VIVITSU
STRIVING TOWARDS KNOWLEDGE

Paper 6

# Financial Management & Strategic Management

## Chapter-wise compilation of RTPs, MTPs and PYPs

NEW *Modified as per new scheme*

*Applicable for Sept'24 & Jan'25*

# SAMPLE MATERIAL

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# HOW TO GET THE BEST OUT OF OUR MATERIAL?

## 1 INITIAL READING

After your initial reading of a particular chapter in your study material, go through the questions in our 3, 5, and 11 attempt's compilations, focusing on the chapter you've just covered. Make note of challenging questions for later reference.

## 2 FIRST REVISION

During your first revision, revisit the marked questions. If you still can't answer them, highlight them in red and review the related concepts to improve your understanding. This process helps you to grasp the key concepts and address your weak points

## 3 KEEP GOING WITH THE REVISIONS

Repeat the reading and revision process as often as possible before your exams. Each iteration will enhance your confidence and knowledge.

## 4 EXAMINERS COMMENTS

Pay attention to the examiner's comments in our compilations, as they highlight common mistakes. Learning from these errors will help you avoid them in your exams

# Frequently Asked Questions

1. **Why RTP's, MTP's and PYP's?**
   RTP's, MTP's, and PYP's are extremely important to ensure that you reproduce ICAI language. These questions train you to understand what is important and what is expected of you.
   At least 41% of questions* are asked from previous RTP's, MTP's and PYP's.

2. **What is included?**
   In this compiler, all questions from the last 3, 5 or 11 attempts depending on the one you have selected will be available. There will be references to the marks and the attempt from which they were asked. Identical or similar questions have been removed and references for both attempts are mentioned.

3. **What is the benefit of Chapter-wise?**
   We have categorized each and every question from all Old RTPs, MTP's, and PYP's into chapters. This means that you don't have to wait until you've completed your entire syllabus to tackle an RTP, MTP, or past paper. You can start solving these questions to check your conceptual clarity right after finishing a particular chapter.

4. **What does amended for the latest attempt mean?**
   When we reviewed all the questions from the past 11 attempts of RTP, MTP, and PYP'S, we didn't just segregate them Chapterwise; we also updated them to reflect the latest provisions. All the answers provided in the compilation are applicable for the May 2024 examination. So, there's no need to stress about outdated or incorrect information.

5. **How are Old RTP's, MTP's & PYP's beneficial for me?**
   All old RTPs, MTPs, and PYPs have been organized according to the new syllabus issued by ICAI. This means that if a specific chapter from the old scheme is not included in the new scheme, it has been omitted. If a particular chapter in the new scheme is based on concepts from two or more chapters in the old scheme, it has been adapted to align with how the chapter should be in the new scheme. If a chapter is only partially included in the new scheme, the questions related to those specific concepts are only included in the corresponding chapter of the new scheme. A comprehensive reconciliation of the chapters between the new scheme and the old scheme is provided on the following page.

6. **What if a new attempt is added post my purchase?**
   If you have purchased materials for the May 2024 attempt, you will receive a file with the questions segregated Chapterwise specifically for that attempt.

7. **What does N/A mean?**
   It could mean any of the following:
   1. No questions from that chapter have been included in the selected attempts.
   2. The chapter is newly introduced, and as a result, no questions have been previously asked in RTP's, MTP's, or PYP's.

*This is on an average based on the last 11 attempts

# Financial Management & Strategic Management

Reconciliation of chapters of the new scheme (May'24) with old course

| New Chapter No. | **Chapter Name as per New Syllabus** | **Old Chapter No.** | **Old Chapter Name** |
|---|---|---|---|
| **Section A: Financial Management** | | | |
| **1** | Scope and Objectives of Financial Management | 1 | Scope and Objectives of Financial Management |
| **2** | Types of Financing | 2 | Types of Financing |
| **3** | Financial Analysis and Planning – Ratio Analysis | 3 | Financial Analysis and Planning – Ratio Analysis |
| **4** | Cost of Capital | 4 | Cost of Capital |
| **5** | Financing Decisions – Capital Structure | 5 | Financing Decisions – Capital Structure |
| **6** | Financing Decisions – Leverages | 6 | Financing Decisions – Leverages |
| | **MODULE 2** | | |
| **7** | Investment Decisions | 7 | Investment Decisions |
| **8** | Dividend Decision | 9 | Dividend Decision |
| 9 | **Management of Working Capital** | | |
| **9.1** | Introduction to Working Capital Management | 10.1 | Introduction to Working Capital Management |
| **9.2** | Treasury and Cash Management | 10.2 | Treasury and Cash Management |
| **9.3** | Management of Inventory | 10.3 | Management of Inventory |
| **9.4** | Management of Receivables | 10.4 | Management of Receivables |
| **9.5** | Management of Payables (Creditors) | 10.5 | Management of Payables (Creditors) |
| **9.6** | Financing of Working Capital | 10.6 | Financing of Working Capital |
| | | | |
| **Section B: Strategic Management** | | | |
| **1** | Introduction to Strategic Management | 6,8 | Introduction to Strategic Management & Strategic Management Process |
| **2** | Strategic Analysis: External Environment | 7,10 | Dynamics of Competitive Strategy & Business Level Strategies |
| **3** | Strategic Analysis: Internal Environment | 7,10,11 | Dynamics of Competitive Strategy, Business & Functional Level Strategies |
| **4** | Strategic Choices | 9 | Corporate Level Strategies |
| **5** | Strategy Implementation and Evaluation | 8,12,13 | Strategic Management Process, Organisation & Strategic Leadership and Strategy Implementation & Control |

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## Table of Contents



**MTPs:** March'19, April'19, Oct'19, May'20, Oct'20, March'21, April'21, Oct '21, Nov '21, March '22, April '22, Sep '22, Oct '22, March '23, April '23,Sep '23 ,Oct '23,March'24 & April '24

**PYPs:** May'19, Nov'19, Nov'20, Jan'21, July '21, Dec '21, May'22, Nov '22, May'23, Nov'23

**RTPs:** May'19, Nov'19, May'20, Nov'20, May'21, Nov '21, May '22, Nov '22, May '23, Nov '23, May'24

# Chapter 1
# Scope & Objectives of Financial Management

**Question 1**

**STATE Agency Cost. DISCUSS The Ways to Reduce the Effect of It. (MTP 4 Marks, Aug'18)**

**OR**

**DISCUSS Agency Problem and Agency Cost.**

**(MTP 4 Marks, Oct'20, MTP 4 Marks March '23, MTP 4 Marks Apr'21, MTP 5 Marks April '23, RTP Nov 20, May'22 & Nov '23)**

**Answer 1**

**Agency Cost:** In a sole proprietorship firm, partnership etc., owners participate in management but in corporate, owners are not active in management so, there is a separation between owner/ shareholders and managers. In theory managers should act in the best interest of shareholders however in reality, managers may try to maximize their individual goal like salary, perks etc., so there is a principal-agent relationship between managers and owners, which is known as Agency Problem. In a nutshell, Agency Problem is the chances that managers may place personal goals ahead of the goal of owners. Agency Problem leads to Agency Cost. Agency cost is the additional cost borne by the shareholders to monitor the manager and control their behavior so as to maximize shareholder's wealth. Generally, Agency Costs are of four types (I) monitoring (ii) bonding (iii) opportunity (iv) structuring

**Addressing the agency problem**

The agency problem arises if manager's interests are not aligned to the interests of the debt lender and equity investors. The agency problem of debt lender would be addressed by imposing negative covenants i.e. the managers cannot borrow beyond a point. This is one of the most important concepts of modern day finance and the application of this would be applied in the Credit Risk Management of Bank, Fund Raising, Valuing distressed companies.

