquisition of fictitious assets such as goodwill etc.
(iv) Improper provision for depreciation, replacement of assets and distribution of dividends at a higher rate.
(v) Wrong estimation of earnings and capitalization.
(Note:** We can answer any two of the above reasons**)

Consequences of Over-Capitalisation

Over-capitalisation results in the following consequences:
(i) Considerable reduction in the rate of dividend and interest payments.
(ii) Reduction in the market price of shares.
(iii) Resorting to "window dressing".
(iv) Some companies may opt for reorganization. However, sometimes the matter gets worse and the company may go into liquidation.
(Note:** We can answer any two of the above consequences**)

Q.39 What is the meaning of Margin of Safety (MOS)? State the relationship between Operating Leverage and Margin of Safety Ratio. (4 Marks)

A. Margin of Safety (MoS) is the excess of total sales over the Break even sales. MoS defines the amount upto which level sales can decline before occurring loss.

Therefore MoS = Total Sales – Break even sales and MoS ratio = $\frac{\text{Sales - Break even sales}}{\text{Sales}}$ Break even sales

(BE sales) will depend on contribution margin (BE sales = Fixed Cost ÷ Contribution margin). Contribution margin is related to operating leverage also. Operating leverage is calculated as Contribution ÷ Operating profit and contribution margin plays an important role in it. If sales are expected to increase, higher operating leverage will result in higher profit. When sales are expected to decrease, lower operating leverage will result in higher profit. Higher variable cost and lower fixed cost will result into higher MoS and risk will be lower and vice versa.
So like Operating leverage, MoS is a measure of risk as to what extent an organisation is exposed to change in sales volume.

Q.40 Describe the steps involved in the budgetary control technique. (4 Marks)

A. There are certain steps involved in the budgetary control technique. They are as follows:
(i) Definition of objectives: A budget being a plan for the achievement of certain operational objectives, it is desirable that the same are defined precisely. The objectives should be written out; the areas of control demarcated; and items of revenue and expenditure to be covered by the budget stated.
(ii) Location of the key (or budget) factor: There is usually one factor (sometimes there may be more than one) which sets a limit to the total activity. Such a factor is known as key factor. For proper budgeting, it must be located and estimated properly.
(iii) Appointment of controller: Formulation of a budget usually required whole time services of a senior executive known as budget controller; he must be assisted in this work by a Budget Committee, consisting of all the heads of department along with the Managing Director as the Chairman.
(iv) Budget Manual: Effective budgetary planning relies on the provision of adequate

information which are contained in the budget manual. A budget manual is a collection of documents that contains key information for those involved in the planning process.

(v) Budget period: The period covered by a budget is known as budget period. The Budget Committee determines the length of the budget period suitable for the business. It may be months or quarters or such periods as coincide with period of trading activity.

(vi) Standard of activity or output: For preparing budgets for the future, past statistics cannot be completely relied upon, for the past usually represents a combination of good and bad factors. Therefore, though results of the past should be studied but these should only be applied when there is a likelihood of similar conditions repeating in the future.

Q.41 ***'Management of marketable securities is an integral part of investment of cash.' Comment.*** ***(4 Marks)***

A. Management of marketable securities is an integral part of investment of cash as it serves both the purposes of liquidity and cash, provided choice of investment is made correctly. As the working capital needs are fluctuating, it is possible to invest excess funds in some short term securities, which can be liquidated when need for cash is felt.

The selection of securities should be guided by three principles namely safety, maturity and marketability.

Q.42 ***What do you mean by capital structure? State its significance in financing decision.*** ***(4 Marks)***

A. Capital structure refers to the mix of a firm's capitalisation i.e. mix of long-term sources of funds such as debentures, preference share capital, equity share capital and retained earnings for meeting its total capital requirement.

Significance in Financing Decision

The capital structure decisions are very important in financial management as they influence debt – equity mix which ultimately affects shareholders return and risk. These decisions help in deciding the forms of financing (which sources to be tapped), their actual requirements (amount to be funded) and their relative proportions (mix) in total capitalisation. Therefore, such a pattern of capital structure must be chosen which minimises cost of capital and maximises the owners' return.

Q.43 ***State the main elements of leveraged lease.*** ***(2 Marks)***

A. Under this lease, a third party is involved beside lessor and lessee. The lessor borrows a part of the purchase cost (say 80%) of the asset from the third party i.e., lender. The asset so purchased is held as security against the loan. The lender is paid off from the lease rentals directly by the lessee and the surplus after meeting the claims of the lender goes to the lessor. The lessor is entitled to claim depreciation allowance.

kanduruvinay@gmail.com