Agency problem between the managers and shareholders can be addressed if the interests of the managers are aligned to the interests of the share- holders. It is easier said than done.

However, following efforts have been made to address these issues:

(A) Managerial compensation is linked to profit of the company to some extent and also with the long term objectives of the company.

(B) Employee is also designed to address the issue with the underlying assumption that maximisation of the stock price is the objective of the investors.

(C) Effecting monitoring can be done.

**Question 2**

**EXPLAIN as to how the wealth maximization objective is superior to the profit maximization objective What is the cost of these sources? [MTP 4 Marks, Mar'19] (RTP May '24)**

**Answer 2**

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

**(i)** The maximization of firm's profit.

**(ii)** The maximization of firm's value / wealth.

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

1. The value maximization objective of a firm considers all future cash flows, dividends, earning per share, risk of a decision etc. whereas profit maximization 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 maximize the shareholder's wealth may pay regular dividends whereas a firm with the objective of profit maximization 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 maximization 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 maximization can be considered as a part of the wealth maximization strategy.

**Question 3**

**DISCUSS the Inter relationship between investment, financing and dividend decisions.**
**(MTP 4 Marks, Oct'19]**

**OR**

**DISCUSS the three major decisions taken by a finance manager to maximize the wealth of shareholders.**
**(MTP 4 Marks, Oct'18)**

**OR**

**BRIEFLY explain the three finance function decisions.**
**[MTP 4 Marks, Oct'21, RTP Nov '19, RTP May'19, PYP 3 Marks Nov'19)**

**OR**

**What are the two main aspects of the Finance Function? (PYP 2 Marks, May '18, Old & New SM)**

**Answer 3**

**Inter-relationship between Investment, Financing and Dividend Decisions**: The finance functions are divided into three major decisions, viz., investment, financing and dividend decisions. It is correct to say that these decisions are inter-related because the underlying objective of these three decisions is the same, i.e. maximization of shareholders' wealth. Since investment, financing and dividend decisions are all interrelated, one has to consider the joint impact of these decisions on the market price of the company's shares and these decisions should also be solved jointly. The decision to invest in a new project needs the finance for the investment. The financing decision, in turn, is influenced by and influences dividend decision because retained earnings used in internal financing deprive shareholders of their dividends. An efficient financial management can ensure optimal joint decisions. This is possible by evaluating each decision in relation to its effect on the shareholders' wealth.

The above three decisions are briefly examined below in the light of their inter-relationship and to see how they can help in maximizing the shareholders' wealth i.e. market price of the company's shares.

**Investment decision:** The investment of long term funds is made after a careful assessment of the various projects through capital budgeting 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.

**Financing decision:** Funds can be raised from various sources. Each source of funds involves different issues. The finance manager has to maintain a proper balance 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 maximize their wealth.

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

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

**EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:**

This was a theoretical question based on explanation of three finance functions decision. Only a handful number of examinees attempted the question, but performance observed was above average.

**Question 4**

**DISCUSS the advantages and disadvantages of Wealth maximization principle.**
**(MTP 4 Marks, Mar'21, PYP 2 Marks May'22)**

**Answer 4**

Advantages and disadvantages of Wealth maximization principle.

**Advantages:**

(i) Emphasizes the long term gains
(ii) Recognizes risk or uncertainty
(iii) Recognizes the timing of returns
(iv) Considers shareholders' return.

**Disadvantages:**

(i) Offers no clear relationship between financial decisions and share price.
(ii) Can lead to management anxiety and frustration.

**Question 5**

**WRITE two main objectives of Financial Management. [MTP 2 Marks, Oct'21, PYP 2 Marks Nov '18)**

**Answer 5**

**Two main objectives of Financial Management**

**Profit Maximization**

It has traditionally been argued that the primary objective of a company is to earn profit; hence the objective of financial management is also profit maximization. This implies that the finance manager has to make his decisions in a manner so that the profits of the concern are maximized. Each alternative, therefore, is to be seen as to whether or not it gives maximum profit.

**Wealth / Value Maximization**

We will first like to define what is Wealth / Value Maximization Model. Shareholders wealth are the result of cost benefit analysis adjusted with their timing and risk i.e. time value of money.

So, Wealth = Present Value of benefits – Present Value of Costs

It is important that benefits measured by the finance manager are in terms of cash flow. Finance manager should emphasis on Cash flow for investment or financing decisions not on Accounting profit. The shareholder value maximization model holds that the primary goal of the firm is to maximize its market value and implies that business decisions should seek to increase the net present value of the economic profits of the firm.

**Question 6**

**A finance executive of an organisation plays an important role in the company's goals, policies, and financial success. WHAT his responsibilities include? (MTP 4 Marks, Sep'22)**

**Answer 6**

**A finance executive of an organisation plays an important role in the company's goals,policies, and financial success. His responsibilities include:**

(i) **Financial analysis and planning**: Determining the proper amount of funds to employ in the firm, i.e. designating the size of the firm and its rate of growth.
(ii) **Investment decisions**: The efficient allocation of funds to specific assets.
(iii) Financing and capital structure decisions: Raising funds on favourable terms as possible i.e. determining the composition of liabilities.

**(iv)** **Management of financial resources** (such as working capital).
**(v)** **Risk management**: Protecting assets.

**Question 7**

**EXPLAIN Financial Distress and explain its relationship with Insolvency. (MTP 4 Marks, Mar'18)**

**OR**

**'Financial distress is a position where Cash inflows of a firm are inadequate to meet all its current obligations.' Based on above mentioned context, EXPLAIN Financial Distress along with Insolvency. [MTP 4 Marks March 22]**

**Answer 7**

There are various factors like price of the product/ service, demand, price of inputs e.g. raw material, Labour etc., which is to be managed by an organization on a continuous basis. Proportion of debt also needs to be managed by an organization very delicately. Higher debt requires higher interest and if the cash inflow is not sufficient then it will put lot of pressure to the organization. Both short term and long term creditors will put stress to the firm. If all the above factors are not well managed by the firm, it can create situation known as distress, so financial distress is a position where Cash inflows of a firm are inadequate to meet all its current obligations.

Now if distress continues for a long period of time, firm may have to sell its asset, even many times at a lower price. Further when revenue is inadequate to revive the situation, firm will not be able to meet its obligations and become insolvent. So, insolvency basically means inability of a firm to repay various debts and is a result of continuous financial distress.

**Question 8**

**DISTINGUISH between Profit maximisation vis-a-vis wealth maximization. (MTP 5 Marks, Apr'23)**

**OR**

**'Profit maximisation is not 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.' DISCUSS four of such problems. (RTP May 22, RTP May 21)**

**OR**

**EXPLAIN "Wealth maximisation" and "Profit maximisation" objectives of financial management (Old & New SM)**

**Answer 8**

It has traditionally been argued that 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.

However, profit maximisation 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. Some of these have been discussed below:

(i) The term profit is vague. It does not clarify what exactly it means. It conveys a different meaning to different people. For example, profit may be in short term or long term period; it may be total profit or rate of profit etc.

(ii) Profit maximisation has to be attempted with a realisation of risks involved. There is a direct relationship between risk and profit. Many risky propositions yield high profit. Higher the risk, higher is the possibility of profits. If profit maximisation is the only goal, then risk factor is altogether ignored. This implies that finance manager will accept highly risky proposals also, if they give high profits. In practice, however, risk is very important consideration and has to be balanced with the profit objective.

(iii) Profit maximisation as an objective does not take into account the time pattern of returns. Proposal A may give a higher amount of profits as compared to proposal B, yet if the returns of proposal A begin to flow say 10 years later, proposal B may be preferred which may have lower overall profit but the returns flow is more early and quick.

(iv) Profit maximisation as an objective is too narrow. It fails to take into account the social considerations as also the obligations to various interests of workers, consumers, society, as well as ethical trade practices. If these factors are ignored, a company cannot survive for long. Profit maximization at the cost of social and moral obligations is a short sighted policy.

**Wealth / Value Maximisation**

We will first like to define what is Wealth / Value Maximization Model. Shareholders wealth are the result of cost benefit analysis adjusted with their timing and risk i.e. time value of money.

So, It is important that benefits measured by the finance manager are in terms of cash flow. Finance manager should emphasis on Cash flow for investment or financing decisions not on Accounting profit. The shareholder value maximization model holds that the primary goal of the firm is to maximize its market value and implies that business decisions should seek to inc rease the net present value of the economic profits of the firm. So for measuring and maximising shareholders wealth finance manager should follow:

A) Cash Flow approach not Accounting Profit
B) Cost benefit analysis
C) Application of time value of **money**.

How do we measure the value/wealth of a firm?

According to Van Horne, "Value of a firm is represented by the market price of the company's common 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 mark et price serves as a performance index or report card of the firm's progress. It indicates how well management is doing on behalf of stockholder's".

Why Wealth Maximization Works? Before we answer this question it is important to first understand and know what other goals a business enterprise may have. Some of the other goals a business enterprise may follow are:-

A) Achieving a higher growth rate
B) Attaining a larger market share
C) Gaining leadership in the market in terms of products and technology
D) Promoting employee welfare
E) Increasing customer satisfaction
F) Improving community life, supporting education and research, solving societal problems, etc.

Though, the above goals are important but the primary goal remains to be wealth maximization, as it is critical for the very existence of the business enterprise. If this goal is not met, public/institutions would lose confidence in the enterprise and will not invest further in the growth of the organization. If the growth of the organization is restricted than the other goals like community welfare will not get fulfilled.

Conflicts in Profit vs. Value maximisation principle

In any company, the management is the decision taking authority. As a normal tendency the management may pursue its own personal goals (profit maximization). But in an organization where there is a significant outside participation (shareholding, lenders etc.), the management may not be able to exclusively pursue its personal goals due to the constant supervision of the various stakeholders of the company-employees, creditors, customers, government, etc.

Every entity associated with the company will evaluate the performance of the management from the fulfilment of its own objective. The survival of the management will be threatened if the objective of any of the entities remains unfulfilled.

The wealth maximization objective is generally in accord with the interests of the various groups such as owners, employees, creditors and society, and thus, it may be consistent with the management objective of survival.

Owing to limitation (timing, social consideration etc.) in profit maximization, in today's real world situations which is uncertain and multi-period in nature, wealth maximization is a better objective. Where the time period is short and degree of uncertainty is not great, wealth maximization and profit maximization amount to essentially the same.

The table below highlights some of the advantages and disadvantages of both profit maximization and wealth maximization goals:-

| Goal | Objective | Advantages | Disadvantages |
|---|---|---|---|
| Profit Maximization | Large amount of profits | (i) Easy to calculate profits<br>(ii) Easy to determine the link between financial decisions and profits. | (i) Emphasizes the short term gains<br>(ii) Ignores risk or uncertainty<br>(iii) Ignores the timing of returns<br>(iv) Requires immediate resources. |
| Shareholders Wealth Maximisation | Highest market value of shares. | (i) Emphasizes the long term gains<br>(ii) Recognises risk or uncertainty<br>(iii) Recognises the timing of returns<br>(iv) Considers shareholders' return. | (i) Offers no clear relationship between financial decisions and share price.<br>(ii) Can lead to management anxiety and frustration. |

**Example:** Profit maximization can be achieved in the short term at the expense of the long term goal, that is, wealth maximization. For example, a costly investment may experience losses in the short term but yield substantial profits in the long term. Also, a firm that wants to show a short term profit may, for example, postpone major repairs or replacement, although such postponement is likely to hurt its long term profitability.



**Question 9**

**"The profit maximization is not an operationally feasible criterion. DISCUSS (RTP May '18, Nov '18 & May'20)**

**Answer 9**

"The profit maximization is not an operationally feasible criterion." This statement is true because Profit maximization can be a short-term objective for any organization 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:

**(a)** **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?

**(b)** **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.

**(c)** It ignores the risk factor.

**(d)** The term maximization is also vague

**Question 10**

**Functions of Finance Manager. (RTP May'19)**

**Answer 10**

**Functions of Finance Manager**

The Finance Manager's main objective is to manage funds in such a way so as to ensure their optimum utilization and their procurement in a manner that the risk, cost and control considerations are properly balanced in a given situation. To achieve these objectives the Finance Manager performs the following functions:

(i) **Estimating the requirement of Funds:** Both for long-term purposes i.e. investment in fixed assets and for short-term i.e. for working capital. Forecasting the requirements of funds involves the use of techniques of budgetary control and long-range planning.

(ii) **Decision regarding Capital Structure**: Once the requirement of funds has been estimated, a decision regarding various sources from which these funds would be raised has to be taken. A proper balance has to be made between the loan funds and own funds. He has to ensure that he raises sufficient long term funds to finance fixed assets and other long term investments and to provide for the needs of working capital.

(iii) **Investment Decision:** The investment of funds, in a project has to be made after careful assessment of various projects through capital budgeting. Assets management policies are to be laid down regarding various items of current assets. For e.g. receivable in coordination with sales manager, inventory in coordination with production manager.

(iv) **Dividend decision**: The finance manager is concerned with the decision as to how much to retain and what portion to pay as dividend depending on the company's policy. Trend of earnings, trend of share market prices, requirement of funds for future growth, cash flow situation etc., are to be considered.

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

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

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

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



**Question 11**

**DISCUSS the points that demonstrates the Importance of good financial management.**
**(RTP Nov'21, PYP 4 Marks Jan'21)**

**Answer 11**

**Points that demonstrate the "Importance of good financial management":**

- **Taking care** not to over-invest in fixed assets
- **Balancing** cash-outflow with cash-inflows
- **Ensuring** that there is a sufficient level of short-term working capital
- **Setting sales** revenue targets that will deliver growth
- **Increasing gross** profit by setting the correct pricing for products or services
- **Controlling** the level of general and administrative expenses by finding more cost-efficient ways of running the day-to-day business operations, and
- **Tax planning** that will minimize the taxes a business has to pay.

**Question 12**

**List out the steps to be followed by the manager to measure and maximize the Shareholder's Wealth?**
**(PYP 2 Marks, Jul'21)**

**Answer 12**

**For measuring and maximizing shareholders' wealth, manager should follow:**

- Cash Flow approach not Accounting Profit
- Cost benefit analysis
- Application of time value of money.

**EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:**

This theoretical question required the examinees to list out the steps to measure and maximize shareholder's wealth. Very few examinees attempted the question and below average performance was observed.

**Question 13**

**List out the role of Chief Financial Officer in today's World. (PYP 4 Marks, Nov'20)**

OR

**What are the roles of Finance Executive in Modem World? (PYP 2 Marks, May'18)**

**Answer 13**

**Role of Chief Financial Officer (CFO) in Today's World:** Today, the role of chief financial officer, or CFO, is no longer confined to accounting, financial reporting and risk management. It's about being a strategic business partner of the chief executive officer, or CEO. Some of the role of a CFO in today's world are as follows-

- Budgeting
- Forecasting
- Managing M&As
- Profitability analysis (for example, by customer or product)
- Pricing analysis
- Decisions about outsourcing
- Overseeing the IT function.
- Overseeing the HR function.
- Strategic planning (sometimes overseeing this function).
- Regulatory compliance.
- Risk management

**Question 14**

**Explain in brief the phases of the evolution of financial management. (PYP 2 Marks, Dec'21)**

**Answer 14**

**Evolution of Financial Management**: Financial management evolved gradually over the past 50 years. The evolution of financial management is divided into three phases. Financial Management evolved as a separate field of study at the beginning of the century.

The three stages of its evolution are:

**The Traditional Phase**: During this phase, financial management was considered necessary only during occasional events such as takeovers, mergers, expansion, liquidation, etc. Also, when taking financial decisions in the organization, the needs of outsiders (investment bankers, people who lend money to the business and other such people) to the business was kept in mind.

The Transitional Phase: During this phase, the day-to-day problems that financial managers faced were given importance. The general problems related to funds analysis, planning and control were given more attention in this phase.

**The Modern Phase**: Modern phase is still going on. The scope of financial management has greatly increased now. It is important to carry out financial analysis for a company. This analysis helps in decision making. During this phase, many theories have been developed regarding efficient markets, capital budgeting, option pricing, valuation models and also in several other important fields in financial management. Here, financial management is viewed as a supportive and facilitative function, not only for top management but for all levels of management.

**Question 15**

**EXPLAIN the limitations of profit maximization objective of Financial Management. (Chapter – Scope and Objectives of Financial Management) (MTP 4 Marks, Mar'24)**

**Answer 15**

Limitations of Profit Maximisation objective of financial management.

(i) **The term profit is vague. It does not clarify what exactly it means.** It conveys a different meaning to different people. For example, profit may be in short term or long term period; it may be total profit or rate of profit etc.

(ii) **Profit maximisation has to be attempted with a realisation of risks involved.** There is a direct relationship between risk and profit. Many risky propositions yield high profit. Higher the risk, higher is the possibility of profits. If profit maximisation is the only goal, then risk factor is altogether ignored. This implies that finance manager will accept highly risky proposals also, if they give high profits. In practice, however, risk is very important consideration and has to be balanced with the profit objective.

**(iii) Profit maximisation as an objective does not take into account the time pattern of returns.** Proposal A may give a higher amount of profits as compared to proposal B, yet if the returns of proposal A begin to flow say 10 years later, proposal B may be preferred which may have lower overall profit but the returns flow is more early and quick.

**(iv) Profit maximisation as an objective is too narrow.** It fails to take into account the social considerations as also the obligations to various interests of workers, consumers, society, as well as ethical trade practices. If these factors are ignored, a company cannot survive for long. Profit maximization at the cost of social and moral obligations is a short sighted policy.

**Question 16**

**What are disadvantages of Profit Maximization? (PYP 2 Marks, Nov'23)**

**Answer 16**

Disadvantages of Profit Maximisation objective of financial management.

(i) Emphasizes the short-term gains

(ii) Ignores risk or uncertainty

(iii) Ignores the timing of returns

(iv) Requires immediate resources.

# Chapter 2
# Types of Financing

**Question 1**

**EXPLAIN the importance of trade credit and accruals as source of short-term finance. DISCUSS the cost of these sources?. (MTP 4 Marks, Aug’18) (RTP May’24)**

**Answer 1**

Trade credit and accruals as source of short-term finance like 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. Micro small and medium enterprises (MSMEs) 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.

**Question 2**

**DESCRIBE Bridge Finance. (MTP 4 Marks, Apr’19)**

**OR**

**Briefly DESCRIBE bridge finance. (MTP 2 Marks, Nov’21, RTP May ’18)**

**Answer 2**

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



**Question 3**

**EXPLAIN the limitations of Leasing? (MTP 4 Marks, Apr’19, PYP 2 Marks, May ’19)**

**Answer 3**

**Limitations are:**

1) The lease rentals become payable soon after the acquisition of assets and no moratorium period is permissible as in case of term loans from financial institutions. The lease arrangement may, therefore, not be suitable for setting up of the new projects as it would entail cash outflows even before the project comes into operation.
2) The leased assets are purchased by the lessor who is the owner of equipment. The seller’s warranties for satisfactory operation of the leased assets may sometimes not be available to lessee.
3) Lessor generally obtains credit facilities from banks etc. to purchase the leased equipment which are subject to hypothecation charge in favor of the bank. Default in payment by the lessor may sometimes result in seizure of assets by banks causing loss to the lessee.
4) Lease financing has a very high cost of interest as compared to interest charged on term loans by financial institutions/banks.

Despite all these disadvantages, the flexibility and simplicity offered by lease finance is bound to make it popular. Lease operations will find increasing use in the near future.

**Question 4**

**What is debt securitization? EXPLAIN the basics of debt securitization process.**
**(MTP 4 Marks, Oct’19 & March ’23, RTP May ’19, RTP May ’20, PYP 4 Marks, May ’19, RTP May’23)**

**Answer 4**

**Debt Securitization:** 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 Securitization**

(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 favor 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 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. Investors are – pension funds, mutual funds, insurance funds.

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

**Question 5**

**EXPLAIN in short the term Letter of Credit. (MTP 4 Marks, May'20 & Sep '23)**

**Answer 5**

**Letter of Credit**: It is an arrangement by which the issuing bank on the instructions of a customer or on its own behalf undertakes to pay or accept or negotiate or authorizes another bank to do so against stipulated documents subject to compliance with specified terms and conditions.



**Question 6**

**DISCUSS in brief the characteristics of Debentures. (MTP 4 Marks, Mar'21)**

**Answer 6**

**Characteristics of Debentures are as follows:**

- Normally, debentures are issued on the basis of a debenture trust deed which lists the terms and conditions on which the debentures are floated.
- Debentures are either secured or unsecured.
- May or may not be listed on the stock exchange.
- The cost of capital raised through debentures is quite low since the interest payable on debentures can be charged as an expense before tax.
- From the investors' point of view, debentures offer a more attractive prospect than the preference shares since interest on debentures is payable whether or not the company makes profits.
- Debentures are thus instruments for raising long-term debt capital.
- The period of maturity normally varies from 3 to 10 years and may also increase for projects having high gestation period.

**Question 7**

**DEFINE Secured Premium Notes. (MTP 2 Marks, Mar'21 & Mar'23, Old & New SM)**

**Answer 7**

**Secured Premium Notes:** Secured Premium Notes is issued along with a detachable warrant and is redeemable after a notified period of say 4 to 7 years. The conversion of detachable warrant into equity shares will have to be done within time period notified by the company.

**Question 8**

**DEFINE Masala bond. (MTP 2 Marks, Mar'21, PYP 2 Marks May '18)**

**Answer 8**

**Masala bond**: Masala (means spice) bond is an Indian name used for Rupee denominated bond that Indian corporate borrowers can sell to investors in overseas markets. These bonds are issued outside India but denominated in Indian Rupees. NTPC raised Rest. 2,000 crores via masala bonds for its capital expenditure in the year 2016.

**Question 9**

**DEFINE Debt Securitization. (MTP 2 Marks, Apr'21)**

**Answer 9**

Debt Securitization is a process in which illiquid assets are pooled into marketable securities that can be sold to investors. The process leads to the creation of financial instruments that represent ownership interest in, or are secured by a segregated income producing asset or pool of assets. These assets are generally secured by personal or real property such as automobiles, real estate, or equipment loans but in some cases are unsecured.

**Question 10**

**BRIEF out any four types of Preference shares along with its feature. (MTP 4 Marks, Nov'21)**

**Answer 10**

| Sl. No. | Type of Preference Shares | Salient Features |
|---|---|---|
| 1 | Cumulative | Arrear Dividend will accumulate. |
| 2 | Non-cumulative | No right to arrear dividend. |
| 3 | Redeemable | Redemption should be done. |
| 4 | Participating | Can participate in the surplus which remains after payment to equity shareholders. |
| 5 | Non- Participating | Cannot participate in the surplus after payment of fixed rate of Dividend. |
| 6 | Convertible | Option of converting into equity Shares. |

**Question 11**

**EXPLAIN any four types of Packing Credit. (MTP 4 Marks, Nov'21, Mar'22, & Oct '23 Old & New SM)**

**Answer 11**

(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 weighed 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 pledge able interest and the goods are hypothecated to the bank as security with stipulated margin. At the time of utilizing the advance, the exporter is required to submit, along with the firm export order or letter of credit relative stock statements and thereafter continue submitting them every fortnight and/or 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.

(iv) **E.C.G.C. guarantee:** Any loan given to an exporter for the manufacture, processing, purchasing, or packing of goods meant for export against a firm order qualifies for the packing credit guarantee issued by Export Credit Guarantee Corporation.

(v) **Forward exchange contract**: Another requirement of packing credit facility is that if the export bill is to be drawn in a foreign currency, the exporter should enter into a forward exchange contact with the bank, thereby avoiding risk involved in a possible change in the rate of exchange.

**Question 12**

**EXPLAIN: Callable bonds and Puttable bonds. (MTP 2 Marks, Nov '21 & March '22, PYP 2 Marks Jan'21)**

**Answer 12**

(i) **Callable bonds:** A callable bond has a call option which gives the issuer the right to redeem the bond before maturity at a predetermined price known as the call price (Generally at a premium).

(ii) **Puttable bonds:** Puttable bonds give the investor a put option (i.e. the right to sell the bond) back to the company before maturity.

**Question 13**

**STATE in brief four features of Samurai Bond. (MTP 2 Marks Mar'22, RTP Nov'22)**

**Answer 13**

**Features of Samurai Bond:**

- Samurai bonds are denominated in Japanese Yen JPY
- Issued in Tokyo
- Issuer Non- Japanese Company
- Regulations: Japanese
- Purpose: Access of capital available in Japanese market
- Issue proceeds can be used to fund Japanese operation
- Issue proceeds can be used to fund a company's local opportunities.
- It can also be used to hedge foreign exchange risk



**Question 14**

**DISCUSS in briefly any two long term sources of finance for a partnership firm. (MTP 4 Marks, Apr'22)**

**Answer 14**

**The two sources of long-term finance for a partnership firm are as follows:**

**Loans from Commercial Banks**: Commercial banks provide long term loans for the purpose of expansion or setting up of new units. Their repayment is usually scheduled over a long period of time. The liquidity of such loans is said to depend on the anticipated income of the borrowers.

As part of the long term funding for a partnership firm, the banks also fund the long term working capital requirement (it is also called WCTL i.e. working capital term loan).

**Lease financing**: Leasing is a general contract between the owner and user of the asset over a specified period of time. The asset is purchased initially by the lessor (leasing company) and thereafter leased to the user (lessee firm) which pays a specified rent at periodical intervals. Thus, leasing is an alternative to the purchase of an asset out of own or borrowed funds. Moreover, lease finance can be arranged much faster as compared to term loans from financial institutions.

**Question 15**

**WHAT is the meaning of Venture Capital Financing. STATE some characteristics of it. (MTP 4 Marks, Sep'22)**

**Answer 15**

**Venture Capital Financing**: The venture capital financing refers to financing of new high risky venture promoted by qualified entrepreneurs who lack experience and funds to give shape to their ideas. In broad sense, under venture capital financing, venture capitalist make investment to purchase equity or debt securities from inexperienced entrepreneurs who undertake highly risky ventures with potential to succeed in future.

**Some of the characteristics of Venture Capital financing are:**

- It is basically an equity finance in new companies.
- It can be viewed as a long-term investment in growth-oriented small/medium firms.
- Apart from providing funds, the investor also provides support in form of sales strategy, business networking and management expertise, enabling the growth of the entrepreneur.

**Question 16**

**BRIEF OUT certain sources of finance- Inter Corporate Deposits and Certificate of Deposit. (MTP 2 Marks, Sep'22)**

**Answer 16**

**Inter Corporate Deposits:** The companies can borrow funds for a short period, say 6 months, from other companies which have surplus liquidity. The rate of interest on inter corporate deposits varies depending upon the amount involved and the time period.

**Certificate of Deposit (CD):** 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 s uch 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

**Question 17**

**STATE in brief four features of Plain Vanilla Bond. (MTP 2 Marks, Sep'22)**

**Answer 17**

**Features of Plain Vanilla Bond:**

- The issuer would pay the principal amount along with the interest rate.
- This type of bond would not have any options.
- This bond can be issued in the form of discounted bond or can be issued in the form of coupon bearing bond.



**Question 18**

**Write a short note on seed capital assistance. (MTP 2 Marks, Oct'22)**

**Answer 18**

**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 ₹ 2 crores and the maximum assistance under the project will be restricted to 50% of the required promoter's contribution or ₹ 15 lacs whichever is lower.
The seed capital assistance is interest free but carries a security charge of one percent per annum for the first five years and an increasing rate thereafter

**Question 19**

**EXPLAIN in brief the features of Commercial Papers.**
**(MTP 4 Marks, Oct'22, Oct'20, Apr'21, & Oct '23 Old & New SM)**

**Answer 19**

**Commercial Paper**: A Commercial Paper is an unsecured money market instrument issued in the form of a promissory note. The Reserve Bank of India introduced the commercial paper scheme in the year 1989 with a view to enabling highly rated corporate borrowers to diversify their sources of short- term borrowings and to provide an additional instrument to investors. Subsequently, in addition to the Corporate, Primary Dealers and All India Financial Institutions have also been allowed to issue Commercial Papers. Commercial papers are issued in denominations of ₹ 5 lakhs or multiples thereof and the interest rate is generally linked to the yield on the one-year government bond.

All eligible issuers are required to get the credit rating from Credit Rating Information Services of India Ltd, (CRISIL), or the Investment Information and Credit Rating Agency of India Ltd (ICRA) or the Credit Analysis and Research Ltd (CARE) or the FITCH Ratings India Pvt. Ltd or any such other credit rating agency as is specified by the Reserve Bank of India.

**Question 20**

**BRIEFLY describe the financial needs of a business. (MTP 2 Marks, Oct'21)**

**Answer 20**

**Financial Needs of a Business**: Business enterprises need funds to meet their different types of requirements. All the financial needs of a business may be grouped into the following three categories-

**Long-term financial needs:** Such needs generally refer to those requirements of funds which are for a period exceeding 5-10 years. All investments in plant, machinery, land, buildings, etc., are considered as long-term financial needs.

**Medium**- term financial needs: Such requirements refer to those funds which are required for a period exceeding one year but not exceeding 5 years.

**Short- term financial needs**: Such type of financial needs arises to finance current assets such as stock, debtors, cash, etc. Investment in these assets is known as meeting of working capital requirements of the concern for a period not exceeding one year.

**Question 21**

**EXPLAIN the difference between Financial Lease and Operating Lease. (RTP Nov '18 & Nov '20)**

**OR**

**Under financial lease, lessee bears the risk of obsolescence; while under operating lease, lessor bears the risk of obsolescence. In view of this, you are required to COMPARE the financial lease and operating lease. (RTP Nov'22)**

**Answer 21**

**Difference between Financial Lease and Operating Lease**

| | Financial Lease | Operating Lease |
|---|---|---|
| 1. | The risk and reward incident to ownership are passed on to 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 belong wholly to the lessor. |
| 2. | The lessee bears the risk of obsolescence. | The lessor bears the risk of obsolescence. |
| 3. | The lessor is interested in his rentals and not in the asset. He must get his principal back along with interest. Therefore, the lease is non- cancellable by either party. | As the lessor does not have difficulty in leasing the same asset to other willing lessor, the lease is kept cancelable by the lessor. |
| 4. | The lessor enters into the transaction only as financier. He does not bear the cost of repairs, maintenance or operations. | Usually, the lessor bears cost of repairs, maintenance or operations. |
| 5. | The lease is usually full payout, that is, the single lease repays the cost of the asset together with the interest. | The lease is usually non-payout, since the lessor expects to lease the same asset over and over again to several users. |

**Question 22**

**DISCUSS the advantages and disadvantages of raising funds by issue of preference shares. (RTP May'21)**

**Answer 22**

**Advantages and disadvantages of raising funds by issue of preference shares Advantages**

(i) No dilution in EPS on enlarged capital base – On the other hand if equity shares are issued it reduces EPS, thus affecting the market perception about the company.

(ii) There is also the advantage of leverage as it bears a fixed charge (because companies are required to pay a fixed rate of dividend in case of issue of preference shares). Non-payment of preference dividends does not force a company into liquidity.

(iii) There is no risk of takeover as the preference shareholders do not have voting rights except where dividend payment are in arrears.

(iv) The preference dividends are fixed and pre-decided. Hence preference shareholders cannot participate in surplus profits as the ordinary shareholders can except in case of participating preference shareholders.

(v) Preference capital can be redeemed after a specified period.

**Disadvantages**

(i) One of the major disadvantages of preference shares is that preference dividend is not tax deductible and so does not provide a tax shield to the company. Hence, preference shares are costlier to the company than debt e.g. debenture.

(ii) Preference dividends are cumulative in nature. This means that if in a particular year preference dividends are not paid they shall be accumulated and paid later. Also, if these dividends are not paid, no dividend can be paid to ordinary shareholders. The non-payment of dividend to ordinary shareholders could seriously impair the reputation of the concerned company.

**Question 23**

**EXPLAIN some common methods of Venture capital financing.**
**(RTP Nov'21, PYP 4 Marks, Nov'20, MTP 4 Marks Mar'24**)

**Answer 23**

Some common methods of venture capital financing are as follows:

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

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

**(iii) Income note**: It is a hybrid security which combines the features of both conventional loan and conditional loan. The entrepreneur has to pay both interest and royalty on sales but at substantially low rates. IDBI's VCF provides funding equal to 80 – 87.50% of the projects cost for commercial application of indigenous technology.

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

**Question 24**

**HIGHLIGHT the similarities and differences between Samurai Bond and Bull Dog Bond. (RTP May'23)**

**Answer 24**

| | |
|---|---|
| Samurai Bond | • Samurai bonds are denominated in Japanese Yen JPY<br>• Issued in Tokyo<br>• Issuer Non- Japanese Company<br>• Regulations: Japanese<br>• Purpose: Access of capital available in Japanese market<br>• Issue proceeds can be used to fund Japanese operation |

| | |
|---|---|
| | • Issue proceeds can be used to fund a company's local opportunities.<br>• It can also be used to hedge foreign exchange risk |
| Bulldog Bond | • It is denominated in Bulldog Pound Sterling/Great Britain Pound (GBP) |
| | Issued in London<br>Issuer Non- UK Company<br>Regulations: Great Britain<br>Purpose: Access of capital available in UK market<br>Issue proceeds can be used to fund UK operation<br>Issue proceeds can be used to fund a company's local opportunities |

**Question 25**

**DESCRIBE the inter relationship between investing, financing, and dividend decisions. (RTP 4 Marks, Nov'23, MTP Apr'24)**

**Answer 25**

**Inter-relationship between Investment, Financing and Dividend Decisions**

The finance functions are divided into three major decisions, viz., investment, financing, and dividend decisions. It is correct to say that these decisions are inter - related because the underlying objective of these three decisions is the same, i.e., maximisation of shareholders' wealth. Since investment, financing and dividend decisions are all interrelated, one must consider the joint impact of these decisions on the market price of the company's shares and these decisions should also be solved jointly. The decision to invest in a new project needs the finance for the investment. The financing decision, in turn, is influenced by and influences dividend decision because retained earnings used in internal financing deprive shareholders of their dividends. An efficient financial management can ensure optimal joint decisions. This is possible by evaluating each decision in relation to its effect on the shareholders' wealth.

The above three decisions are briefly examined below in the light of their inter - relationship and to see how they can help in maximising the shareholders' wealth i.e., market price of the company's shares.

**Investment decision:** The investment of long-term funds is made after a careful assessment of the various projects through capital budgeting 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 has an influence on the profitability of the company and ultimately on its wealth.

**Financing decision**: Funds can be raised from various sources. Each source of funds involves different issues. The finance manager must maintain a proper balance between long-term and short-term funds. With the total volume of long-term funds, he must ensure a proper mix of loan funds and owner's funds. The optimum f inancing mix will increase return to equity shareholders and thus maximise their wealth.

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

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

**Question 26**

**STATE the meaning of debt securitization (RTP Nov'23)**

**Answer 26**

**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. 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 based on 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. Investors are – pension funds, mutual funds, insurance funds.

**Question 27**

**Explain in brief the forms of Post Shipment Finance. (PYP 4 Marks, Jul'21)**

**Answer 27**

**Post-shipment Finance: It takes the following forms:**

a. **Purchase/discounting of documentary export bills:** Finance is provided to exporters by purchasing export bills drawn payable at sight or by discounting since export bills covering confirmed sales and backed by documents including documents of the title of goods such as bill of lading, post parcel receipts, or air consignment notes.
b. **E.C.G.C. Guarantee**: Post-shipment finance, given to an exporter by a bank through purchase, negotiation or discount of an export bill against an order, qualifies for post- shipment export credit guarantee. It is necessary, however, that exporters should obtain a shipment or contracts risk policy of E.C.G.C. Banks insist on the exporters to take a contracts shipment (comprehensive risks) policy covering both political and commercial risks. The Corporation, on acceptance of the policy, will fix credit limits for individual exporters and the Corporation's liability will be limited to the extent of the limit so fixed for the exporter concerned irrespective of the amount of the policy.
c. **Advance against export bills sent for collection**: Finance is provided by banks to exporters by way of advance against export bills forwarded through them for collection, taking into account the creditworthiness of the party, nature of goods exported, since, standing of drawee, etc.
d. **Advance against duty draw backs, cash subsidy, etc**.: To finance export losses sustained by exporters, bank advance against duty draw-back, cash subsidy, etc., receivable by them against export performance. Such advances are of clean nature; hence necessary precaution should be exercised.

**Question 28**

**Briefly describe any four sources of short-term finance. (PYP 4 Marks, Nov'19)**

**OR**

**What are the sources of short term financial requirement of the company? (PYP 4 Marks, May'18)**

**Answer 28**

**Sources of Short Term Finance:** There are various sources available to meet short- term needs of finance. The different sources are discussed below-

**(i)** **Trade Credit**: It represents credit granted by suppliers of goods, etc., as an incident of sale. The usual duration of such credit is 15 to 90 days. It generates automatically in the course of business and is common to almost all business operations. It can be in the form of an 'open account' or 'bills payable'.

**(ii)** **Accrued Expenses and Deferred Income**: Accrued expenses represent liabilities which a company has to pay for the services which it has already received like wages, taxes, interest and dividends. Such expenses arise out of the day-to-day activities of the company and hence represent a spontaneous source of finance.

**Deferred Income:** These are the amounts received by a company in lieu of goods and services to be provided in the future. Since these receipts increases a company's liquidity, they are also considered to be an important sources of short- term finance.

**(iii)** **Advances from Customers**: Manufacturers and contractors engaged in producing or constructing costly goods involving considerable length of manufacturing or construction time usually demand advance money from their customers at the time of accepting their orders for executing their contracts or supplying the goods. This is a cost free source of finance and really useful.

**(iv) Commercial Paper**: A Commercial Paper is an unsecured money market instrument issued in the form of a promissory note. The Reserve Bank of India introduced the commercial paper scheme in the year 1989 with a view to enabling highly rated corporate borrowers to diversify their sources of short-term borrowings and to provide an additional instrument to investors.

**(v) Treasury Bills:** Treasury bills are a class of Central Government Securities. Treasury bills, commonly referred to as T-Bills are issued by Government of India to meet short term borrowing requirements with maturities ranging between 14 to 364 days.

**(vi) Certificates of Deposit (CD):** A certificate of deposit (CD) is basically a savings certificate with a fixed maturity date of not less than 15 days up to a maximum of one year.

**(vii) Bank Advances**: Banks receive deposits from public for different periods at varying rates of interest. These funds are invested and lent in such a manner that when required, they may be called back. Lending results in gross revenues out of which costs, such as interest on deposits, administrative costs, etc., are met and a reasonable profit is made. A bank's lending policy is not merely profit motivated but has to also keep in mind the socio- economic development of the country. Some of the facilities provided by banks are Short Term Loans, Overdraft, Cash Credits, Advances against goods, Bills Purchased/Discounted.

**(viii) Financing of Export Trade by Banks**: Exports play an important role in accelerating the economic growth of developing countries like India. Of the several factors influencing export growth, credit is a very important factor which enables exporters in efficiently executing their export orders. The commercial banks provide short-term export finance mainly by way of pre and post-shipment credit. Export finance is granted in Rupees as well as in foreign currency.

**(ix) Inter Corporate Deposits**: The companies can borrow funds for a short period say 6 months from other companies which have surplus liquidity. The rate of interest on inter corporate deposits varies depending upon the amount involved and time period.

**(x) Certificate of Deposit (CD):** 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 encase the deposit before maturity period and the investor is assured of liquidity because he can sell the CD in secondary market.

**(xi) Public Deposits:** Public deposits are very important source of short-term and medium term finances particularly due to credit squeeze by the Reserve Bank of India. A company can accept public deposits subject to the stipulations of Reserve Bank of India from time to time maximum up to 35 per cent of its paid up capital and reserves, from the public and shareholders. These deposits may be accepted for a period of six months to three years. Public deposits are unsecured loans; they should not be used for acquiring fixed assets since they are to be repaid within a period of 3 years. These are mainly used to finance working capital requirements.

**Question 29**

**Write short notes on Bridge Finance and Clean Packing Credit. (PYP 4 Marks, Dec'21)**

**Answer 29**

**Bridge Finance**: Bridge finance 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. Though it is of short-term nature but since it is an important step in the facilitation of long-term loan, therefore it is being discussed along with the long term sources of funds. Normally, it takes time for financial institutions to disburse loans to companies. However, once the loans are approved by the term lending institutions, companies, in order not to lose further time in starting their projects, arrange short term loans from commercial banks. The bridge loans are repaid/ adjusted out of the term loans as and when disbursed by the concerned institutions. Bridge loans are normally secured by hypothecating movable assets, personal guarantees and demand promissory notes. Generally, the rate of interest on bridge finance is higher as compared with that on term loans.

**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 weighed 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.

**Question 30**

**Distinguish between American Depository Receipts and Global Depository Receipts.**
**(PYP 2 Marks, May'22)**

**Answer 30**

**Distinguish Between American Depository Receipts and Global Depository Receipts:**

| | American Depository Receipts | Global Depository Receipts |
|---|---|---|
| **Meaning** | It is a negotiable instrument which is issued by US bank, which represent the nazon-US Company stock that is being traded in US stock Exchange | It is a negotiable instrument which is issued by the international depository bank that represent the foreign company's stock trading world-wide. |
| **Issued where** | In the US domestic capital market. | European capital market. |
| **Listed in** | In the American Stock Exchange | In the Non-US Stock Exchange |
| **Relevance** | Foreign companies are able to trade in the US Stock Market. | Foreign companies can trade in any country's stock market other than that of the US. |

**Alternatively:**

**American Depository Receipts (ADRs):** These are securities offered by non-US companies who want to list on any of the US exchange. Each ADR represents a certain number of a company's regular shares. ADRs allow US investors to buy shares of these companies without the costs of investing directly in a foreign stock exchange.

**Global Depository Receipts (GDRs):** These 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.

**Question 31**

**These bonds are issued by non-US Banks and non-US corporations in US. What this bond is called and what are the other features of this Bond? (PYP 4 Marks, Nov'22)**

**Answer 31**

The Bond is called as Yankee Bond.

Features of the bond:

- These bonds are denominated in Dollars
- Bonds are to be registered in SEC (Securities and Exchange Commission)
- Bonds are issued in tranches
- Time taken can be up to 14 weeks

**Question 32**

**List out the conditions, framed by SEBI, which a company needs to fulfil in order to issue of bonus shares. (PYP 4 Marks, May'23)**

**Answer 32**

To issue Bonus shares, a Company needs to fulfill all the conditions given by Securities Exchange Board of India (SEBI):

(i) As per SEBI, the bonus shares are issued not in lieu of cash dividends.

(ii) A bonus issue should be authorized by Article of Association (AOA) and not to be declared unless all partly paid-up shares have been converted into fully paid-up shares.
(iii) The Company should not have defaulted on re-payment of loan, interest, and any statutory dues.
(iv) Bonus shares are to be issued only from share premium and free reserves and not from capital reserve on account of fixed assets revaluation.

**Question 33**

**Discuss features of Secured Premium Notes. (PYP 2 Marks, May'23)**

**Answer 33**

**Features of Secured Premium Notes:**

- SPN instruments are issued with a detachable warrant.
- These instruments are redeemable after a notified period of say 4 to 7 years.
- No interest is paid during the lock in period.
- The conversion of detachable warrant into equity shares will have to be done within time period notified by the company.

**Question 34**

**NAME the various financial instruments dealt with in the International market. (MTP 2 Marks, Apr'24)**

**Answer 34**

**Financial Instruments in the International Market**

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

(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.

**Question 35**

**EXPLAIN the concept of Indian depository receipts. (MTP 2 Marks, Apr'24)**

**Answer 35**

**Concept of Indian Depository Receipts:** 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.

**Question 36**

**Write the main features of Bulldog Bond. (PYP 4 Marks, Nov'23)**

**Answer 36**

**Features of Bulldog Bond**

- It is denominated in Bulldog Pound Sterling/Great Britain Pound (GBP)
- Issued in London
- Issuer non-UK Company
- Regulations: Great Britain
- Purpose: Access of capital available in UK market
- Issue proceeds can be used to fund UK operation
- Issue proceeds can be used to fund a company's local opportunities

**Question 37**

**What do you understand by Spontaneous Sources of finance and explain its sources of finance? (PYP 4 Marks, Nov'23)**

**Answer 37**

Spontaneous sources of finance are those which naturally arise in the course of business operations. Trade credit, credit from employees, credit from suppliers of services, etc. are some of the examples which may be quoted in this respect.

**Spontaneous Sources of Finance**

(i) **Trade Credit:** Trade credit is a spontaneous source of finance which is normally extended to the purchaser organization by the sellers or services providers. It contributes to about one-third of the total short-term requirements.

(ii) **Bills Payable:** In the case of "Bills Payable" the purchaser will have to give a written promise to pay the amount of the bill/invoice either on demand or at a fixed future date to the seller or the bearer of the note.

(iii) **Accrued Expenses:** The accrued expenses refer to the services availed by the firm, but the payment for which has yet to be made. It is a built in and an automatic source of finance as most of the services like wages, salaries, taxes, duties etc., are paid at the end of the period.

**Question 38**

**What is the maximum period for which company can accept Public Deposits?**

(a) 1 year
(b) 6 months
(c) 3 years
(d) 5 years **(MTP 1 Mark, Mar'24)**

**Answer 38: (c)**

These deposits may be accepted for a period of six months to three years.